

FX OPTIONS: More Options for Spot Traders

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 of experience as an Options Specialist at several leading exchanges, including the NYSE, PHLX and AMEX.

FX Options: More Options for Spot Traders

With so many trading strategies to choose from and the limited risk, FX Options are especially helpful in volatile markets and are a great alternative to Spot Trading.

It doesn't matter what medium you are using to get your financial news, one thing has been fairly consistent—extensive coverage of the US dollar. Whether you are on your favorite financial website, blog, newspaper or television channel, you have most likely stumbled across headlines saying: "US dollar rallying"; "US dollar slumping" or "US dollar holding steady". The foreign exchange market was created as a mechanism to facilitate global trade; it is a relative market. For example, currencies trade in pairs; therefore, you need to have two views, a bullish view on one currency and a bearish view on the opposing currency.

Not only has there been more coverage on the FX market lately, but due to recent technology advancements, the market is much more accessible and transparent these days. Decades ago, foreign exchange trading was done primarily by large banks and other financial institutions. Today, retail investors easily and openly participate in the foreign exchange market. One relatively new development is the introduction of exchange-listed foreign exchange options. The International Securities Exchange (ISE) now offers options trading in six currencies relative to the United States dollar, providing investment opportunities for any market condition. What are the differences between spot FX trading and trading listed ISE FX Options? I will examine these differences and provide some deeper insight into the benefits of ISE FX Options®.

Today, retail investors easily and openly participate in the foreign exchange market.

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In order to decide whether this is the right investment class, you probably want to answer a few questions first: *What are options?* With options you have more choices and increased flexibility when selecting your foreign exchange trading strategy. Options allow you to trade in view of your own unique risk/reward tradeoffs. *How can I understand all of the terminology required?* There are rights, obligations, premiums, strike price, intrinsic value, expiration, calls and puts and settlement process, to name just a few. These terms may seem a little intimidating, but it is worth spending even just a small amount of time learning some of the options jargon.

The US listed equity options market has existed for over 35 years. ISE is the world's largest equity options exchange and the first fully electronic options exchange (launched in 2000). Experienced equity options investors have learned that the options market offers another dimension of choices. ISE currently trades equity, Exchange Traded Fund (ETF), index and foreign currency options. The exchange is regulated by the Securities and Exchange Commission, which means the FX Options can be traded from an options-enabled brokerage account. One major difference between the spot FX market and ISE FX Options is that the ISE does not hold your trading account. ISE's markets were built with a market maker mode; market makers are assigned different trading instruments where they are responsible for providing ample liquidity each and every trading day; thus increasing the integrity of the market. ISE has created very liquid markets with complete transparency for all market participants.

With options you have more choices and increased flexibility when selecting your foreign exchange trading strategy.

If the ISE does not hold your trading account, who does? ISE FX Options can be easily traded through all options-enabled online brokerage accounts. Some of these brokers have both spot trading and ISE FX Options capabilities. While each broker provides its own unique benefits, you need to pick the one that's right for you, based on your investment goals. To learn more about ISE FX Options, sign up for trade alerts and ISE's weekly webinar and podcast series, visit www.ise.com/fx. For more general options education and tools, visit www.optionseducation.org, an Options Industry Council (OIC) site.

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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)

If you have been trading the spot foreign exchange market, you already know that the base currency varies dependent on the specific pair. According to the Bank of International Settlements in 2007, approximately 86% of all foreign currency transactions involve the US dollar. With that in mind, ISE decided that its FX Options would originate with the USD as the base currency for all the pairs. Another important consideration was to ease options trading. Since the USD is the base currency for the all of the ISE pair values, if you are bullish on USD you could simply buy call options or, conversely, if you are bearish on the USD, you buy put options. The dollar relative convention allows ISE FX Options to be consistent for all the currency pairs. While this diverges from the spot FX market, it allows for ease of use in implementing call and put strategies. ISE FX Options are currently available in six currency pairs, as illustrated above.

To help explain options, I will provide a more practical example. Years ago, I used to visit a local pizza restaurant with my family and order a pizza each time we visited. As an incentive, the restaurant gave us a coupon every time we came for a pizza, where, after obtaining five coupons, we had the option to purchase a pizza at a 50 percent discount. In effect, we were given a call option to purchase pizza at a 50% discount. Of course, we were under no obligation to exercise that option. In our case, we always exercised the option since we liked the pizza, especially at the discount. We were holders of the option (though, in the listed

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options market, options are not available for free). Listed options have rights and obligations. There are two types of options, **calls** (the right to purchase the exchange rate) and **puts** (the right to sell the exchange rate). Another way to consider options is in relation to your car or home insurance. Owning insurance is a form of a put option.

