ASX
AUSTRALIAN STOCK EXCHANGE

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Options

A simple guide

Phone 1800 028 585 or visit www.asx.com.au/options

FSR

TERMINOLOGY CHANGES

ASX has changed its business framework for trading, clearing and settlement. As a result there have been changes to the terminology used in this document.

OLD TERM	NEW TERM
Options Clearing House Pty Ltd	Australian Clearing House Pty Ltd
OCH	ACH
ASXF Pty Ltd	ASX
ASX Futures Exchange	
ASXF Exchange	
ASX Business Rules	ASX Market Rules
SCH Business Rules	ASTC Settlement Rules
OCH Business Rules	ACH Clearing Rules
OCH Derivatives Clearing Rules	
OCH Clearing Rules	
ASXF Exchange Business Rules	ASX Market Rules
ASXF Business Rules	
Broker	ASX Market Participant or Market Participant (may also be a ACH Clearing Participant and/or ASTC Settlement Participant)
ASX PO	Market Participant / Trading Participant (may also be a ACH Clearing Participant and/or ASTC Settlement Participant)
Participating Organisation	
RIOT	ASX Market Participant or Market Participant (Trading Participant only for selected products) and Market Maker
Non-Broker Participant (NBP)	General Settlement Participant
Limited Purpose NBP	Specialist Settlement Participant
NSSP	Account Participant
Non sponsoring settlement participant	
Security	Financial Product (except for overseas products)
Securities	
Shares	
Derivative	Financial Product
DTF or Derivatives Trading Facility	DTP or Derivatives Trading Platform
Clearing Participant Only (currently derivatives only)	Direct Clearing Participant
Third Party Clearer	General Clearing Participant
Non-CHESS Approved Security	Non-CS Approved Product
Foreign Portal Dealer	Overseas Portal Dealer
Participating ASX Security	Participating ASX Traded Product
Participating Foreign Security	Participating International Financial Product
Participating Foreign Exchange	Participating Overseas Exchange

For further details of the Financial Services Reform terminology changes, please visit www.asx.com.au/fsr.htm.

What is an option?

An option is a contract between two parties giving the taker (buyer) the right, but not the obligation, either to buy or to sell a parcel of shares at a specified price on, or before a specified date.

There are two types of options traded on ASX, call options and put options.

Call options give the taker the right, but not the obligation, to buy the underlying shares, while put options give the taker the right, but not the obligation, to sell the underlying shares.

For example, a Westpac Banking Corporation (WBC) October 1700 call option gives the taker the right to buy 1000 WBC shares for $17 each, on or before the expiry date of the option in October.

If exercised, the writer (seller) of this option must sell 1000 WBC shares for $17.

At the time of the option transaction, the option buyer pays the option seller a premium, which is the cost of the option.

Note that the taker of the option is not obligated to exercise the option. The taker can sell the option before it expires, or alternatively let the contract lapse at expiry, but will forego the option premium.

Features of an option

Option contracts have five main components. Four of these are set by the Options Clearing House (OCH), which is the subsidiary of ASX responsible for overseeing the clearing and operations of ASX's options market. These components are:

1. The underlying securities

Options may be listed over the shares in a company listed on ASX, or over a share price index.

You can trade options over most of Australia's largest companies, including News Corporation, Telstra, BHP Billiton and the major banks. Options are also available over the S&P/ASX 200 Index. To find out which securities have options listed over them, please refer to the ASX website, www.asx.com.au/options

2. Contract size

One option contract covers 1,000 underlying securities, unless an adjustment to the terms of the contract has taken place. In the case of index options, the contract value is currently fixed at $10 per index point. To calculate the value of the contract, multiply the index level by $10. However, you should check the ASX website or consult with your broker for the latest contract values.

3. Exercise price

This is the price at which you buy or sell the underlying securities if you exercise your option.

There is a range of exercise prices to choose from for each options stock, for each expiry month. New exercise prices are listed as the underlying share price moves. You will usually be able to select from an exercise price close to the current market price of the underlying share, with at least two exercise prices also available above and below the current share price.

4. Expiry date

This is the day on which all unexercised options in a particular series expire.

Each options stock has a range of different expiry months to choose from. The quarterly expiry cycle for a stock extends for a minimum period of nine to twelve months. As one series expires a new, more distant one is created. Many stocks also have a spot month available. Share options usually expire on the Thursday before the last business Friday in the month. Index options usually expire on the third Friday of the contract month.

Benefits of options

Investors are attracted to options for several reasons:

Earn income

You can earn income over and above dividends by writing call options against shares you own.

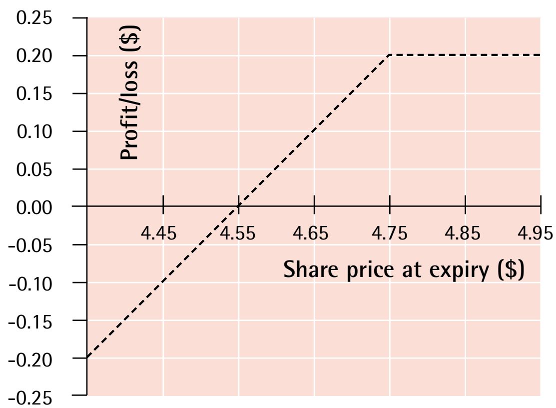
This is a very popular strategy with investors who expect the price of their shares to remain flat or fall slightly. Writing call options can generate extra income during such periods.

