CANADIAN EQUITY DERIVATIVES

Quarterly Newsletter - July 2014

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TMX Montréal Exchange

GENERAL INFORMATION

Richard Croft

Richard Croft, President of R. N. Croft Financial Group, Inc., a company that provides personal portfolio management and consulting services to individual investors, has been in the securities business since 1975. He has been collaborating with the Montréal Exchange as an instructor for several years in addition to developing two options writing indices (MX Covered Straddle Writers' Index and MX Covered Call Writing Index) and publishing options commentary on MX blog (optionmatters.ca). Richard is also a regular contributor to the *MoneyLetter*, where his articles focus on using individual stocks, mutual funds, and exchange-traded funds within a portfolio model. Most recently, he co-authored *Protect Your Nest Egg*, a Canadian best-seller on portfolio building.

Martin Noël

Martin Noël holds an MBA in Financial Services from the Université du Québec à Montréal since 2003. The same year, he received his Fellow of the Institute of Canadian Bankers and was awarded the Silver Medal for his superior level of performance in the completion of the Professional Banking Program.

Martin began his career in the derivatives industry in 1983 as an options market maker for various brokerage firms on the floor of the Montréal Exchange. He later became an Options Specialist and ultimately an independent trader. In 1996, he joined the Montréal Exchange as Options Market Supervisor where he had the opportunity to contribute to the development of the Canadian Options market. Since May 2009, he is President of Monetis Financial Corporation, which specializes in professional trading and financial communication.

2014 Trading Calendar

JULY

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		

AUGUST

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						

SEPTEMBER

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				

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

For more information, please contact
Josiane Lanoue, Business Development Manager, Equity Derivatives
jlanoue@m-x.ca or 514 871-3539

CLIENT EDUCATION AT THE CORE OF YOUR SUCCESS

A special invitation to your clients and prospects to join the Montréal Exchange and the Options Industry Council (OIC) at the 2014 Options Education Days!

The advisor-client relationship is a fragile one built on trust and understanding. This relationship is also catalyst to the investment advisors business growth potential as nowadays, existing clients are the main source of referrals.

One integral component of making this relationship successful is introducing and familiarizing your client with your investment strategy. When it comes to options, it is difficult to think of any product more misunderstood by investors. Many of them think of options as speculative investment vehicles that will either make them win, or lose, a lot of money. Your role then becomes key in making your clients and prospects comfortable with your own usage of options whether it involves using put options to reduce the volatility of a portfolio or write covered call options to enhance overall returns.

Investors have very important misperceptions when it comes to options and it can be challenging for advisors to introduce options or explain their benefits to clients and prospects. However, now that more traditional financial products, such as mutual funds and Exchange-Traded Funds (ETFs), make use of options, education is deemed essential in taking your business to the next level.

To understand why options are often misunderstood, The Options Industry Council (OIC) undertook a qualitative research study among high net worth investors. The study explored the investors' reticence to include options strategies in their portfolios and if educational information on options could alter their attitudes. Below are key findings published by the OIC that may better equip you to break the ice!

- Although the participants read general interest business publications and regularly received information from their financial advisors, no information about options strategies had reached most of the participants beyond advertising for options trading programs, which they believed involved speculating with naked calls and puts.
- More than three quarters assumed options would never be appropriate for them because they had been taught and believed that investing should be for the long term and options are short term.
- Initially, the vast majority had difficulty understanding how covered calls and protective puts worked and had to read through the explanation a few times. At the end most were not able to describe options in their own words even though it was clear from their questions they had grasped the concepts.
- Despite not fully understanding how covered calls and protective puts worked, they recognized that these strategies were very different from their initial understanding of options and a significant majority, who had earlier been critical of options, expressed interest in learning more about them.

- Participants said they looked to their financial advisors for new ideas and would be open to discussing options strategies with them. Several noted that they were more receptive to new investment ideas when they had at least heard about the concept previously.
- The Montréal Exchange offers various educational tools that can assist you through this sometimes tedious process from simple guides that include an overview of basic options terminology to videos with interactive demonstrations of concepts such as the impact of time decay on option premiums. Moreover, free access to a trading simulator that allows your clients to experience first hand how different options strategies will impact their portfolio as the underlying security fluctuates.

