

FX OPTIONS: Globalization of the Forex Market

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.

## Globalization of the Forex Market – New Trading Opportunities Using FX Options

The price of money is determined in the foreign currency market, FX Options provide investors with the versatility needed to hedge their risk and profit.

Why are financial institutions monitoring the price trends of the foreign exchange market so closely? What is their objective? Why should you be concerned and how does this impact your portfolio? Are there trading opportunities that you should consider? How do options fit into FX trading? I will attempt to answer all of these commonly asked questions, as well as why investors need to start educating themselves about the foreign exchange market.

The foreign exchange market has had an ever-growing influence on the equity, bond, commodity and real estate markets, having changed dramatically since the advent of free-floating currencies in 1971. This change was brought on by the explosive growth of globalization and technology, impacting every individual worldwide. Goods are now manufactured across the globe. Is this a positive or negative development? Unfortunately, it is not that clear-cut. It is most likely a mix of both, since as with many opportunities in life, there is usually a trade-off. Consumers may receive lower prices for their goods, but displaced workers in higher cost countries/regions may feel the adverse impact.

The foreign exchange market is responsible for pricing the currencies involved in these international business transactions. This market is ultimately determined by supply and demand. The FX market is just a formal mechanism for finding price equilibrium, each day, for buyers and sellers

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of the respective currency pairs. Technological advances have extended the transparency of the market as well as the reach of the market to many new participants. This transparency has increased the integrity of the market by giving participants confidence in the foreign currency market. The FX market price has an enormous impact on the international business community.

To gain additional perspective on today's foreign exchange market; let's look at the past. Back in the early 1970's, the Nixon Administration was faced with some very tough decisions. The Vietnam War and an economic slowdown in the U.S economy created a difficult monetary and fiscal situation. Inflation started to heat up creating a highly precarious position for the United States. The U.S. was forced to abandon the gold standard, whereby U.S. dollars were readily transferable into a fixed amount of gold. Up until 1944, the U.S. dollar was fixed at a price of \$20.00 to one ounce of gold. That price was subsequently increased to \$35.00 per ounce after 1944. By the end of the 1960's, the U.S. was under pressure to devalue the USD once again due the decreasing demand for U.S currency. The U.S. was forced to abandon the gold standard in 1971, ending the dollar-gold convertibility. The "official" gold price was raised to \$38 in 1972. By 1974, gold soared from the previously fixed price of \$38.00 to \$195.00. By releasing the "fixed price" of dollars to gold this inevitably led to the "floating" of the world's currencies relative to each other. This was the very beginning of the currency market as we know today.

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As the US dollar floated, investors began to consider other alternatives than just keeping all of their savings in US dollar investments. For additional perspective, let's take a look at the US dollar over the last 36 years from 1944 and to today. In 1972, \$1 could be converted to gold at \$38 per ounce. Today (August 2008), 1 ounce of gold costs approximately \$800. Using a compound growth rate calculator, gold has increased at an annual compounded growth rate during the period of 1972-2008 of 8.83%. Conversely, the US dollar has fallen by 8.83% per annum during that period relative to the price of an ounce of gold. We, should be concerned with this dollar devaluation and consider the implications for our own portfolios.

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So, the dollar devaluation relative to gold is important. What about the foreign exchange market, isn't that important too? If you live, work and invest in a certain country, why should the "price" of the currency matter to you? Investors must realize that their own currency is priced not only relative to commodities, but against other currencies. Being apprised of not only the inflationary view of the market (as measured by gold) but the relative value of your currency compared to others is also important. Currencies are a means of payment and create a relative price of equal goods in two economies. The exchange rate is, therefore, an enormous factor in global competition. The expansion of economic activity in countries such as Brazil, Russia, India and China have greatly affected the United States, Europe, Canada, Japan, United Kingdom and Australia. This has created currency pricing shifts that influence an individual's real estate values, employment wages, their retirement assets, even energy and food costs.

Investors with a long term trading plan can take advantage of sudden FX pricing shifts by trading the foreign currency market.

A deeper understanding of the relationships between the different economies and their currencies gives investors an opportunity to hedge their overall financial position relative to another currency, or, for the more aggressive investor, to exploit opportunities in the foreign currency market when they arise. The economy is truly global with information traveling around the world in milliseconds. Ironically, an increase in value for a country's currency translates into a manufacturing cost disadvantage in the global market, for which an economy has to make up with efficiency gains. The offsetting balance is that as your currency strengthens certain goods, such as energy and food, and may become less expensive in relation to other nations with weaker currencies. With technological advances and cost savings, corporations now find it much easier to shift their production facilities to the most cost effective country or region very swiftly. Recent trends indicate that the global workplace encourages lower prices worldwide. Each trading day, the foreign exchange market factors in multiple dimensions from business into one currency pair. Investors have a good understanding and a long term trading plan can take advantage of sudden FX pricing shifts by trading the foreign cur-

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rency market.

