CANADIAN EQUITY DERIVATIVES

Quarterly Newsletter - January 2016

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TMX | Montréal Exchange

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2016 Trading Calendar

JANUARY

S	M	T	W	T	F	S
					1	2
3	4	5	6	7	8	9
10	11	12	13	14	15	16
17	18	19	20	21	22	23
24	25	26	27	28	29	30
31						

FEBRUARY

S	M	T	W	T	F	S
	1	2	3	4	5	6
7	8	9	10	11	12	13
14	15	16	17	18	19	20
21	22	23	24	25	26	27
28	29					

MARCH

S	M	T	W	T	F	S
		1	2	3	4	5
6	7	8	9	10	11	12
13	14	15	16	17	18	19
20	21	22	23	24	25	26
27	28	29	30	31		

- --- Listing
- ····· Last trading day
- —— Expiration
- ● Equity & ETFs options
- ■ Weekly options
- ● S&P/TSX 60 Index Options (SXO)
- ● Options on the US Dollar (USX)

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ARE NEGATIVE INTEREST RATES COMING IN CANADA?

By Patrick Ceresna

It was back in early December when Stephen Poloz spoke at the Empire Club in Toronto and planted the seed that the Bank of Canada could follow the lead of other countries and set benchmark interest rates below zero. In the weeks after the speech, the Canadian dollar plunged from around $0.74 to a low of $0.68. This was at a time where there was little correlation to the U.S. Dollar Index (U.S. vs. a basket of international currencies) and almost no considerable movement in the Euro or the Yen. It is pretty safe to assume that the Canadian dollar did not weaken because of a broad base rise in the U.S. Dollar, but rather deterioration in the fundamental outlook on Canada.

What we need to consider is whether this was just Stephen Poloz jawboning the currency lower (Mario Draghi style), or is he seriously advertising to the Canadian financial community to begin preparing for the harsh reality that a European style NIRP could be around the corner if the economic situation deteriorates further?

It is my opinion that he needed to both jawbone the market while preparing the market for a harsh reality.

Mission accomplished! Through shock and awe, Poloz drove a decline in the currency that was more economically impactful than any 25 basis point drop in interest rates could have been. The decline was so pronounced that Poloz did not have to move on interest rates and waste a proverbial bullet from his arsenal. In fact, arguably if he did move on rates during the January meeting driving further deterioration in the dollar, he would risk turning the decline into an outright rout.

Likely outcome:

The Canadian dollar is oversold and unloved. There is plenty of room for the price to stabilize at these current levels. When looking at the behaviour of global currencies after such a pronounced move, they tend to fall into a 6+-month trade range that consolidates the price.

Can the Canadian dollar go lower?

Yes, but my suspicion is that lower levels like $0.60-$0.65 would be reserved for a later time if Canada was to begin experiencing a deeper and more pronounced recession.

The Canadian Bear Market Roars!

I find a sense of irony that investors need to be losing 20% or more on their equity investments before the economic experts feel they can officially conclude that it is a bear market. It makes it almost meaningless to react to the news as often the worst part of the portfolio damage has already occurred. Nonetheless, we find ourselves in a situation that is a double whammy for Canadian investors, as they are being pummeled by the currency and the stock market simultaneously. This makes the situation here financially far worse than places like Japan where their 2013-14 currency plight was accompanied by an equity rally, lessening the economic impact.

The brutal reality is that over the last 18 months, any Canadian investor invested in Canadian Dollars owning a Canadian equity fund is down over 20% on their investment and down a further 30% in the decline in the purchasing value of the currency. A hard pill to swallow!

Bear Market Options for Advisors

The most common response advisors give to clients is the typical cliché of “don’t panic”, focus on the “long-term plan”. While I don’t mean to be condescending, I have to ask how does that in any way instill confidence when an advisor takes no action to remove their clients from harm’s way or to have even taken actions to lessen the blow?

While I fully understand that based on portfolio management theory, a diversified portfolio should be able to weather the storm, the increasing problem is that asset classes that in normal conditions behave uncorrelated suddenly correlate when volatility and fear are introduced to the market.

This is where I feel there is value in applying a few basic strategies to reduce volatility and increase yield.

The Hedge Wrap

If you are an advisor faced with KYC obstacles when changing a client’s asset mix, a hedge wrap could be implemented on part of the equity in the portfolio to reduce the overall volatility and to synthetically change the exposure. Obviously, this is not an ideal scenario with the market at 52 week lows, but if there was a considerable rebound in the market, it could be a strategic option.