In addition to those resources, the Montréal Exchange in collaboration with the Options Industry Council (OIC), encourages you to invite your clients and prospects to attend the Options Education Day, which will be held in Montréal and Toronto this coming September. The Options Education Days are workshops tailored to retail investors of all levels who are looking to gain a general understanding of the options market.

To view the program for upcoming events, click on the links below.

OED MONTRÉAL	OED TORONTO
September 13	September 27

As we all know, education is an ongoing process and with that in mind, remember that the Options Education Day will be back next year!

For further information or to reserve a seat, please contact:
Josiane Lanoue, Business Development Manager, Equity Derivatives
jlanoue@m-x.ca or 514 871-3539

ABNORMALLY LOW VOLATILITY

By Richard Croft

Options premiums have not been this cheap for this length of time for more than a decade. A reflection of abnormally low volatility which almost everyone believes is not sustainable. Mind you, that is the same argument that economists have been making about abnormally low interest rates for the past two years.

Interestingly, the two may be linked at the hip. One could argue that low interest rates and accommodative central banks have placed a floor under the equity markets leading to investor complacency.

One might also point that tighter controls on financial institutions have reined in their ability to take excessive risk. Also noteworthy is high frequency traders who have been re-thinking their algorithms under the glare of the regulatory spotlight. High frequency trading has long been considered a strategy that enhances volatility patterns.

Certainly, these factors help explain the current low volatility environment and support the broadly accepted thesis that higher interest rates and the eventual return of the small investor will cause market volatility to expand. But are these assumptions reasonable?

Interest rates will climb as inflation rises but that is typically the result of price expansion caused by a surge in consumer spending patterns which so far, at least, has been lagging. More to the point for inflation, to become entrenched, it must catch corporations off guard and must come on so quickly that the increase in costs cannot be absorbed by productivity improvements. In a highly competitive global environment with just in time delivery models firmly entrenched in the corporate psyche, it is highly unlikely that managements cannot deal effectively with inflation risk.

Another consideration is how governments account for inflation. In most mature industrialized economies heath care is a significant component that goes into accounting for inflationary trends. Is it possible that Obamacare will eventually rein in health care costs? I am not saying that health care costs will not rise, but under government controls, these increases should be calculated and contained much like they have been in Canada. US corporations in particular can manage margins without raising prices in an environment of cost certainty.

All of this leads me to ask whether we may be in the early innings of a prolonged period of expansion? Something we have not seen since the end of the second world war. Granted we are not seeing the euphoria that drove consumer spending after the war. But we are seeing a strengthening of consumer balance sheets, the result of higher stock prices coupled with stability in the real estate sector. Historically, that has led to increased spending patterns and improved earnings. In that context, it is possible that investor complacency could remain entrenched for a prolonged period of time implying a continuance of low volatility patterns.

Low Volatility Option Strategies

If low volatility becomes a new multi-year norm, traders need to re-think their investment strategies. Seeking opportunities from the buy side of the ledger as it were!

At the top of this list is straddle buying (i.e. buying a long call and a long put). If you are not sure about the direction of the market, long index straddles are an excellent way to hedge parts of your portfolio. The risk of course is that you are paying two, albeit cheap, premiums which if market volatility remains low, can end up costing you more than you may have expected.

Straddles only make sense if you believe that minor spikes in volatility will occur from time to time which is a risk as bond traders betting on higher interest rates will attest. As advisors are well aware, markets can remain in an entrenched pattern much longer than historical models would imply. Past performance not being indicative of future performance and all that!

On the other hand, buying calls or puts to make a directional bet has never been more attractive. In fact, one could argue that buying a combination of calls and bonds for companies that have outstanding debt may be an attractive alternative to buying the shares outright.

With the long calls, you have limited risk and using the money that you would have used to buy the shares to instead buy the debt of the company creates a do it yourself convertible debenture (CV), especially at a time when many companies are paying up for ten year debt!

