REV UP YOUR RETIREMENT

10 TACTICS TO MAKE YOUR MONEY LAST LONGER

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HEDGE YOUR BETS WITH OPTIONS

Options are probably the best-known derivative instrument and are easily bought and sold by retail investors in the Australian sharemarket.

They can be used as hedging tools or as highly leveraged bets. Prudent investors could do worse than follow the rules laid out in the legislation for superannuation funds, says Wai-Yee Chen, the Sydney-based head of derivatives at RBS Morgans' Asian desk and author of *OptionsWise: How to invest sensibily*.

Those rules specify that super funds are not to use derivatives to gear up. Investors will fall foul of this rule if they use options – or other derivatives – to take a punt on a large move in the value of an underlying asset. Investors are gearing because, using derivatives, they're seeking a potential gain at only a fraction of what it would have cost to buy the underlying shares.

As mentioned previously, options give the holder the right to buy or sell the underlying asset at a predetermined price within a set period, usually about three to six months, although it can be longer.

For a call option over a listed share, you pay a premium to the seller for the right to buy the share at the exercise price before the option expires. In the case of a put option you're buying the right to sell the share.

Say you're worried about China's economic growth, and think BHP Billiton (BHP) shares could be in for a fall in the coming nine months. Assuming BHP Billiton shares are now worth about $41, you could buy a BHP put option with an exercise price of $38 and nine-month expiry.

The timeframe and the exercise or strike price will determine the premium you pay. Each option contract usually covers 1000 shares and the number of contracts you buy would reflect how much of your position you want to cover.

Let's assume you hold 1000 BHP shares and so you buy one contract. If the premium is $3, you'll pay $3000 for the contract. You're now protected should BHP's share price move below $35 (the $38 strike price minus the premium of $3) as you can exercise your option to sell your BHP shares and receive $35 each. You'll still have lost money but not as much as you would have otherwise. If the price moves up over the six months, the option expires and you lose your premium.

A similar effect can be achieved but for your entire portfolio by hedging market risk through buying an S&P/ASX 200 put option, which settles in cash rather than shares.

Investor's view:
Woolworths (WOW) shares are good value at the current price.

Investor's intention:
Buy 1000 WOW shares at $26. The retailer last traded at $26.

WOW, WHAT A DEAL ... BOOST RETURNS, BUT COVER YOURSELF	
Options strategy	Sell one put on WOW
Contract specifications	June 2010; $26 strike price
Income	$1.20 an option or $1200 per contract income
Total margins	$2000 per contract (ASX margin estimator)
Break-even purchase price	$24.80 ($26 strike minus $1.20 premium)
Maximum exposure	$24,800 cash (including $1200 premium received)
Reward	• Opportunity to buy shares at a lower price of $24.80 if WOW expires below $26. • Earn extra income of $1200 if WOW expires above $26 (though not successful in buying shares).
Risks	• No protection if WOW falls below $24.80. • Investor may end up buying shares at $24.80 when the prevailing market price is lower. • Investor undertakes gearing if not fully covering exposure of $26,000 per contract.

Source: Wai-Yee Chen, author of OptionsWise: How to invest sensibly

It takes two to tango, and so it is for options contracts. Not only can you buy an option, you can also sell the right to buy or sell shares to somebody else, receiving a premium in return.

That ability to sell a contract separates options from warrants and CFDs.

Deciding to sell options over your shares is a more complicated and potentially risky proposition than buying options. But if it is done carefully and in certain situations, it can be a profitable trade.

In our example above, we've looked at an investor who plans to buy a thousand Woolworths shares at $26 each and who wants to boost the return by selling a put contract (see above). She receives $1.20 for each option, or $1200 for the contract, which expires in about two months' time.

This time, the investor has an obligation to buy a thousand Woolworths shares at $26 if the other party chooses to exercise the right to sell in the coming two months. That could happen if the price falls below the exercise price of $26. But because the investor is receiving $1.20 in premium per option, she'll still be better off if she buys the shares at any price above $24.80 ($26 minus $1.20). If the price falls below $24.80, the investor loses out. If Woolies shares stay above the strike price, the contract expires and our investor is $1200 better off.

Instead of paying the premium, the investor is now receiving it. Importantly, this investor is fully covered with $26,000 in the account. Technically, when selling a put, investors are only required to hold a small portion of the value of the underlying asset – referred to as the margin. That's known as a naked position and it can be dangerous. Prudent investors are advised to be fully covered.

The bottom line is be prepared for the worst-case scenario and be ready and able to buy or sell the underlying shares.