Traditionally, investors would measure their portfolio’s performance relative to a locally calculated index. Some of the most popular equity indexes in the world are as follows: Nikkei 225 (Tokyo), FTSE 100 (London), DAX (Frankfurt), TSX (Toronto), S&P/ASX 200 (Sydney) and the SP-500 (New York). Normally the returns are calculated in the local currency. What if the index is moving up but the local currency is actually declining? This would cause non-local (international) investors a currency drag on those local index returns. An example would be Canadian investor with their assets invested in the U.S. SP-500 index in 2007. The U.S. dollar dropped approximately 14% against the Canadian dollar that year. The SP-500, in USD terms was up about 4% in 2007. But in the context of the Canadian investor, considering the USD dollar devalued 14% against the Canadian dollar, the loss for the SP-500 portfolio in Canadian investor would be negative 10% net of the currency translation. Using ISE FX Options® (please refer to the table below) there are many strategies that could have been used to mitigate most of that currency risk. Just remember that options are about risk and reward. If an investor wants to hedge out some

Investors that are looking for asset classes that have very low correlation to the equity and bond markets might want to consider foreign currency trading.

### CONSTRUCTION OF ISE FX PAIRS

CONVENTION	ISE FX SYMBOL	RATE MODIFIER	ISE UNDERLYING RATE EXAMPLES
USD/AUD	AUX	100	107.10 (1.0710 X 100)
USD/GBP	BPX	100	50.65 (0.5065 X 100)
USD/CAD	CDD	100	102.88 (1.0288 X 100)
USD/EUR	EUI	100	64.36 (0.6436 X 100)
USD/CHF	SFC	100	104.96 (1.0496 X 100)
USD/JPY	YUK	1	107.57 (107.57 X 1)

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currency risk, an additional debit must be paid for the option. As investors, we wonder “what trading strategies are the larger financial institutions implementing?” More recently, large institutions have been known to employ several different strategies in relation to foreign exchange trading. Similar to retail investors, the institutional goal is to find profitable strategies that will lead to greater trading profits. Following are just some of the most popular strategies: trend following, relative-value, carry-trade and volatility trading. As a result of the explosive growth in the foreign exchange market over the past few decades and the corresponding liquidity, many institutions can enter and exit trades with just a subtle price impact in the foreign exchange market. Now that ISE FX Options are available, larger institutions and individual investors are taking advantages of its unique market structure. Most of the familiar strategies that have been used in the spot-foreign exchange market can be adapted to the options market in various shapes and forms.

Trading the technical trend by using technical analysis is a strategy that is familiar to most investors. Relative value trading uses the concept of fundamental value between a certain price good in country or region relative to another country or region. Carry trading is based on the concept that foreign currencies offer differing risk-free interest rates and the strategy attempts to forecast the future changes (or lack thereof) in the respective countries’ interest rates of the various risk-free interest rate spreads for profit. Volatility trading uses the option volatilities to predict either greater underlying pair movement or a reduction in pair movement. Investors might actually have an edge in many of these categories relative to larger institutions. Since retail investors normally trade in smaller trading unit sizes, they have a slight edge when entering and exiting their trades. Retail investors must also have a well organized trading strategy based on sound trading principles.

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Determining if the FX market is appropriate for you is based on your financial goals and your own risk tolerances. The use of options allows for many

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different strategies, including hedging, increasing portfolio returns by the use of selling options and various spread strategies that allow the investor to actually select their own risk and reward tradeoffs. There are many sub-classifications of these three broad categories. Just as a reminder, ISE FX Options allow investors to implement their specific forecasts on the US dollar relative to another currency. The ISE FX Options are US dollar based. The trading convention is intuitive, if you are bullish on the USD, you can implement that forecast by purchasing calls. If you are bearish on the USD, you can implement that forecast by purchasing puts. There are, literally, thousands of options strategies, and, most important, there is no one supreme options strategy. The options market offers tremendous opportunities each trading session, the key question for investors is what are they looking for? The essence of trading is determining what you are good at forecasting and then trading within your risk tolerance.

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According to the Bank for International Settlements the traditional turnover for the foreign exchange market has compounded at 17.67% increase from the years 2004-2007. What is fueling this explosive growth? Globalization is one factor, but another driver has been the growth of electronic FX trading. Larger institutions can now set up algorithmic trading systems that have all of the pre-defined rules of trading. Retail investors now have the ability to use algorithms based on their very own set of trading rules. Interestingly, spot FX trading is losing market share (although it did increase in aggregate turnover) to other categories such as swaps, forwards and options. The ISE FX Options market is fully electronic with complete transparency for all market participants. Options give the self-directed investor a wide range of alternatives. With the impact of the foreign exchange market on equity, bond, commodity and real estate markets, options provide investors with financial versatility. The flexibility in the market structure, with a wide range of currency pairs available for trading (calls/puts, strike prices and expiration months), can help meet every investor's needs. The most important consideration is your trading plan. ISE FX Options gives investors a greater range of tools to meet your financial goals. How you use those tools is entirely up to you.

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