Debit spreads are also interesting in this environment. Going long an at-the-money call (or put depending on your view of the underlying security) and then writing a call above or put below the option purchased allows you to take advantage of low premiums.

The rationale underpinning this strategy is that out-of-the-money options tend to trade at a slightly higher implied volatility because these options are more appealing to speculators who will generally pay up for a more aggressive position.

On the other hand, calendar spreads may not be the best strategy in such market conditions. A calendar spread involves the simultaneous sale of a shorter term option against the purchase of a longer dated option. This is an excellent strategy if you believe the markets – or individual stocks – will continue to trade in a range for the short term with a break out longer term. The challenge with calendar spreads is that an increase in volatility will cause the short option to rise at a faster rate than the longer term option. It may still work out but you need to be aware of the risks.

Collar strategy on Alimentation Couche-Tard

Shares of Alimentation Couche-Tard (ATD.B) have been trading at a price of between $29 and $31 since March 2014. Momentum, as represented by the STO89 indicator ("Stochastic" over 89 sessions), has been declining since the month of May. After experiencing over 50% growth since last September, many investors may be tempted to purchase put options as protection against a drop below the $29 mark. Purchasing ATD AUG 28 put options at $0.55 per share (as at June 25, 2014 when the stock was trading at $29.10) would allow investors to sell their ATD shares at a price of $28 and limit their losses, in case of a sharp drop. However, since it may be costly over the long term to protect themselves by purchasing put options, some investors finance the purchase of put options by selling call options for an equivalent premium. For example, selling ATD AUG 30 call options at $0.55 per share would, in this case, allow investors to finance 100% of the put option purchase. With this so-called "Collar Strategy", investors are guaranteed that they will be able to sell their shares at a bottom price in case of a decline below the strike price of the put option, at minimum cost. In return for this reduction in the cost of protection, investors sell their shares at expiration in case of an increase above the strike price of call options sold. In this case, not taking into account commissions, investors will be able to sell their shares on the August expiration date at a price of $28 in case of a decrease, and will have to sell them at a price of $30 in case of an increase.

Bear call spread on iShares S&P/TSX Capped Financials Index ETF

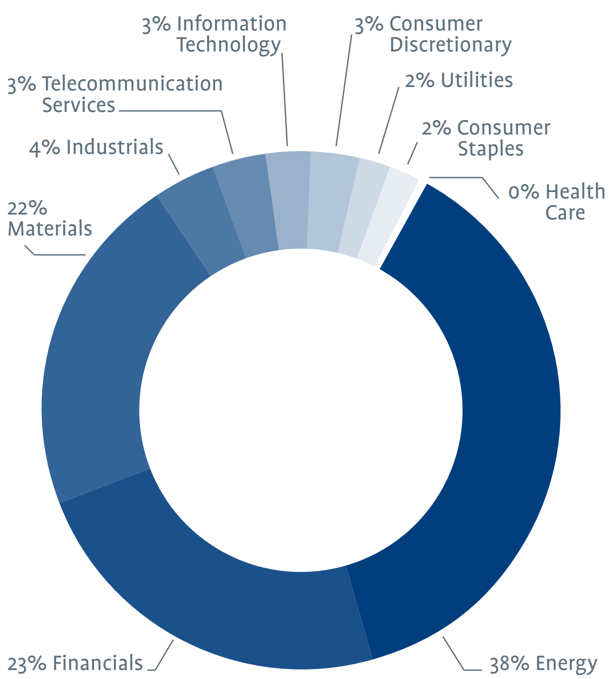
The price of shares of the iShares S&P/TSX Capped Financials Index ETF (XFN), which is aimed at replicating the long-term return of the S&P/TSX Capped Financial Index, met resistance twice, at around $30.80, during its rise over the past few weeks. Investors who feel that the $31 level will not be exceeded and who expect prices to drop below the $30 mark by the August 2014 expiration date may sell XFN AUG 30 in-the-money call options at $0.75 per share (as at June 25, 2014 when the stock was trading at $30.57) and simultaneously purchase XFN AUG 32 call options at $0.05 per share in order to limit their risk. The maximum profit per share of $0.70 corresponds to the net premium received, and will be achieved by the August expiration date if XFN closes at a price below or equal to the $30 strike price of call options sold. The maximum loss of $1.30 per share corresponds to the difference between the strike prices for call options sold ($30) and call options purchased ($32), less the net premium received ($0.70), and will be achieved by the August expiration date if XFN closes at a price above or equal to the $32 strike price of call options purchased. The breakeven point of $30.70 is obtained by adding the net premium received ($0.70) to the strike price of $30 for call options sold. This level represents the dividing line between profits and losses. As long as the price of XFN remains under this threshold, investors will be in a profit zone. However, losses will be incurred if the price of XFN climbs above this level.

