

Trading Futures and Options

Equity Products

SFE futures and options are investment products used by traders and investors, both professional and private. There are a number of characteristics which distinguish futures and options from stocks, bonds or other traditional investment products which may make them particularly attractive to private investors.

Leverage: the ability to undertake a comparatively large position for a very small initial outlay. This concept is similar to what is experienced when you buy a house. Imagine paying 10% deposit on a house worth \$100000 and borrowing the remainder from a bank. If the property increases in value by 5% in one year, the return on your initial investment of \$10000 is 50% ($100000 \times 0.05 = \5000). Futures and options provide a similar form of 'Leverage'.

Reduced cost of funding: SFE futures and options enable a private investor to gain exposure to Australian Equities, Bonds and currencies at a fraction of the cost of traditional investments. This results in a reduced cost of funding for those borrowing the money to invest.

Making money from both a rising or a falling market: unlike traditional investment products which profit only when the market is going up, with futures and options you can also make money when the market goes down. To achieve this in traditional markets may necessitate the borrowing of stock, which incurs considerable cost.

Developing trading strategies: futures and options provide traders with the flexibility and opportunity to exploit trends and variations in the marketplace that are not possible with traditional traded products. By combining different options and/or futures, traders can create a wide range of potentially profitable scenarios regardless of the direction of the market. Some of these are discussed later in this document.

However, this increased potential to profit may bring with it an increased potential for loss when trading futures and options. For this reason this document is intended as a simple introduction to the world of trading futures and options. We recommend all investors seek expert advice from an experienced client adviser prior to participating in these markets.

About Sydney Futures Exchange

Sydney Futures Exchange (SFE) is the 10th largest financial futures and options exchange in the world by volume turnover, and the second largest in the Asia Pacific region. SFE provides futures and options on the four most actively traded markets – interest rates, equities, currencies and commodities, with a number of its flagship products ranked in the world's top ten most actively traded products in their market sector.

With 24 hour a day trading capability, access to these products is made possible via a global electronic communications network and the world's leading futures brokers. Regardless of location, users can choose between direct electronic access, utilising trading software from major Independent Software Vendor's (ISV's), broker proprietary systems, and the Internet, or traditional phone broking.

SFE staff are available to assist new brokers, banks and customers through the process of connecting to and trading on the Sydney Futures Exchange.

Sydney Futures Exchange is a wholly owned subsidiary of SFE Corporation Limited. In April 2002, SFE Corporation Limited was publicly listed on the Australian Stock Exchange and is included in the S&P/ASX 200 Index¹ of top Australian stocks

¹ S&P/ASX 200 is a trademark of Standard & Poor's. The trademark is used under licence by Sydney Futures Exchange.

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Steps to Trading Futures and Options

TRADING FUTURES AND OPTIONS can provide investors with potentially rewarding opportunities in financial, equity and currency markets. But they are not for everyone. Before trading futures and options it is important that investors are fully acquainted with the risks as well as the rewards associated with these investment products. For this reason the following steps are recommended before entering into futures and options trading:

1 Learn the basics

It is essential for first time investors to become familiar with their chosen products before entering into the market. There are a wide range of educational courses available for private investors such as those provided by the Australian Financial Markets Association, Securities Institute of Australia and the major futures broking firms. Details of these courses can be found on www.sfe.com.au.

2 Understand the trading rules, terminology and responsibilities

There is a distinct language used when trading futures and options to describe both the market and the rules and responsibilities of the various parties involved. Your broker will provide you with documentation outlining these rules and responsibilities.

3 Decide which markets and products you wish to trade

If you have traded an underlying market such as equities you may find the futures and options of equities the best place to start. In the case of Australia these would be the SFE SPI 200™ Equity Futures and Options or Individual Share Futures.

4 Form a strategy

Before placing any orders into the market you need to decide at what point you would 'cut your losses' or ideally 'take your profits'. These points of entry and exit represent the basis of your trading strategy.

5 Practise

Before entering the market, it is a good idea to practise trading without committing cash (eg paper trading). It allows you to determine how successful your strategy would have been. Continue this for some time to develop a feel for the market you have chosen.

6 Select a broker

When you are comfortable with your product and strategy, then select a broker. You may want to talk to several futures brokers before making your selection and consider how you want to trade (eg do they allow you to trade via the internet). The details of a number of futures brokers are available on our website (www.sfe.com.au).

Once you've found and contacted a broker who meets your needs, the broker will then ask you to:

- provide the information necessary to open an account
- sign a Client Agreement Form formalising the relationship between you and the broker.
- deposit a minimum amount of cash or certain securities stipulated by your broker (see *deposit and margins* in glossary).

The following pages describe the products available via the Sydney Futures Exchange and the types of strategies you could consider when embarking on trading Futures and Options.

SFE SPI 200™ Index Futures

SFE SPI 200™ Index Futures enable you to trade movements in Australia's benchmark stock index, the S&P/ASX 200 Index[†], in a single transaction. This means that you can get exposure to Australia's top 200 companies without the need to buy or sell shares in every company in the index. This provides significant savings in transaction costs and provides a cost efficient means to get exposure to the broader Australian market.