In this scenario, our advisor has a client invested 70% into equity 30% bonds and 0% cash. In that asset mix, they hold 20% in Canadian equity, 10% of which is in the iShares S&P/TSX 60 Index ETF (XIU). Without having to sell any of the equity exposure, the advisor can buy a protective put option on the XIU while utilizing a covered call above to generate a cash flow to reduce the cost of the protection. This essentially collars the downside risk and upside potential and synthetically reducing the equity risk down to 60% from the original 70%. During this time, the investor continues to collect the dividends and has no immediate tax considerations as there is no taxable disposition of any shares.

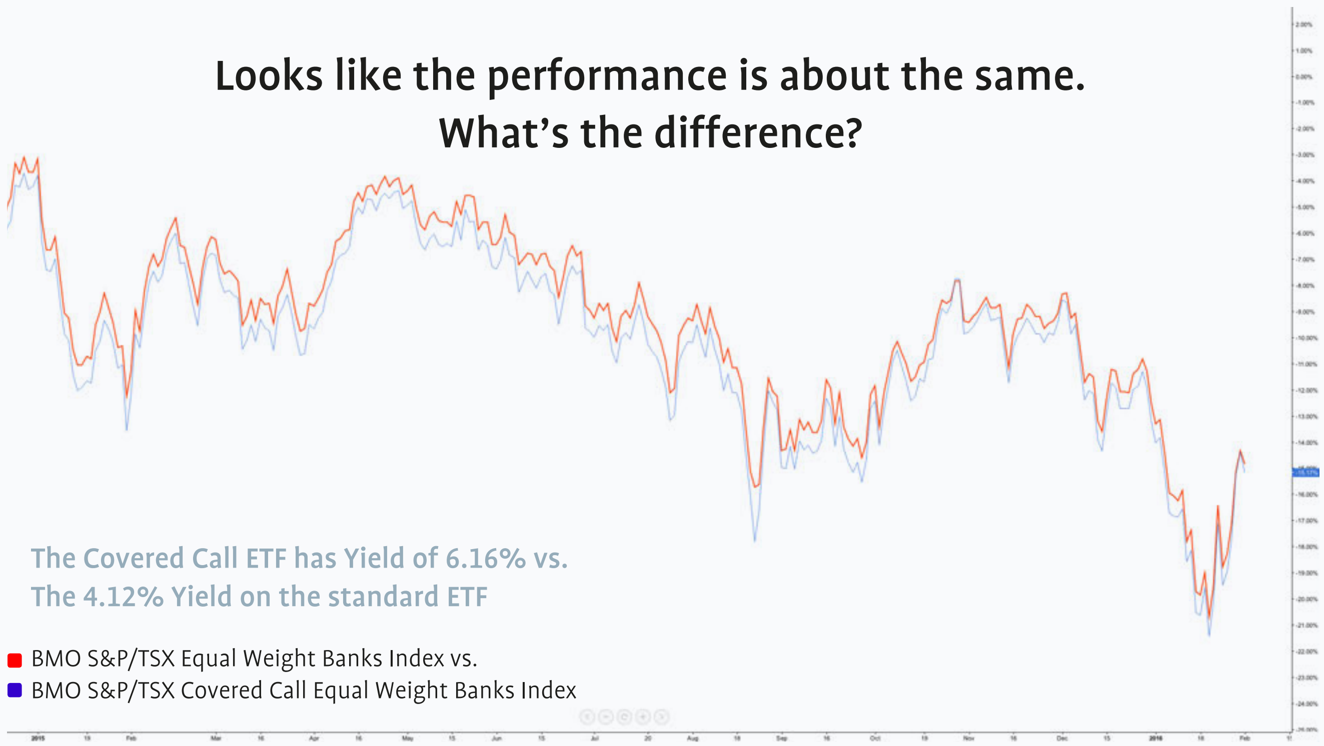
How to exit? If the advisor has no intention to liquidate the position, the collar would have to be closed before expiration if one of the strikes is “in-the-money”.

Covered Calls as an Asset Class

Another proactive way an advisor can attempt to create alpha is to incorporate covered call writing within the asset mix. Let’s consider the following portfolio.

