

FX OPTIONS: Trading Currency Moves

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.

Trading Currency Moves with ISE FX Options

With limited loss and higher return potential, FX Options® allow you to implement your views on the foreign currency market.

Many aspects of life are relative. For example, when we speak about the weather and comment that the temperature is “hot” or “cold”, this is usually relative to the season and also the specific locality. Money is also relative. There are many different currencies in the world, which measure the cost of goods or services in that particular region or country. These currencies are all traded relative to another currency. I will attempt to explain foreign exchange trading and how it can be implemented using ISE FX Options.

Currencies trade in pairs. This is quite different from equities. In equities, if you are bullish on a particular company you could simply buy the shares (alternatively, call and put options are available for many equities). In the foreign currency market, an investor that is bullish on one currency must select an opposing currency to complete this transaction. Many of currency pair transactions being completed are consummated in the “spot” foreign exchange market. The “spot” market just means the cash market; this is analogous to the equity market. To facilitate international trade, the foreign exchange market provides a mechanism to transfer money from one currency to another. The foreign exchange market is the largest and most liquid market in the world. Whether you are focused on importing and exporting or just a tourist traveling on vacation, the foreign exchange market is vital in creating this universally accepted medium of exchange.

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(Continued)

A natural question an investor might ask is, “what moves the currency markets”? Just as in equities, there are many ways to answer that question, but one thing is sure, supply and demand moves all markets. Generally, high productivity with low inflation creates an environment of sustainable growth most countries and regions aspire to. The opposing conditions of low productivity and high inflation are very undesirable. Ultimately, the prices of all goods and services are transacted using foreign exchange; whether is a new electronic device, toothpaste or the price of an international common stock. Naturally, most countries publicly state that they prefer their currency to be either stable or strong. Extreme currency movements are normally not preferred as they may help certain sectors of their economy while having adverse effects on other sectors. Currency exchange rates have a definitive impact on both domestic and international economies.

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As exchange rates move, challenges and opportunities are created for all market participants. A viable alternative for implementing your views of the foreign exchange market is ISE FX Options. Options allow the transfer of risk from one party to another. Calls and puts are traded, allowing for a method of hedging foreign exchange risk or forecasting a specific direction in a particular currency relative to another. One of the main advantages of ISE FX Options, just like equity options, is the limited loss potential and higher potential returns when purchased. Also similar to equity options, the premiums quoted for ISE FX Options are multiplied by 100. The currency spot value is multiplied by 100 or 1 to create the ISE underlying values (see the chart below). ISE FX Options use the base currency as the United States dollar for all of the pairs, meaning the valuation is expressed as the number of units of the opposing currency per U.S. dollar. Think of the relationship as U.S. dollar’s worth relative to another currency.

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Trading Currency Moves with ISE FX Options (Continued)

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)

The options are cash settled, if an option has intrinsic value at expiry and was not closed out prior to expiry that option would settle into its intrinsic value. Let me give you an example, if an investor purchased a 102 call and decided not close out the position prior to expiry and the exchange rate value settled at 105, the option would be worth 105-102 or (\$3.00 X 100) or \$300 per contract. Puts would follow a similar methodology, if an investor purchased a 106 put and the exchange rate value settled at 105, the option would be worth 106-105 or (\$1.00 X 100) or \$100 per contract. All options that settle out-of-the-money at expiration would not be subject to cash settlement and thereby expire worthless. The ISE FX Options are quite simply just an option on the exchange rate itself. This is a straightforward approach that enables the ISE FX trading instrument to be easy to comprehend.

The ISE
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ISE FX Options are a dollar relative trading instrument. The U.S. dollar is the base currency in all six pairs ISE currently offers. This trading convention simplifies your options trading decision-making process. If you are bullish on the U.S. dollar, or would like to hedge another currency relative to the U.S, you purchase calls. If you are bearish on the U.S. dollar, or would like to hedge your U.S. dollar exposure relative to another

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currency you purchase puts. Investors familiar with options can use various spread strategies to create unique payoffs that are compatible with their financial goals and risk tolerance.

The pricing of the ISE FX Options is very similar to equity and index options. There are six variables that are used for pricing an ISE FX option: ISE currency value, strike price, time left until expiration, foreign currency risk-free interest rate, U.S. risk-free interest rate, and volatility. The one difference between equity options and FX options is that since currencies do not pay dividends, dividends are not included in the pricing of FX options. The interest rate differential, volatility, time remaining and the spot currency value all influence the option value prior to expiration. At expiration, the ISE FX Option only has intrinsic value if it is in-the-money. ISE FX Options are European style, meaning an investor cannot exercise them early. Don't worry though if you change your mind, you can always trade out of your position any time prior to expiration date.

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More importantly, ISE FX Options allow you, the investor, to implement your views of the foreign currency market directly through your equity options broker. You can choose to hedge, forecast a direction or even use a spreading strategy to create unique payoffs that are compatible with your financial goals and risk tolerances. In this era of increased globalization, investors must consider what their currency is worth relative to other currencies. This relative value ultimately determines the cost of goods and services in each country or region. Each currency will fluctuate in the marketplace relative to another currency. Now, you should consider ISE FX Options as an investment tool that's at your disposal when you feel the time is appropriate.

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