Leverage

The real appeal of using futures is the leverage they provide. In the case of one SFE SPI 200™ Index Futures contract an initial outlay of \$2500* to your broker provides you with approximately \$87500 worth of exposure to the Australian share market.

To work out the exact value of the SFE SPI 200™ Index Futures contract you multiply the SFE SPI 200™ Index level (e.g. 3500) by \$25, which is the value of each point.

Lower brokerage

The brokerage for trading SFE SPI 200™ Index Futures is significantly lower than the brokerage incurred when trading the underlying portfolio of stocks.

Ability to take advantage of a rising and falling market

SFE SPI 200™ Index Futures have no restrictions on short selling. Therefore, you avoid the complications and costs associated with borrowing stock.

You can buy a future if you expect the market to rise, or sell the future if you expect the market to fall. For every point that the market moves in your favour you will gain \$25.

1 index point = \$25 Contract Value = \$25 x SFE SPI 200™ Index Level

Obtain leverage without any interest payments

As with Individual Share Futures, the SFE SPI 200™ Index Future allows you to gain significant exposure to Australia's top 200 companies without having to borrow the funds and service the associated interest payments (see example below).

Examples of how the SFE SPI 200™ Index Futures can be used are illustrated on the following page.

[†] S&P/ASX 200 is a trademark of Standard & Poor's. The trademark is used under licence by Sydney Futures Exchange.

* The actual initial margin varies between approximately 2-10%. Brokers work this out depending on your total exposure, products and their assessment of your financial position.

Directional Trading Using SFE SPI 200™ Index Futures

Bullish View

How do you profit from a rising share market using futures?

Buy a SFE SPI 200™ Index Futures contract and then sell the contract when the price has risen. This is also known as going long a futures contract.

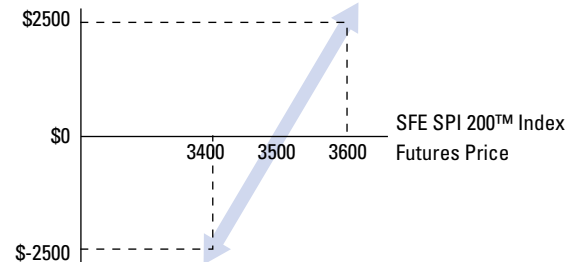
Example

Buy a SFE SPI 200™ Index Futures contract when the price is 3500 points and then sell a SFE SPI 200™ Index Futures when the price has risen.

If the SFE SPI 200™ Index Futures contract price increased by 100 points to 3600 points then the value of your exposure would have increased to \$90000 (ie 3600 x \$25). In this case you have effectively made \$2500 or a 100% profit on your initial margin outlay of \$2500*. To realise your gain you simply sell your futures contract at the higher level.

Profit from a Rising Market

Profit Diagram at expiry if you buy one SFE SPI 200™ Index Futures at 3500 points



Bearish View

How do you profit from a falling share market?

Sell a SFE SPI 200™ Index Futures contract and then buy the contract when the price has fallen. This is also known as going short a futures contract.

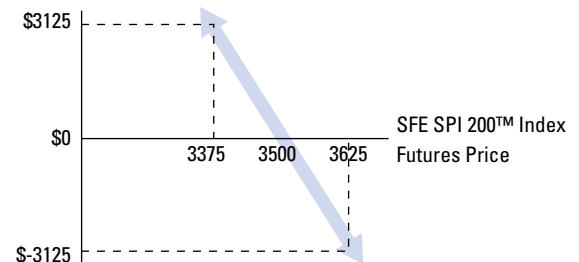
Example

Sell a SFE SPI 200™ Index Futures contract when the price is 3500 points and then buy a SFE SPI 200™ Index Futures contract when the price has fallen.

By paying your broker an initial margin of \$2500* you can sell a SFE SPI 200™ Index Futures contract. Unlike when you bought the futures contract, this time you make a profit if the market falls. If the SFE SPI 200™ Index Futures price decreases by 125 points to 3375 points you are able to close out your futures contract by buying at the lower level. If you originally sold the contract at 3500 and bought at 3375 you would have made a profit equal to \$3125 (ie 125 x \$25) or a 125% profit on your initial margin of \$2500*.

Profit from a Falling Market

Profit Diagram at expiry if you sell one SFE SPI 200™ Index Futures at 3500 points



Using futures to protect the value of your portfolio (hedging)

If you own a portfolio of stock and believe that the market is going to fall but do not want to sell (for either cost or tax reasons) you can safeguard the value of your portfolio by selling SFE SPI 200™ Index Futures. This act of protecting your portfolio is known as hedging.

When you implement a hedging strategy using futures any decrease (increase) in the value of your sharemarket portfolio will be compensated for by an increase (decrease) in the value of the futures contract.

* The actual initial margin varies between approximately 2-10%. The initial margin is worked out by your broker and is dependant on your total exposure, products and their assessment of your financial position.

Why hedge?

- To eliminate/reduce your exposure to the market without incurring the transaction costs of selling your entire portfolio of stock.
- To lock in a buying and selling price for your stock market portfolio.
- To lock in a particular return for an equity portfolio (eg a trader may have achieved their target return for a period and they want to lock this in. By trading a futures contract they do not have to sell their shares).

