

The Quest for Efficient Markets: When Good Predictions Go Bad

OPTIONS EDUCATION



Steve Meizinger, Director of Education at the International Securities Exchange (ISE), is a leading expert in Forex, equity, and index options trading. As a top rated instructor for ISE and the Options Industry Council, Steve has led thousands of seminars, helping investors navigate the market and identify the most appropriate trading strategies. Steve has over twenty years experience as an Options Specialist at several leading exchanges, including the NYSE, PHLX and AMEX.

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Though impossible to predict with total accuracy where the markets are headed, options are a versatile tool for investors looking to hedge their exposure or implement their forecasts.

As we have learned from the recent market turmoil, financial models can never fully replicate reality. While these models play an important role in helping understand probabilities in the markets, they still can't predict the future. Instead, investors should focus on diversifying their portfolio into multiple asset classes to help reduce their exposure to risk. One alternative is the listed options exchange market, which offers a wide range of strategies suitable for any market condition with limited risk.

What makes the markets tick? How is information priced into the markets? Is there a way to accurately predict where the markets are headed? Why can't I just create a spread sheet with X variables to calculate the expected future values of the markets?

Technology has truly altered so many aspects of our day-to-day lives; it's not surprising that we expect the same convenience from the financial markets. Unfortunately, it's not that simple.

Investors should focus on diversifying their portfolio into multiple asset classes to help reduce their exposure to risk.

In order to meet your financial goals in today's environment, it's imperative to consider all of the different asset classes, including cash, equities, bonds, foreign currencies, natural resources, precious metals and real

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estate. If you are actively managing your own finances, exchange-traded options are one of the most versatile trading instruments with strategies for forecasting and hedging to minimize your exposure to risk. It's just a matter of selecting the most appropriate strategy, based on your specific financial goals and risk tolerance. Options are available in equities, equity indexes, and Exchange Traded Funds (ETFs). A relatively recent introduction by the International Securities Exchange (ISE) offers exchange-traded foreign currency options on six of most popular currency pairs.

The markets price risk each and every trading day. How is this risk priced? According to the Efficient Market Hypothesis (EMH), prices on traded assets already reflect all known information. There is much debate on EMH since it assumes that the financial markets are "informationally efficient," meaning it's impossible to outperform the market by using information that it already knows. Therefore, EMH theorizes that the only way to beat the markets is through random luck. Regardless of your take on EMH, the financial markets still provide investors with a wide range of trading opportunities in multiple asset classes.

Foreign exchange is the asset class that determines the relative value of money. The markets are constantly anticipating the release of new information, including "numbers" announcements (i.e., Central Bank interest rate policy meetings, employment, inflation, consumer, and housing reports). Since the financial markets are so unpredictable, investors should never lose sight of what is driving their behavior. Blindly following certain economic releases is not in your best interest – you need to know how to interpret the information. While the economic number is important, so is the market's expectation for that particular release. These expectations cannot easily be quantified. Even if they were, the "new information" is virtually an unknown. So the market's reaction to new information further underscores the uncertainty in market pricing creating even more potential risks. This is where ISE FX Options can help investors trade their view or hedge their currency exposure.

Because options are so versatile, investors can select from a wide range

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of trading strategies that balance between the risk and rewards trade off that is most appropriate for them. Though there are many different options terminology to learn (i.e., calls, puts, expiration months, strike price, premiums, intrinsic value, extrinsic value and volatility), with practice these terms become almost second nature. ISE FX Options allow you to implement your view of the U.S. dollar (USD) against the six major currencies, using the USD as the base currency. Using this convention, if you are bullish on the USD you simply purchase calls. If you are bearish on the USD, you purchase puts. Simple call and put strategies are the most straightforward option strategies. There are also spread strategies that allow you to implement bullish, bearish, or even neutral options strategies for the USD. Spread strategies also help to mitigate the risks of time

CONSTRUCTION OF ISE FX PAIRS

| CONVENTION | ISE FX SYMBOL | RATE MODIFIER | ISE UNDERLYING RATE EXAMPLES |
|------------|---------------|---------------|------------------------------|
| USD/AUD | AUX | 100 | 153.94 (1.5394 X 100) |
| USD/GBP | BPX | 100 | 72.55 (0.7255 X 100) |
| USD/CAD | CDD | 100 | 130.13 (1.3013 X 100) |
| USD/EUR | EUI | 100 | 78.76 (0.7876 X 100) |
| USD/CHF | SFC | 100 | 115.65 (1.1565 X 100) |
| USD/JPY | YUK | 1 | 97.39 (97.39 X 1) |

decay and volatility.