The concepts of **rights** and **obligations** are extremely important to understanding the options market. For example, investors that purchase rights pay **premiums** to the option sellers. The option sellers earn the premiums but are obligated to sell the underlying exchange at a certain price (the strike price for calls) or obligated to buy the underlying exchange rate at a certain price (the strike price for puts). What is the benefit to options then? Limited risk for the buyer of the options. The most you can lose if you purchase an option is the amount you paid for the option (options must be paid for next day in cash). Two simple strategies are buying calls if you are bullish on the USD or, buying puts if you are bearish on the USD.

What is the benefit to options then?
Limited risk for the buyer of the options.

The buyer's pay premiums to the seller's based on the supply and demand factors of the options market. The option premiums are disseminated each day. For example, if an investor was bullish USD/JPY, he might look at the calls to implement that bullish view on ISE symbolYUK. Based on this forecast, an options buyer is expecting their premium to expand so that they can sell the options at higher prices to their initial trade. Options sellers have the reverse view; they hope that the premiums contract so that they can buy the options back at lower prices to their initial trade. The ISE FX Options market is open each trading day from 9:30 ET to 4:15, nearly concurrent with the equities market. The option premiums that are quoted on the ISE are multiplied by \$100 giving the investor the aggregate funds that will be either be debited or credited. For example, a premium of \$1.00 would be \$100 per contract paid by the option buyer to the option seller. The brokerage commission varies from broker to broker.

The rights and obligations do not exist in perpetuity; options have a limited life span. An investor must decide the length of time they would like to purchase. In most cases the more time, the higher the premium.

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If an investor wanted to own the right to buy the exchange rate for three months at a certain price, the strike price, it would normally cost more than an option to buy the exchange rate for one month at the identical strike price. Of course, investors that wanted to own the right to sell the USD exchange rate for three months would normally pay more than an investor that wanted to own the right to sell the USD exchange rate for one month at the identical price. One disadvantage of owning an option is that the time value of the option depreciates as time passes, while all other factors remain constant.

Options can be used for a variety of reasons. Options were created to transfer risk from those parties that want to reduce their financial risk to those that are willing to expose themselves to more risk in return for the option premium. Again, think of it in terms of an insurance policy, non-US investors that are call buyers are hedging their currency risk relative to the US dollar (i.e. yen). For those investors that wanted to insure their USD exposure, ISE FX puts are available. There are many different time periods, called **expirations**, and **strike prices**, the price at which the contract exists. Hedging is not the only use for options. For limited risk, options also allow investors to make forecasts on the USD relative to another currency. There are many other available strategies, but investors should also understand the risks and rewards inherent in any options transaction.

Options were created to transfer risk from those parties that want to reduce their financial risk to those that are willing to expose themselves to more risk in return for the option premium.

Since options have a limited life, what happens to them at expiration? Do you have to hold them until expiration? No, you do not have to hold them until expiration. Each day, there is a market for all the different options, although, some options may expire worthless as time goes on. At expiration, ISE FX Options are cash-settled, meaning that if the option has value at expiration that amount is paid to the buyer from the seller. For example, an investor decides to buy a two month YUK 110 call (a right

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to buy the exchange rate) when YUK is 108 for \$1.25. Assuming the buyer does not, subsequently, sell the option back to the options marketplace, but holds the options until expiration two months later, *what is its worth at expiration?* That value is called **intrinsic value**, (the difference between the strike price and the ISE pair value). The intrinsic value is the ultimate value at expiration. Prior to expiration, an option premium consists of intrinsic value and time premium. At expiration, all options are worth zero or their intrinsic value. An alternative way to look at the intrinsic value is the value of an option if it were exercised immediately. If the YUK value expired at 112, the 110 call would be worth \$2 or \$200 per contract. If YUK closed at 109 at expiration, that corresponding call would be worth 0. The options seller would be able keep the entire premium they originally received.

But it does mean that with less correlated positions, the likelihood of all of your positions moving against you is lower.

Premiums drive the options market as “pips” drive the spot FX market. The FX options market has many different strike prices to select from. There are three main strike price categories. The categories are determined by how far the given exchange rate pair is from the strike price. The three categories are: **in-the-money**, **at-the-money** and **out-of-the-money**. In-the-money (ITM) options have intrinsic value and cost the most in nominal terms. They will “act” in price most like the spot market. The benefit of ITM (in-the-money) options is a higher correlation of option price movement with the underlying spot. One of the main disadvantages of the ITM options relative to at-the-money and out-of-the-money is the cost is higher. This cost translates into greater option price risk for the option buyer.