Bearish View

How do you protect your portfolio?

Sell SFE SPI 200™ Index Futures. By selling a SFE SPI 200™ Index Futures you can lock in the value of your portfolio for the life of the futures contract.

Example

Assume you hold a portfolio that approximately tracks the S&P/ASX 200 Index† worth \$90000 and that the current level of the futures contract is 3500 points. You expect that the market will drop by approximately 5% within the month.

To avoid this you could sell your portfolio and re-enter the market when you have more confidence that the market will continue to rise. By doing this you would incur significant transaction costs, both on the sale and the re-purchase of the portfolio.

The alternative is to sell futures. Not only are futures transaction costs lower than those associated with portfolio liquidation, but the selling process is faster. Another benefit of using futures is that the original portfolio is maintained.

The first step is to determine how many futures contracts will be required to hedge the portfolio.

With the SFE SPI 200™ Index Futures price at 3500 points, one futures contract is worth \$87500 (3500 points x \$25). To determine the number of contracts that will be required, divide the value of the portfolio by the face value of the futures contract, which in this case is $\$90000/\$87500 = 1.03$. Rounding down to the nearest whole number, one futures contract will be required to provide an adequate hedge for this portfolio. The investor should therefore sell one SFE SPI 200™ Index Futures contract to hedge this portfolio.

Assume that your prediction turned out to be correct and your market portfolio dropped by 5% and lost \$4500 and that the futures price fell by 185 points to 3315 points. At this time you could choose to close out the position by buying back the one futures contract.

Period	Index Level	Stock Position	Futures Position
Day 1	3500	\$90000	Sell Futures: Number of futures = Stock portfolio value/Face Value of Futures Contract = $\$90000/(\$3500 \times \$25) = 1.03$ = 1 Futures contract (rounded to the nearest whole digit) Receive \$87500
Day 30	Index Level drops 5% to 3315	Stock Portfolio value falls 5% to \$85500	Buy back futures Notional Value at 3315 Index Level = $3315 \times \$25$ Pay \$82875
GAIN		-\$4500	\$4625
NET GAIN			\$125

Since you sold the futures contract at 3500 points and you bought at 3315, the profit on the futures transaction is \$4625 (ie 185 points x \$25).

Accordingly, even though the market and value of the portfolio declined \$4500, the short futures position increased in value by \$4625, offsetting the equity loss.

† 'S&P/ASX 200' is a trademark of Standard & Poor's. The trademark is used under licence by the Sydney Futures Exchange.

SFE SPI 200™ Options

FOR MANY TRADERS, SFE SPI 200™ Options are the trading vehicle of choice to get exposure to the Australian share market. This is because options can provide you with the opportunity to trade the direction of a market whilst limiting the down side risk to the initial price of the option (known as the premium). There are two types of options – calls and puts.

The buyer of a call option buys the right, but not the obligation, to buy a futures contract at a particular price on or before a particular date.

The buyer of a put option buys the right, but not the obligation, to sell a futures contract at a particular price on or before a particular date.

The following descriptions and the terms used for describing the trading of options will help with your understanding of the options market.

Characteristics of Options

Premium

This is the price of the call or put option

Contract size

Each SFE SPI 200™ Option contract represents one SFE SPI 200™ Index Futures contract

Expiry day

The last day the option can be traded

Expiry Month

The month in which the option contract expires

Exercise

The act of converting the option into the futures contract. Exercise Price (also called Strike Price) is the price at which an option holder has the right to buy (in the case of a call option) or sell (in the case of a put option) the underlying futures contract. Options are listed with multiple exercise prices.

Terms for describing options

In-the-Money

A call option is in-the-money when the underlying futures price is greater than the exercise price. A put option is in-the-money when the exercise price of the option is greater than the price of the underlying futures contract.

Options that are in-the-money have 'intrinsic value' equalling the difference between the exercise price of the option and the market price of the underlying futures price.

At-the-Money

An option where the underlying futures price equals the exercise price.

Out-of-the-Money

A call option is out-of-the-money if the exercise price is greater than the underlying futures price. A put option is out-of-the-money if the underlying futures price is greater than the strike price.

What influences the price of options?

Premium

The premium of an option is the sum of the intrinsic value and time value of that option. This is illustrated below.

Intrinsic Value

The extent to which an option is in the money is its intrinsic value. The intrinsic value is calculated as follows:

For a Call Option: $\max(\text{Futures Price} - \text{Strike Price}, 0)$
 For a Put Option: $\max(\text{Strike Price} - \text{Futures Price}, 0)$

An illustration of the intrinsic value for a call option is shown below.

	Strike	Futures Price	Intrinsic Value
Call Option (In-the-money)	3350	3375	$= \max(3375 - 3350, 0) = 25$
Call Option (At-the-money)	3350	3350	$= \max(3350 - 3350, 0) = 0$
Call Option (Out-of-the-money)	3350	3325	$= \max(3325 - 3350, 0) = 0$

Time Value

An option with a long period of time remaining until expiration commands a higher premium than an option with a short time to expiry because it has more time in which to become profitable. Time value is determined by subtracting intrinsic value from the option premium. (ie Time value = option premium - intrinsic value).