> 60% Equity
> 20% Equity Covered Calls
> 20% Bonds
> 0% Cash

In study after study, it has been proven that covered call writing reduces the portfolios volatility while creating more consistency as the client does not need the markets to rise to make returns. More proactive advisors can manage their own covered call portfolios, but for an average advisor, it is often sufficient to buy their clients a few ETFs with a covered call focus.



As an example, on the chart above, you can see the performance of the BMO S&P/TSX Equal Weight Banks ETF (ZEB) vs. the Covered Call Canadian Banks ETF (ZWB). You can identify that the performance of the two ETFs is very similar. So what's the difference? The covered call writing ETF has a yield of over 2% more than the standard one. So even if the ETF was unchanged by year's end, the ETF would have yielded an equity style return for the investor. That is a no brainer to me..

Enhanced Income on Enbridge (ENB)

In spite of the devastating rout on energy stocks in Canada, Enbridge remains one of Canada's premier oil & gas pipeline companies. As the energy industry goes through a major fundamental shift to adapt to the decade low-energy prices, Enbridge has to also redefine its business model to adapt to the changing conditions.

The question that investors are asking today is "Was the 2015 decline from $66.00 a share to lows near $40.00 sufficient to now say that the current bad news has been fully baked into the cake?" Traders certainly are looking to test that theory as they swung the stock from its $40.03 low to $47.42 in just two full trading days. Have we seen a double bottom? Will the stock recover back into the $50's?

It very well can.

One can consider buying shares of Enbridge (trading at $47.42 on January 22). Enbridge has announced an increase in the 2016 dividends to $0.53 a quarter or $2.12 (4.47%) in annual dividends. To further enhance that income, one can consider selling a July $52.00 covered call which is bidding $1.44 (or a 3.03%) over the six months. While, it would be nice to own Enbridge over the long-term, if the call is assigned at $52.00, the investor would have made $4.58 in capital gains, $1.44 in premium and potentially two quarterly dividends of $0.53 which represents a 14.93% return over just one half of a year.

Catching a Falling Knife on CIBC (CM)

The January global equity selloff gave investors very few places to hide as the selling was indiscriminate, particularly in Canadian markets. The selling was especially pronounced amongst the Tier 1 Canadian Banks. While likely the majority of the bank stocks represent an equal opportunity, I am going to focus on CIBC in this example. In early December, CIBC flirted with $100.00 a share, before plummeting lower toward $82.00 by mid-January. While I do believe the situation in Canada is poor, a drop of this magnitude is either signalling a very bad hard landing for the Canadian economy or a great opportunity to catch a short term mispricing.

If you were of the opinion that it was a mispricing, then one of the ways to profit from the heightened volatility is to sell a cash covered put at a price you would be willing to accumulate more of the stock. Here is the idea.

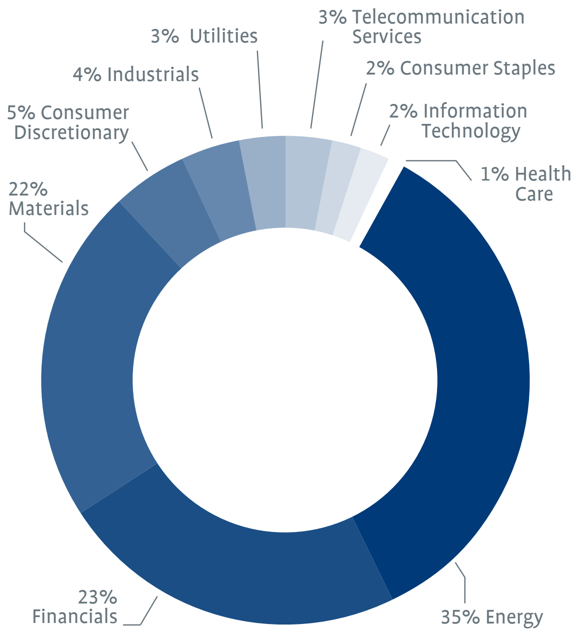
CIBC shares are selling at $88.08 on January 22. The stock had an intraday trading low on January 20 at $82.19, or about $6.00 lower than where it is trading right now. The April $82.00 put option is bidding $1.92. If you view this as an opportunity, you can collect a 2.17% cash flow yield from the put premium for undertaking the obligation to potentially have to buy the stock at $82.00 if the put buyer elects to exercise their right. If exercised, you own CIBC shares at an average cost of $80.08 ($82.00-$1.92). Alternatively, if the put expires worthless, you realize the 2.17% return over the three months (8.72% annualized).