At-the-money options tend to be the most popular for options investors. An at-the-money (ATM) strike is defined as the given exchange rate pair value having an almost equal value with the strike price. They have no intrinsic value, but the potential to gain intrinsic value relatively quickly. For example if YUK is trading at 108, the 108 calls and puts would be defined as ATM. ATM options are a balance between the in-the-money options and the out-of-the money options. *Why would an investor need an ATM option, why not just buy the spot value?* The answer is that the option

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reflects the limited risk. It's important to remember that you cannot lose more than you paid for the option. In the spot market, many investors tend to use tight stop loss orders to reduce their catastrophic loss occurrence. The disadvantage of using stop-loss orders is that occasionally the spot trader may be forced to exit from potentially profitable trades due to using tight stop orders. Long options have an embedded stop-loss feature. Option buyer's maximum risk is the option premium. Options offer limited risk and are especially helpful in volatile markets.

Out-of-the-money options tend to be the most speculative of the three strike price categories. An out-of-the-money (OTM) option would be defined as having no intrinsic value, and also with a low probability to gain intrinsic value relatively quickly. For example if YUK were trading at 108, the 111 calls or the 105 puts would be defined as OTM. *Why would an investor purchase an OTM option, why not just buy the spot value?* Again the answer is the option reflects limited risk. The OTM will be even less expensive than the ATM option, with a lower probability of success. OTM options tend to be used when investors are expecting a large move up in the USD exchange rate (calls) or a large move down in the USD exchange rate (puts).

How does leverage relate to options? When trading spot FX, many investors are faced with the dilemma of how much leverage should to use. *Is it 10 to 1, 25 to 1, 50 to 1 or more?* Leverage can be a double-edged sword. If your forecast is correct, leverage allows you to magnify the gains. If your forecast is wrong, increased leverage only magnifies your losses. *What is reasonable?* The spot trader needs to make that decision based on their individual goals and risk tolerances. When trading options, the leverage consideration is based on the selected strike price. ITM options have the least leverage, but you can lose the most in nominal terms. ATM options have a bit more leverage than ITM, but they cost less with a lower probability of success. OTM options have the most leverage with the low-

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est probability of success. Leverage is not the only consideration when trading ISE FX Options. An investor should consider how quickly they believe the pair value could move and in what time frame. You should always consider, *"If I am wrong, how much could I lose?"*

Another difference between ISE FX options and the spot market is that the interest rate differential is priced into the options market each day. After an investor purchases an option, there are no subsequent debits or credits to your account. The total cost is the premium multiplied by 100 and any brokerage commissions that might apply. Options pricing models are available to aid investors in the selection of the proper strike and month for the option they select. The parameters that affect the ISE FX Options price are: ISE exchange rate value, interest rate differential between the two currencies, option volatility, time remaining until expiration and the strike price.

One of the key advantages of ISE's market is that it is market maker-driven, removing any exchange conflicts of interest that exist in the spot FX market.

ISE FX options are options on the exchange rate themselves. Using the ISE FX Options trading convention, the USD is the base currency. The valuation is expressed as the number of units of the other currency per US dollar. Think of it as, *"What is the US dollar really worth relative to another currency?"* There are many strike prices available and various expirations extending as far back as ten months. The options are cash-settled at expiration. The settlement occurs each month, normally on the third Friday of the month at the noon buying rate of the New York Federal Reserve Bank. Cash-settlement avoids any further complications at expiration of ending up with an unwanted underlying position. The premiums are dynamically priced and they are quoted in US dollars.

ISE FX Options are available through conventional equity brokerage accounts. One of the key advantages of ISE's market is that it is market maker-driven, removing any exchange conflicts of interest that exist in the spot FX market. ISE provides investors with the ability to trade foreign currency

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options, but will never take the opposing side of an investor's trade. Another benefit is the enhanced transparency of the ISE FX Options market relative to the spot market.

The exchange-listed options market provides numerous benefits for investors. Specifically, ISE FX Options allows investors to manage their foreign currency risk more efficiently than spot trading. With the unique alternatives that options provide, each investor is able to pick the best options strategy that is most compatible with their risk/reward tradeoffs. Options give buyers the right to buy or sell the US exchange rate at a certain price, the strike price, and a certain time, the expiration date, with limited risk. If you believe the US dollar will increase in value you buy calls to implement that view. If you believe the US dollar is going to decline in value, you simply buy puts.

If you believe the
US dollar is going
to decline in value,
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puts.

As you learn more about options, there are so many different FX options strategies that you can implement. Whether you choose to hedge, implement a directional FX bias or build more advanced options strategies, ISE FX Options are a great way to take advantage of the constantly fluctuating value of the US dollar.

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