Volatility

The greater the volatility of the underlying market/futures contract, the higher the premium. In a volatile market, the option stands a greater chance of becoming profitable to exercise over the life of the option.

Exercising Options

SFE SPI 200™ Options may be exercised on any business day up to and including the Last Trading Day (expiry day). Only 'in-the-money' options are automatically exercised at expiry. Note that generally traders do not exercise their options but sell them to realise their gain or loss.

Directional Trading using Options

Bullish View

How do you Profit from a Rising Market?

Buy a SFE SPI 200™ Index Call Option.

Example

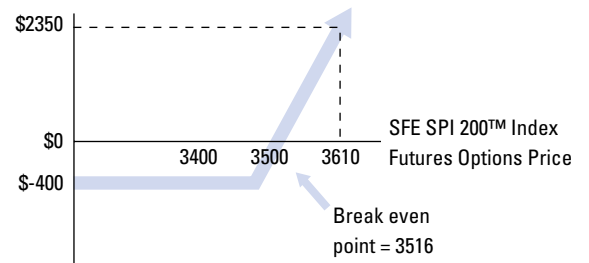
Buy a 3500 SFE 200™ Index Call Option for a price of 16 points.

By paying your broker premium of \$400 (ie 16 points x \$25) you have bought the right to buy a futures contract if the futures price is greater than 3500 before the option expires. The diagram to the right shows the potential profit or loss on the strategy for different index futures prices at expiry. Since you paid \$400 for the option you will need the futures price to be above the break-even point of 3516 to make a profit on the option. The diagram shows that while the futures price is below 3516 points the call option buyer would make a loss. The most the call option buyer can lose is the price of the option, worth \$400.

The maximum profit to the buyer is unlimited. If by the expiry date the futures contract price had risen to 3610 points, then your profit would be \$2350 (\$2750 - \$400).

Profit from a Rising Market

Profit Diagram at expiry if you buy a 3500 Call Option
 One Index Point = \$25



Bearish View

How do you Profit from a Falling Market?

Buy a SFE SPI 200™ Index Put Option.

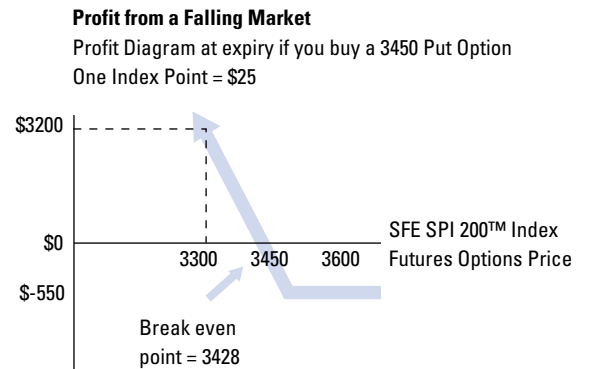
Example

Buy a 3450 SFE SPI 200™ Index Put Option for a price of 22 points.

By paying your broker the premium of \$550 (ie 22 points x \$25) you have bought the right to sell a futures contract for 3450 points before the option expires.

The diagram to the right shows the potential profit or loss on the strategy for different index futures prices at expiry. Since you paid \$550 for the option you will need the futures price to be below the break-even point of 3428 to make a profit on the option. The diagram shows that while the futures price is above 3428 points the put option buyer would make a loss. The most the call option buyer can lose is the price of the option, worth \$550.

The maximum profit to the buyer is limited because the minimum index level is 0. If by the expiry date the futures contract price had fallen to 3300 points, then your profit would be \$3200 (\$3750 – \$550).



Using Options as Hedging Instruments

If you hold a long Futures position or position in the underlying stock, and are concerned about a short term fall in their value you can use options to provide you with downside protection.

Bearish View

How do you protect a long futures position?

Buy put options. During a market fall the increase in the price of the put option will counter the fall in the value of the long futures position.

Example

You have bought a SFE SPI 200™ Index Futures contract (gone Long) for 3550 points and want to protect yourself from a fall in the futures price. You could place a 'Stop Loss' order with your broker, but that could result in you being 'closed-out' just before the market rallies. An alternative is to buy a 3550 put option. This allows you to close out your futures contract for 3550 points no matter how far the market falls. This option would protect your bought position until its expiry date.

Bullish View

How do you protect a short futures position?

Buy call options. During the market rise the increase in the price of the call option will help counter the fall in the value of the short futures position.

Example

You have sold a SFE SPI 200™ Index Futures contract (gone Short) for 3400 points and want to protect yourself from a significant rise in the futures price. You could buy a 3400 call option to ensure that you can buy if the market rises significantly. This allows you to at least close out your current bought futures position by buying at 3400 points. This option would protect your short position until its expiry date.

Selling (Writing) Options

For every option that someone buys there is a seller. The seller receives the option premium during the life of the contract. This transaction occurs via the margining process. A futures style margining methodology is applied to SFE SPI 200™ Options positions and there is a daily mark-to-market over the life of the option. Selling options carries substantial risk if you do not have an underlying futures contract position to cover the option. Notwithstanding, selling options can earn extra income without having to take unnecessary risks.