Top 10 Most Active Option Classes (Q4 2015)

RANK	SYMBOL	VOLUME	INSTITUTIONAL	RETAIL	INSTITUTIONAL %	RETAIL %
1	XIU	2,339,652	2,195,179	144,473	94%	6%
2	FM	363,046	320,777	42,269	88%	12%
3	TRP	263,932	241,368	22,564	91%	9%
4	SU	229,271	151,649	77,622	66%	34%
5	RY	165,911	72,363	93,548	44%	56%
6	CNQ	160,456	110,753	49,703	69%	31%
7	SXO	159,866	132,300	27,566	83%	17%
8	BNS	157,409	65,023	92,386	41%	59%
9	TD	150,050	70,172	79,878	47%	53%
10	BMO	146,678	68,571	78,107	47%	53%

Options Trading Volume by Sector

Q4 2015



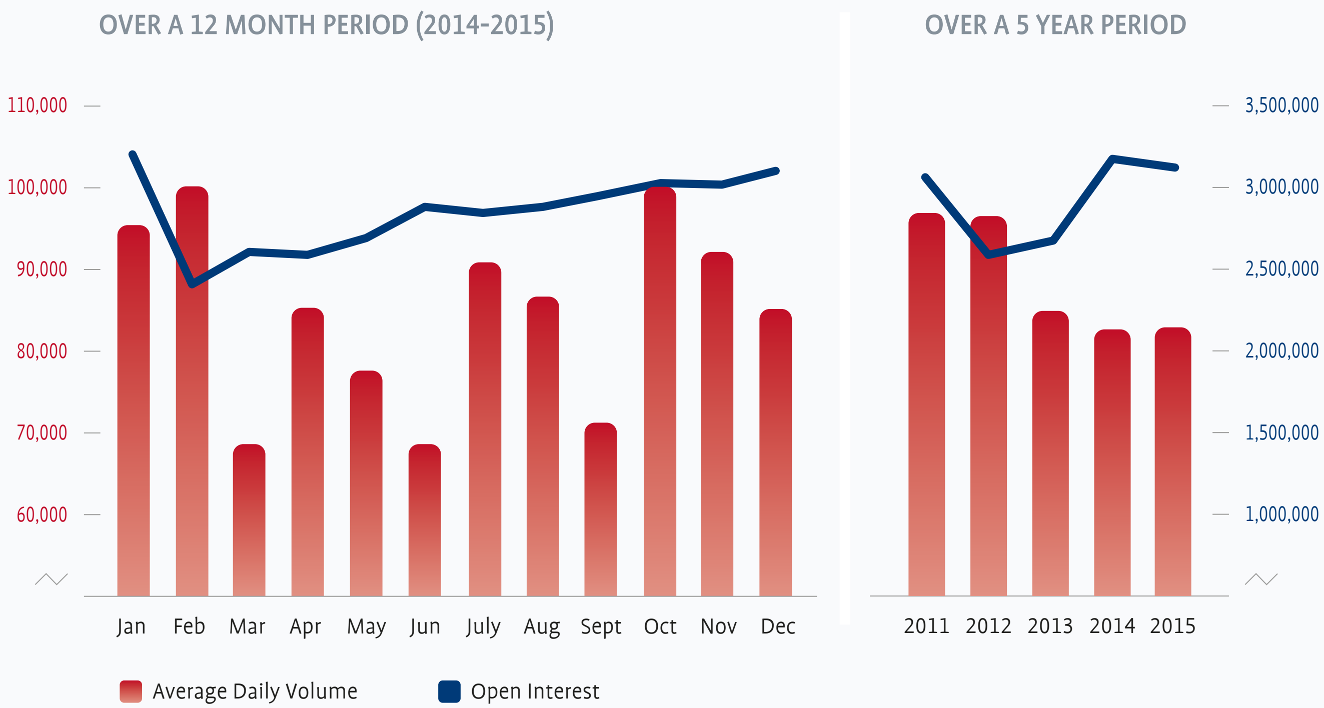
Source: Bloomberg

Note: Options volume from delisted or acquired companies are excluded.