Options can be tailored to meet your own FX market forecast while balancing between your investment goals and tolerance for risk. Some of the key benefits to trading FX Options include their limited risk, the ability to implement longer term strategies (relative to the short-term nature of the FX Spot market), as well as the multiple combinations of expiration months and strike prices.

As of March 9, 2009, the CDD (USD/CAD) closed at a multi-year high value, indicating that the USD was extremely strong relative to the CAD

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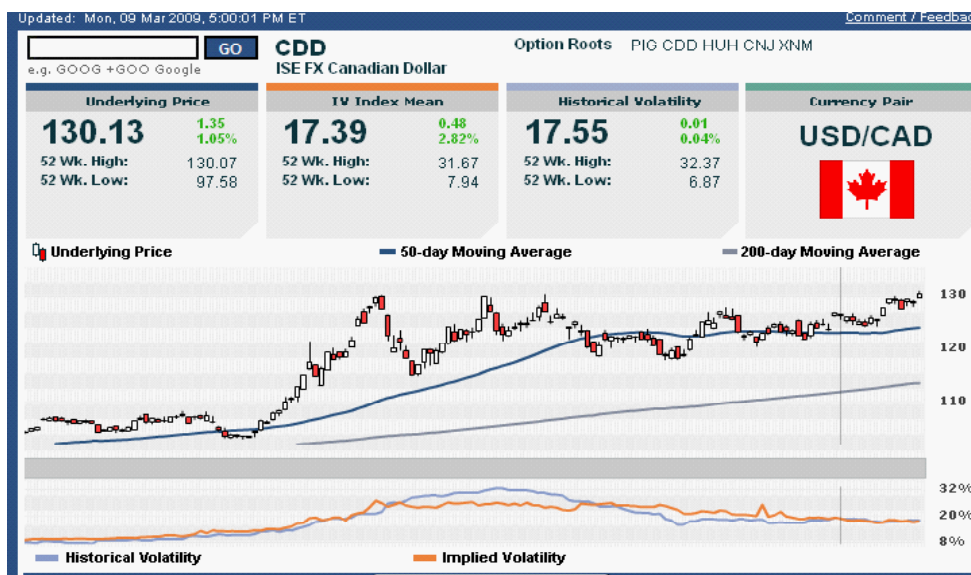
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(Canadian dollar). If you are expecting a further strengthening of CDD, you can simply purchase call options to implement that bullish USD forecast. There are many different months available. For this example, I looked at the May options. The at-the-money call (130) was priced at \$4.35. If the option was purchased, the risk per contract would of have been \$435 (not including commissions). One method for examining the risk of the trade is to review the break-even at expiry. The break-even at expiry for calls is the strike price (130) plus the option (4.35). If you felt that CDD is going to trade above 134.35 prior to the May expiration, then purchasing CDD 130 calls would be one viable option strategy. If you prefer a higher delta, then you could purchase 128 calls with a cost of \$5.43. If you wanted more leverage (with a lower cost and lower delta), you buy the 132 calls for \$3.45.

If you are expecting a further strengthening of CDD, you can simply purchase call options to implement that bullish USD forecast.

USD/CAD (ISE Symbol: CDD) on Trade Date – March 9, 2009



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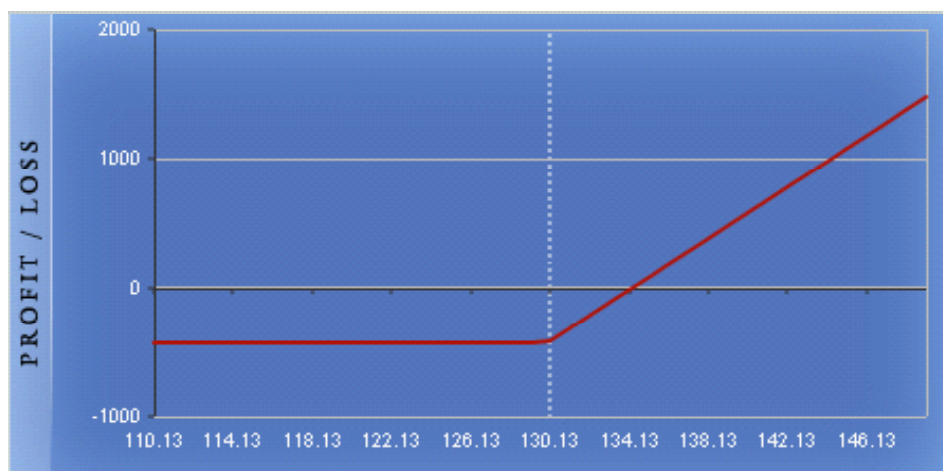
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BUY A CALL