Opportunistic View

How do you earn extra income by selling options?

Sell options against an existing futures position or a portfolio of stocks. These are known as 'covered options'.

Example

Assume you have a bought SFE SPI 200™ Index Futures position. The current price is 3400 points and you would be happy to sell and close out this position at 3500 points. You find out that SFE SPI 200™ Call Options with an exercise price of 3500 expiring in 3 months are worth around 30 points. You instruct your broker to sell one of these options. You now have the obligation to sell at 3500 points should the buyer of the call option exercise the option. For undertaking this obligation you have received \$750 ($\25×30 points) in premium.

Introduction to Option Strategies

BY COMBINING DIFFERENT OPTIONS and futures contracts traders can create a wide range of potential profit scenarios that can be used to take advantage of views they have on the market.

The following introduction provides some examples of basic options strategies that traders can use for different market expectations and the potential profit opportunities that they offer the trader. In this introduction, the payoff characteristics of the options strategy are shown as at expiry.

Market View One

You believe there will be high volatility in the market that will move the price significantly but do not know in which direction.

Strategy **LONG STRADDLE**

Buy a put option and buy a call option with the same exercise price that is at-the-money.

Profit and loss characteristics at expiry

Profit: Unlimited for a decrease or increase in the underlying futures price.

Loss: Limited to the premium paid to establish the position. This is greatest if the underlying futures price equals the exercise price of the options at expiry.

Break Even: If the underlying rises or falls above or below the exercise price by the same amount as the premium cost to establish the position.

Example

Assume the SFE SPI 200™ futures price when you establish the strategy is 3500.

Establish the Options Strategy

Buy one 3500 SFE SPI 200™ Index Call Option for the price of 22 points. Buy one 3500 SFE SPI 200™ Index Put Option for the price of 18 points.

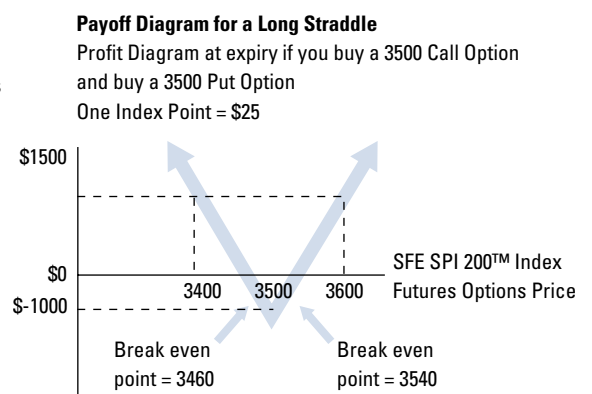
Cost of the Options Strategy

The total cost of the strategy is 40 points or \$1000 (ie 22+18 points x \$25).

Payoff

The diagram to the right shows the potential profit or loss on the strategy for different futures prices at expiry. Since you paid 40 points (\$1000) for the strategy, to profit you will need the futures price at expiry to have increased above the break-even point of 3540 or decreased below the break even point of 3460 points.

The maximum profit is unlimited. If at the expiry date the futures price had risen to 3600 or fallen to 3400 points, then your profit would be \$1500. (\$2500-\$1000).



Market View Two

You believe there will be low volatility in the market and you don't expect the underlying futures price to move significantly in either direction.

Strategy **SHORT STRADDLE**

Sell a put option and sell a call option with the same exercise price that is at-the-money.

Profit and loss characteristics at expiry

Profit: Limited to the premium you receive from establishing the position.

Loss: Unlimited for both an increase or a decrease in the underlying futures price.

Break Even: If the underlying rises or falls above or below the exercise price by the same amount as the premium received to establish the position.

Example

Assume the SFE SPI 200™ Index Futures price when you establish the strategy is 3500.

Establish the Options Strategy

Sell one 3500 SFE SPI 200™ Index Call Option and receive a price of 22 points. Sell one 3500 SFE SPI 200™ Index Put Option and receive the price of 18 points.

Premium Received Options Strategy

The total potential premium that you could receive is 40 points or \$1000 (ie 22+18 points x \$25).

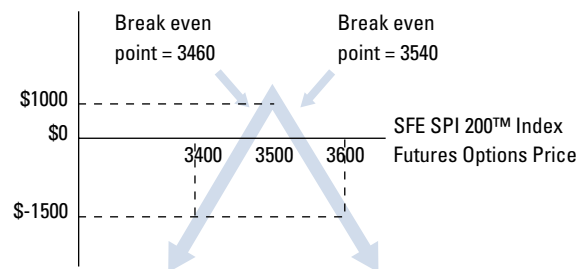
Payoff

The diagram to the right shows the potential profit or loss on the strategy for different futures prices at expiry. The maximum profit you could receive is the premium or 40 points (\$1000). To lose, the futures price at expiry needs to have increased above the break-even point of 3540 or decreased below the break even point of 3460 points.

The maximum loss is unlimited. If at the expiry date the futures price had risen to 3600 or fallen to 3400 points, then your loss would be \$1500. (ie \$2500 – \$1000).