Top 10 Most Active Option Classes (Q2 2014)

RANK	SYMBOL	Q1 2014 VOLUME	INSTITUTIONAL	RETAIL	INSTITUTIONAL %	RETAIL %
1	XIU	333,248	241,465	91,783	72%	28%
2	ATH	185,719	168,850	16,869	91%	9%
3	TD	188,922	103,091	85,831	55%	45%
4	BNS	151,851	74,314	77,537	49%	51%
5	BMO	131,319	66,022	65,297	50%	50%
6	CNQ	135,207	84,927	50,280	63%	37%
7	G	103,611	55,130	48,481	53%	47%
8	RY	107,233	38,453	68,780	36%	64%
9	SXO	101,008	66,589	34,419	66%	34%
10	SU	117,491	45,253	72,238	39%	61%

Options Trading Volume by Sector

June YTD 2014



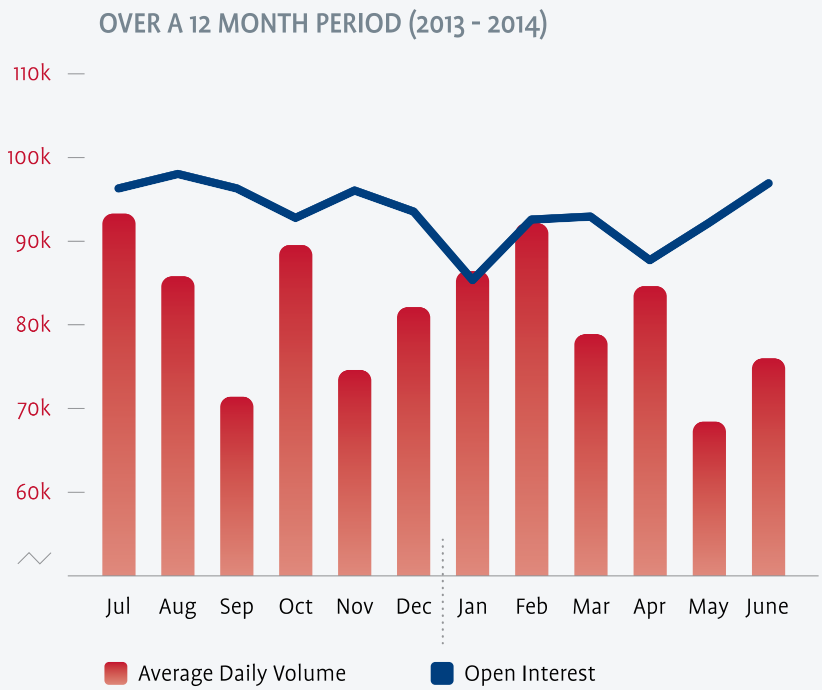
Source: Bloomberg

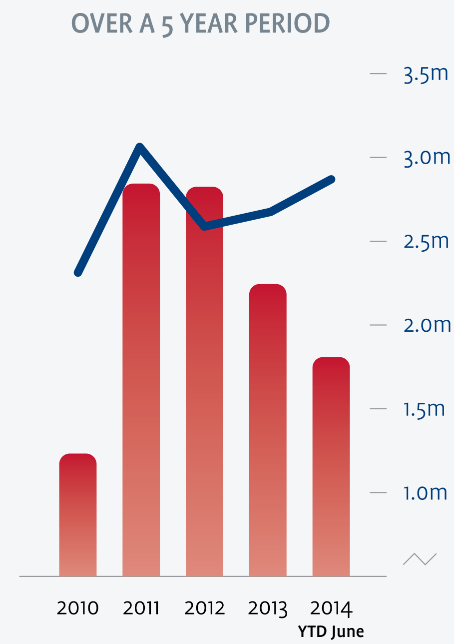
Note: Options volume from delisted or acquired companies are excluded.