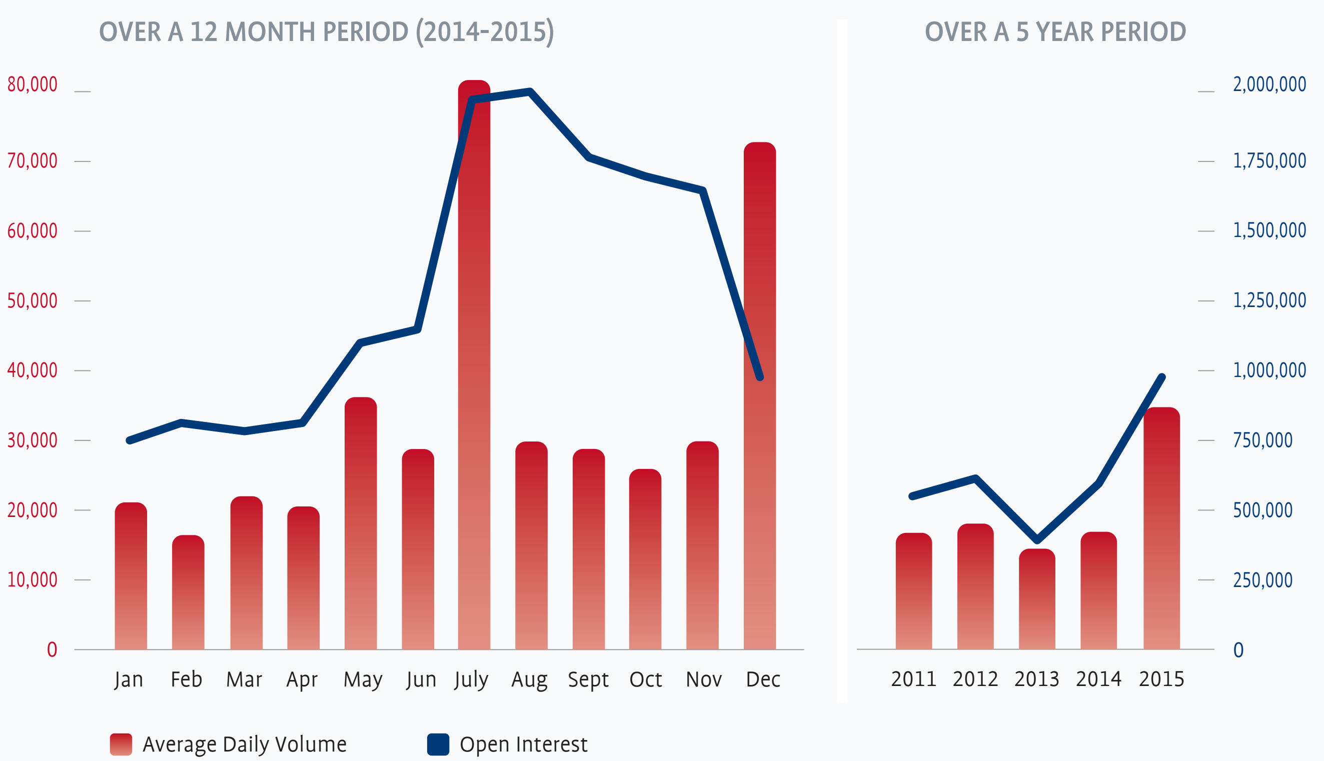
Most Crossed Option Classes

RANK	SYMBOL	CROSS VOLUME
1	XIU	2,195,179
2	FM	320,777
3	TRP	241,368
4	SU	151,649
5	TX60	132,300
6	CNQ	110,753
7	EFN	107,399
8	COS	90,952
9	VSN	90,126
10	ECA	86,169
11	ENB	85,703
12	ZEB	82,000
13	XGD	72,753
14	RY	72,363
15	TD	70,172
16	BMO	68,571
17	SLF	67,005
18	BNS	65,023
19	CM	54,427
20	DGC	53,742

Equity Average Daily Volume and Open Interest



ETF Average Daily Volume and Open Interest



Trading Tools

COVERED CALL Calculator

OPTIONS Calculator

TMX Trading SIMULATOR

Useful Links

GUIDES

» Equity derivatives

» Index derivatives

» Currency derivatives

» Equity options tax regime

MX INDICES

» S&P/TSX 60 VIX Index (VIXC)

» MX Covered Straddle Writers' Index (MPCX)

» MX Covered Call Writers' Index (MCWX)

OTHERS

» Options List

» Put/Call Ratios

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