Payoff Diagram for a Short Straddle

Profit Diagram at expiry if you sell one 3500 Call Option and sell one 3500 Put Option
One Index Point = \$25



Market View Three

You believe there will be a major movement in the market but are unsure of the direction. A larger directional move is required to make a profit compared to a Long Straddle.

Strategy **LONG STRANGLE**

Buy a put option and buy a call option with a higher exercise price.

Profit and loss characteristics at expiry

Profit: Unlimited – although a significant movement in either direction is necessary to make any profit.

Loss: Limited to the premium paid to establish the position. This is greatest if the underlying futures do not move.

Break Even: If the underlying rises or falls above call exercise price or below the put exercise price by the same amount as the premium cost to establish the position.

Example

Assume the SFE SPI 200™ futures price when you establish the strategy is 3500.

Establish the Options Strategy

Buy one 3550 SFE SPI 200™ Index Call Option for the price of 14 points. Buy one 3450 SFE SPI 200™ Index Put Option for the price of 11 points.

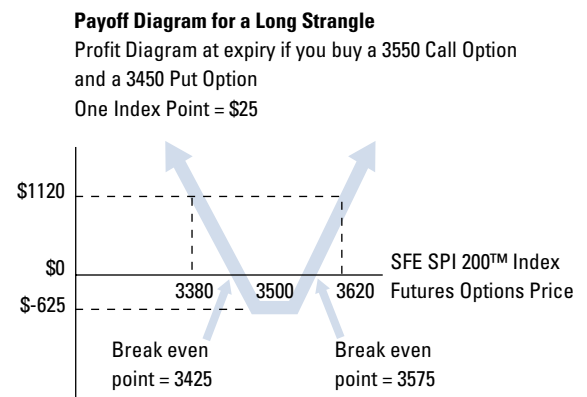
Cost of the Options Strategy

The total cost of the strategy is 25 points or \$625 (ie 14+11 points x \$25).

Payoff

The diagram to the right shows the potential profit or loss on the strategy for different futures prices at expiry. Since you paid 25 points (\$625) for the strategy, to profit you will need the futures price at expiry to have increased above the break-even point of 3575 or decreased below the break-even point of 3425 points.

The maximum profit is unlimited. If at the expiry date the futures price had risen to 3620 or fallen to 3380 points, then your profit would be \$1125. (\$1750 - \$625).



Market View Four

You believe there will not be a major movement in the futures price. Whilst the profit potential spans a larger range this is more conservative strategy than a Short Straddle as the maximum potential profit will be lower.

Strategy **SHORT STRANGLE**

Sell a put option and sell a call option with a higher exercise price.

Profit and loss characteristics at expiry

Profit: Limited to the premium you receive from establishing the position. This will be highest if the futures price is between the put's exercise price and the call's exercise price.

Loss: Unlimited for a significant movement in the market either up or down.

Break Even: If the underlying rises or falls above call exercise price or below the put exercise price by the same amount as the premium cost to establish the position.

Example

Assume the SFE SPI 200™ futures price when you buy the strategy is 3500.

Establish the Options Strategy

Sell one 3550 SFE SPI 200™ Index Call Option for the price of 14 points.
Sell one 3450 SFE SPI 200™ Index Put Option for the price of 11 points.

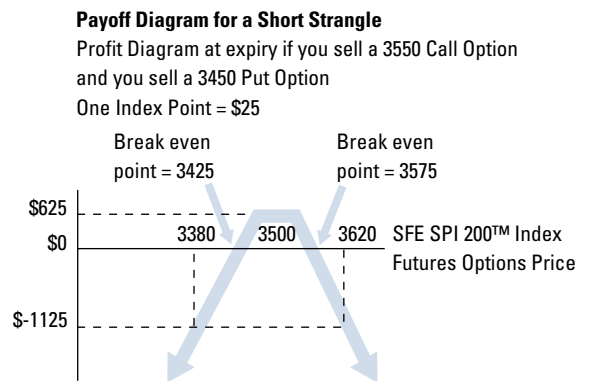
Premium Received Options Strategy

The total potential premium that you could receive is 25 points or \$625 (ie 25 points x \$25).

Payoff

The diagram to the right shows the potential profit or loss on the strategy for different futures prices at expiry. The maximum profit you could receive is the premium or 25 points (\$625). To lose, the futures price at expiry needs to have increased above the break-even point of 3575 or decreased below the break even point of 3425 points.

The maximum loss is unlimited. If at the expiry date the futures price had risen to 3620 or fallen to 3380 points, then your loss would be \$1125. (\$1750 – \$625).



The SPIDO (SFE SPI 200™ Intra-Day Options)

The SPIDO is a new trading instrument, unique to the Sydney Futures Exchange (SFE).

The SPIDO is based on SFE SPI 200™ Index Futures (the Underlying). The SFE SPI 200™ is based on the S&P/ASX 200 Index and therefore accurately represents movements in the broad Australian equity market in real-time.

Like traditional options products, the SPIDO is a highly flexible tool. It can be used individually or as part of more sophisticated strategies designed to take advantage of prevailing market conditions. The SPIDO has two notable differences to traditional exchange traded options. These are:

- 1 A one-day lifecycle
- 2 Cash settlement, not physical settlement.