Most Crossed Option Classes

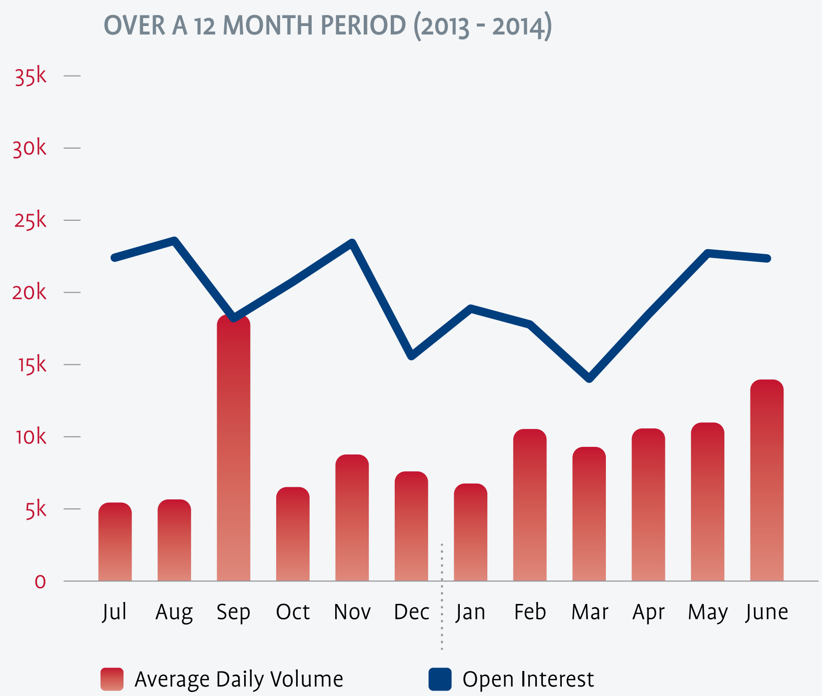
RANK	SYMBOL	CROSS VOLUME
1	XIU	241,465
2	ATH	168,850
3	XEG	108,875
4	TD	103,091
5	XFN	93,500
6	ECA	86,045
7	CNQ	84,927
8	COS	76,129
9	ELD	74,492
10	BNS	74,314
11	TLM	67,261
12	NA	66,686
13	SXO	66,589
14	BMO	66,022
15	ENB	56,888
16	CVE	55,603
17	G	55,130
18	MFC	52,566
19	CM	51,030
20	XGD	50,862

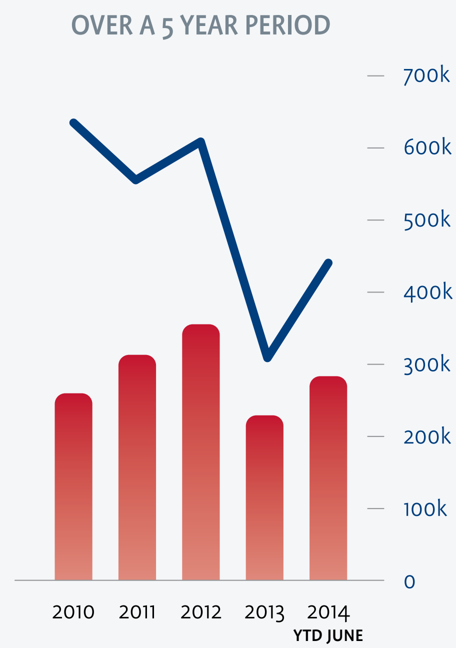
Equity Average Daily Volume and Open Interest





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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