Bullish on the U.S. dollar/Bearish on the CDD

Buy 3 Month \$130 Call \$4.35
\$4.35 Net Debit



Alternatively, a bearish USD forecast means you are expecting weakness in the CDD. You can purchase put options to implement that specific view. Using the same May time frame (where there were many strike prices available), the at-the-money put (130) is priced at \$3.66. If you purchased that option, the risk per contract would be \$366 (not including commissions). Break-even at expiry for puts is the strike price (130) less the option premium (3.66). If you felt that CDD is going to trade below 126.34 prior to May expiration, then it makes sense to purchase CDD 130 puts. If you preferred a higher delta, then purchase the 132 puts, costing \$4.76. If you preferred more leverage (with a lower cost and lower delta), purchase the 128 puts for \$2.75.

Alternatively, a bearish USD forecast means you are expecting weakness in the CDD.

Options also allow investors to target many different investment objectives. With all the technology currently available for your portfolio, solely using a “black-box” trading methodology might not be the wisest choice. Technical strategies that exclusively use

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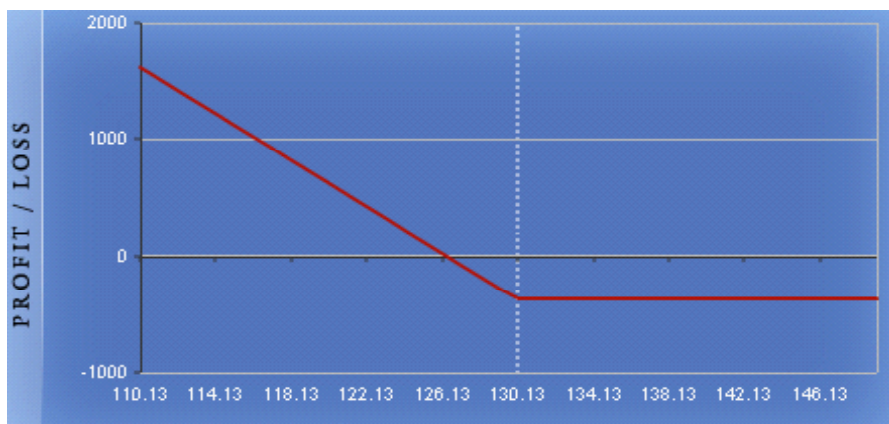
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BUY A PUT

Bearish on the U.S. dollar/ Bullish on the CDD

Buy 3 Month \$130 Put \$3.66
\$3.66 Net Debit



moving averages, Bollinger bands, or oscillators can experience significant draw-downs. Options are also complementary to many FX trading strategies. What happens when highly unlikely events occur? How much will the strategy lose? Unfortunately, there are no guarantees with any strategy, no matter how successful it has been in the past. Options offer investors unique payoffs that allow them to assess the best and worst case scenarios for any strategy.

Investors should also take into account the behavioral aspects of trading since having a good risk-reward trade off is critical for success.

Trend trading has regained its popularity in the past few years. The trading phrase “the trend is your friend, until the end” needs to be reexamined, because it can misguide many investors. Each day, the markets react to new information. Rather than just relying on trend loyalty, the risk-reward trade off should constantly be reevaluated. On the other hand, being a consistent contrarian is not advisable. The fa-

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amous British economist, John Maynard Keynes, once remarked, “Markets can remain irrational far longer than you or I can remain solvent.” His point was to warn investors in blindly trading against the trend.

Clearly, the choice is yours in determining which, of the many, trading strategies to employ, while also taking into account your financial goals and tolerance for risk. The only challenge is being able to assess exactly how expectations are priced into the markets. Therefore, you should be flexible with your investment strategies. Whether you are trading with or against the trend or using technical or fundamental analysis, ISE FX Options are a great alternative for trading the foreign exchange market. All you need to do is to have a forecast and pick a strategy. You should also try to limit your FX market risk to a quantifiable amount. ISE FX Options also help you cope with all the vagaries of market volatility, while continuing to target own your financial goals.

Rather than just relying on trend loyalty, the risk-reward tradeoff should constantly be reevaluated.

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