As the SPIDO has a one day lifecycle, there is no initial margin to pay as there may be with regular derivatives. Cash settlement of the SPIDO means that there is no requirement to make or take delivery of the Underlying.

The profit or loss on the SPIDO at expiry is simply the difference between the exercise price and the settlement price. Of course, the SPIDO can be bought and sold during the trading day, so traders don't have to wait until market close to lock in a price.

SFE also appoints official SPIDO Market Makers to provide continuous quotation in key strikes and to respond to Request-For-Quotes (RFQs) in all other strikes, ensuring that SPIDOs can be bought and sold at any time and at a fair value.

The SPIDO is an ideal product for both speculators and hedgers.

Trading the SPIDO – Typical Applications

The SPIDO can be used individually or as part of more sophisticated strategies to take advantage of prevailing market conditions.

Speculating:

The SPIDO is an ideal tool for exercising trader judgment over a single day. Investors can buy SPIDOs to generate profit or they can sell SPIDOs to generate income. In-The-Money SPIDOs are high delta, high intrinsic value products, whereas Out-Of-The-Money SPIDOs are low delta, high time value products. SPIDOs, therefore, offer the full gambit of opportunities for traders, depending on their personal objectives.

Hedging:

SPIDOs are also an ideal product with which to hedge one day movements in the broad Australian share market. Whether protecting an SFE SPI 200™ Futures position or even a portfolio of shares, the SPIDO can be used as portfolio insurance against adverse price movements in the broad equity market.

Directional Trading using SPIDO

Bullish View

How do you profit from a rising market?

Buy a SPIDO call

Example

Buy one 3,600 SPIDO call for 5 points.

Your forecast is correct and the Underlying closes at a price of 3,618, an increase of 0.5% on the day (or 18.0 index points). The result of his trade is as follows:

Purchase price	Sale price	SPIDO Cost	Gross Profit	Profit as a % of initial cost
3,600 index points	3,618 index points	5 index points	$(3,618 - 3,600) - \text{initial cost}$ $= 18 - 5$ (or 13 index points) Each point = \$25, so total profit is $\$25 \times 13$ index points = \$325.00	$(18 - 5) / 5 = 160\%$

While the Underlying moved by 0.5% on the day, the SPIDO trade moved by 160%.
Maximum loss is limited to 5 index points (\$125).

Bearish View

How do you profit from a falling market?

Buy a SPIDO put

Example

Buy one 3,400 SPIDO put for 6 points.

Your forecast is correct and the Underlying closes at a price of 3,366, a decrease of 1% on the day (or 34 index points). The result of the trade is as follows:

Purchase price	Sale price	SPIDO Cost	Gross Profit	Profit as a % of initial cost
3,400 index points	3,366 index points	6 index points	$(3,400 - 3,366) - \text{initial cost}$ $= 34 - 6$ (or 28 index points) Each point = \$25, so total profit is $\$25 \times 28$ index points = \$700	$(34 - 6) / 6 = 367\%$

While the Underlying moved by 1%, the SPIDO trade moved by 367%.
Maximum loss is limited to 6 index points (\$150).

Individual Share Futures

INDIVIDUAL SHARE FUTURES provide investors and traders with the benefits of trading stocks on the share market with the flexibility of derivative markets. Individual Share Futures enable you to buy or sell exposure to 1,000¹ shares in Australia's largest listed companies at a fraction of the cost of buying the physical stock. Other features of Individual Share Futures include:

Leverage

Individual Share Futures enable you to trade the price of a company without having to buy the physical stock. Instead, brokers require a minimum deposit that is typically between 2% and 20% of your exposure. This means that the capital outlay to trade futures is only a fraction of the capital outlay to trade stocks.

For example you can buy exposure to 1000 NAB shares with an initial outlay of \$2000*. If NAB is priced at \$33 this provides you with approximately \$33000 worth of exposure to National Australia Bank shares. So your initial capital outlay in this example is $\$2000/\$33000 = 6\%$ of the outlay of a similar stock transaction.

Obtain leverage without any interest payments

Many products offered to investors allow you to leverage your exposure to the stock market by allowing you to borrow money to invest. With these products investors incur interest on the money that they borrow. However, with Individual Share Futures you can obtain the same high levels of leverage as these products without having to pay interest on funds borrowed.

Lower brokerage

The brokerage for trading Individual Share Futures is typically less than the brokerage for trading shares.

Cost effective method of buying shares

Individual Share Futures provide the ability/choice to take or make delivery of the stock at expiry giving you a cost effective and easy method of buying (or selling) shares.

Ability to take advantage of a rising or falling market

Individual Share Futures have no restrictions on short selling. Therefore, you avoid the complications and costs associated with borrowing stock. Some examples of trading a rising and a falling market are presented on the following pages.

Market makers

The presence of Official Market Makers ensures that Individual Share Futures have bid ask spreads providing traders with the ability to enter and exit the market with confidence.

How to work out the value of an Individual Share Futures Contract

To work out the exact value of the Individual Share Futures contract you multiply the Futures Price by the Individual Share Futures contract unit. For most of SFE's Individual Share Futures the contract unit is equal to 1000 shares.