Example: Assume you own 1000 shares in Telstra (TLS) which in early July are trading at $4.70. You believe that over the next couple of months, the share price is likely to stay around current levels.

You write an August expiry 475 call option for a premium of $0.15.

Writing the August 475 call means that you accept the obligation to sell your Telstra shares for $4.75, if the option is exercised. For this you receive the premium of $0.15 per share ($150 for the contract).

The following graph illustrates the profit or loss you would make at expiry:



If at expiry, the share price is below $4.75, the option should expire worthless. Your TLS shares may have fallen in value, but you have earned $150 in extra income for selling the call. Because of the extra income in this example, the share price can fall to $4.55 before you make a loss on the strategy overall.

If, however, the share price is above $4.75, the option will be exercised and you will have to sell your shares. Effectively you have sold your shares for $4.90 (the exercise price of $4.75 plus the option premium of $0.15).

Brokerage and transaction fees will also apply when trading and exercising option contracts.

Covered calls can also be written against stock you have bought on margin. Please refer to the ASX website for more details.

Protect the value of your shares

Put options allow you to protect your shares against a fall in value. Buying a put option locks in the sale price of your shares for the life of the option, no matter how low the share price may go.

Without using put options, in a market downturn you can only watch your shares fall in value, or sell them.

For example, if in early June you believe the share price of News Corporation (NCP) is going to fall from current levels of $13, you could buy an NCP July 1300 put option, say for $0.65. This option gives you the right to sell your NCP shares at the exercise price of approximately $13 any time up until the option's expiry.

A great advantage of this strategy is that if the share price should rise, you are not obligated to sell your shares. Your shares will benefit from the price rise, and all you have lost is the put option premium.

Speculate

You can use options to profit from a movement in the underlying shares without having to trade the shares themselves.

Options give you exposure to movements in the share price for a fraction of the cost of purchasing the shares themselves. Because of the small initial outlay, you gain leveraged exposure to share price movements.

With an increase in the price of the underlying shares, the percentage return on the purchase of a call option will be greater than on the purchase of the underlying stock. Similarly, if the price of the underlying shares falls, the percentage return on the purchase of a put option will be greater than the percentage change in the value of the shares.

For example, assume it is mid-January and you believe the share price of BHP will rise over the next two months. The following table compares the returns from buying BHP shares at $10.50 with the returns from buying a BHP March 1050 call option at $0.50, assuming that the BHP share price has risen to $11.50 by the option's expiry in March.

	Shares	March 1050 Call
10 January	$10.50	$0.50
30 March	$11.50	$1.00
Profit	$1.00	$0.50
Percentage return	9.5%	100%

In this example, the percentage return from buying the call options is significantly greater than the return from buying the shares.

However, just as leverage provides the potential to make high percentage returns, it also involves the risk of making large percentage losses.

Time to decide

There may be times when you are unsure whether you want to go ahead with the purchase or sale of shares. Buying an option enables you to defer your decision until the option's expiry.

When you buy a call option you lock in the purchase price for the shares. You then have until the expiry day to decide whether or not to exercise the option and buy the shares. Similarly, by taking a put option you lock in a selling price, and give yourself time to decide whether or not to proceed with the sale of the shares.

In both cases, the most you can lose is the premium you have paid for the option in the first place.

Index options

Index options are similar in many ways to share options. The difference is that they are over the S&P/ASX 200 Index, instead of over shares in a single company.

This means that you can effectively trade the top 200 stocks in one transaction. If you hold a view on how the market as a whole will perform, buying or selling index options is a simple way to trade your view. Index options provide you with diversified exposure, without having to invest directly in all the stocks in the index.

How options are traded

Options are traded on the CLICK system, which is an automated system linking brokers from all around Australia. You place an order through your broker, just as you would with shares.

To give advice on options transactions, your broker must be an Accredited Derivatives Adviser. If you need help in finding an adviser, please refer to the list of advisers on www.asx.com.au/options

Once you have opened your position, either by buying or by selling an option, you can close out your position at any time on the market, or hold it until expiry.

Opening and closing option positions is facilitated by the market makers operating in ASX's options market. Market makers play an important role in the options market, and are required under the ASX Business Rules to provide quotes in certain option series. This requirement is to promote liquidity in the market, so that you are more easily able to trade into and out of option positions.

In order to trade options, you will have to open an options account with your broker and sign a client agreement form and a risk disclosure statement. Your broker will provide you with these documents.

More information

ASX offers introductory and advanced options courses in most capital cities and selected regional centres across Australia. Attendance at these courses can help you gain the knowledge and confidence to become proficient options investors.

The course is a practical programme presented by qualified ASX staff with extensive options trading experience. Audience participation is encouraged with an interactive question and answer format. No prior knowledge of the options market is necessary, however it is assumed that those attending the introductory course have a working knowledge of the sharemarket. Unless appropriately experienced, we recommend that participants in the advanced course should first attend the introductory course. Self-learning and online courses are also available.

For course details, call 1800 028 585 or visit www.asx.com.au/options

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