For example, if Woodside Petroleum Ltd Futures price is \$12.00, then the value of the Woodside Petroleum Ltd Individual Share Futures contract is $(12.00 \times 1000 \text{ shares})$ This equals \$12000. For every cent that the price moves in your favour you will gain \$10 $(\$0.01 \times 1000)$.

¹ Most, but not all ISFs are based on 1,000 shares

Trading Examples Using Individual Share Futures

If you predict a stock will rise...

buy an Individual Share Futures contract and sell the contract when the price has risen.

Trading example

On a given date, you decide to buy two ANZ Bank Individual Share Futures contracts at a price of \$19.00. As one contract is equal to 1000 shares the value of your exposure is equal to \$38000 ($\$19.00 \times 1000 \text{ shares} \times \text{two contracts}$).

To buy these two contracts your broker only requires a minimum margin of \$1800* to be held as deposit.

Four weeks later, ANZ Bank Individual Share Futures have increased to \$21.30. You decide that you want to close out your position by selling two ANZ Bank Individual Shares Futures contracts. The resulting profit on the trade is $(\$21.30 - \$19.00) \times 1000 \text{ shares} \times \text{two contracts} = \4600 .

If you predict a stock will fall...

sell an Individual Share Futures contract and then buy the contract when the price has fallen.

Trading example

On a given date, you decide to sell one News Corporation Limited Individual Share Futures contract at a price of \$10.00. As one contract is equal to 1000 shares the value of your exposure is equal to \$10000 ($\$10.00 \times 1000 \text{ shares} \times \text{one contract}$). To buy this contract your broker only requires a minimum margin of \$1400* to be held as deposit.

Four weeks later, News Corporation Individual Share Futures have decreased to \$9.10. You decide that you want to close out your position by buying one News Corporation Individual Shares Futures contract. The resulting profit on the trade is $(\$10.00 - \$9.10) \times 1000 \text{ shares} \times \text{one contract} = \900 .

* the actual margin varies between approximately 2% and 20%.

SFE currently lists Individual Share Futures based on:

Alumina Ltd
Ampcor Ltd
AMP Ltd
Ansell Ltd
ANZ Bank Ltd
AXA Asia Pacific Holdings Ltd
BHP Billiton Ltd
Bluescope Steel
Boral Ltd
Brambles Industries Ltd
Coca-Cola Amatil Ltd
Coles Myer Ltd
Commonwealth Bank of Australia Ltd*
Foster's Group Ltd
Insurance Australia Group Ltd
John Fairfax Holdings Ltd
Lend Lease Corp Ltd
Lihir Gold Ltd
Mayne Group Ltd
National Australia Bank Ltd
Newcrest Mining Ltd
Publishing & Broadcasting Ltd
Qantas Airways Ltd
QBE Insurance Group Ltd
Rinker Group Ltd
Rio Tinto Ltd
Southcorp Ltd
St George Bank Ltd
Suncorp-Metway Ltd
Tabcorp Holdings Ltd
Telstra Corporation Ltd*
Wesfarmers Limited
Westfield Holdings Ltd
Westpac Banking Corporation Ltd*
WMC Resources Ltd
Woodside Petroleum Ltd
Woolworths Ltd

* Also available in cash settled contracts.

Glossary

Hedging

The act of protecting your portfolio is known as hedging. By entering into a futures or options contract you can also protect the value of your existing portfolio. Please refer to pages 6 and 7 for examples.

Closing Out

In most cases, traders do not hold their open futures position until expiry. Instead, traders normally close out their futures positions by offsetting them with another trade. To offset a position the holder of a bought futures contract sells futures and the holder of a sold position buys futures. By offsetting a futures contract, the trader cancels any obligation they have made by entering into the original futures contract. The difference between the price of the futures contract when the trade was initiated and the price when it is offset is the net gain or loss on the trade.

Deposits and Margins

When opening an account to trade futures and options your broker will ask you for an initial deposit to launch the account. This deposit will vary by broker and client and is retrievable when contracts are closed out if they are not eroded by loss. In addition to this deposit they will ask for enough money to cover the **initial margin** for each futures or options contract you wish to buy or sell.

At the end of each day, your broker 'marks-to-market' your open futures positions. This is the process by which your broker will add and deduct your gains and losses from your account balance. During volatile trading your broker might mark-to-market your positions more frequently than once a day. If your margin deposit falls below a certain level (as determined by your brokerage firm) your broker will ask you to deposit additional money to your account to bring your margin back up to the required minimum. This is called a **variation margin**. In the event that you have made a profit from your futures position your account will be credited accordingly.

Expiration of a Futures Contract

All futures contracts are quoted with an expiration month (also known as contract month). For example SFE SPI 200™ Futures have expiration months of March, June, September and December. Broadly speaking when you enter into a futures contract you are trading an agreement about how many and at what price you will buy or sell the underlying product in the expiration month. The exact day when the future expires is known as the expiry date or last trading date. If you do hold your futures contract until expiry then you must settle your position. In the case of SFE SPI 200™ Index Futures this is done via a cash payment.

Contacts

For contact details of brokers who can advise on trading futures and options, please refer to www.sfe.com.au/privateinvestors

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