

FX OPTIONS: Low Correlation Investment Alternatives

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.

FX Options: Low Correlation Investment Alternatives

FX options provide a lower-correlation trading alternative to the equity and bond markets.

Every day, the financial markets present exciting opportunities for individual investors. As an investor, is it possible to achieve long-term sustainable success? It is possible, but your first step is to build a comprehensive financial plan that is tailored to your financial goals and risk tolerance. In fact, you may only need to implement intermediate or short-term strategies to meet

these objectives. These strategies should never conflict with each other, but rather, complement your overall financial plan. A good strategy to improving your odds for long-term success is taking into consideration, not only which assets fit your portfolio, but also the concept of low-correlated assets.

With so many different assets classes to choose from, which one is right for you? Your financial needs, age, and risk tolerance, all play a critical role in determining which opportunities are most suitable for you. Financial risk can be defined as the potential to lose some or all of your investment. So, risk is a huge factor. As an investor, you should carefully weigh what you define as *unlikely*. More importantly, if you define a financial event as *Unlikely* that doesn't make its likelihood an impossibility. Also, even if a financial event is *very likely*, there are no guarantees that it will actually occur. When looking at the markets, the only certainty is uncertainty. What is the potential reward if my market forecast is correct? How much am I risking if I am wrong? Is the reward worth the risk? Essentially, don't put all of "your investment eggs in one basket." Being

When looking at the markets the only certainty is uncertainty.

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FX Options: Low Correlation Investment Strategies *(Continued)*

cognizant of potential financial risk can help you in your asset selection process. With that in mind, diversification (*finding assets that have relative value but do not move exactly alike*) is vitally important. You may want to diversify asset classes as well as specific instruments within those classes.

What's the best way to diversify my portfolio? Just as there are many methodologies to achieving financial success, there are also ways to implement the diversification of your assets. Some of the most popular asset classes are: *equities, bonds, real estate, foreign currencies and commodities*. In the first seven months of 2008, the most popular asset class has been commodities. What does that mean for the future? Are equities, bonds, real estate and certain currencies doomed? That depends on your time period. Some experts believe that investors are better off rebalancing their portfolios at a specific time period to take advantage of the market's changing opinions. The laws of probability favor real estate, foreign currencies, bonds and equity markets to regain at least some of their lost value from 2007 and 2008. The key question is when? It's impossible to predict the future.

Traditionally, investors have participated in the *equities market* and (to a much smaller extent) the *bond market*. As home owners, we have a vested interest in the house we live in. The commodities market has been traditionally volatile and there are even many ways to participate in this market without trading the specific commodity. For example, individual equities or Exchange Traded Funds (GLD is one example) are currently listed on equity exchanges with longer-term time horizons. There are even exchange-traded options on many of these instruments. Options are a versatile investment tool that allow investors to target their short to intermediate-term financial goals, depending on their risk tolerance. Investors can easily hedge underlying instruments, implement price forecasts with limited risk, and increase portfolio returns using options selling strategies. Multiple-leg strategies can also be implemented creating an almost infinite amount of investment opportunities.

Options... allow investors to target their short to intermediate-term financial goals...

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Is there such a thing as the “best” options strategy, whether you are trading equities, ETFs or foreign currencies? Unfortunately, there is no one supreme options strategy, since its outcome is dependent on what transpires in the markets. In addition, the process for selecting an options strategy is dependent on how much risk an investor can tolerate, their financial goals and their ability to actively manage their trades. Your long term financial success is affected not only by your most profitable investment holdings but also by your most unprofitable holdings. Managing your winning positions and your losing positions are equally important. Just think of how hard it might be to actively manage positions that are all moving against your original market forecast. Are you now able to understand what diversification entails? Options are an investment tool that can help you actively manage your asset allocations. I will now attempt to explain how recent volatility in equity market translates for the individual investor.

The financial markets have been exceptionally volatile in 2008, due in part, to the varying degrees of financial exposure to the sub-prime debacle. Each week that goes by, the markets await fresh news from the financial industry as whole and from individual companies. The risk, as measured by the implied option volatilities, has reached record levels in many cases. Does that mean that investors should feel secure that the specific companies should “revert” back to a more normal trading state sometime in the future? My response would be *no*, not necessarily, especially on an individual company basis. Infrequently, an isolated company or even a few companies might get themselves into a position that they may not be able to rebound from. An example of this might be World-Com or Enron from days gone-by. Another example of non-reversion is the “Internet” stocks that peaked in 2000. Many of those stocks might not ever revert back to their previous price ranges. This explains why specific equity implied volatility is normally higher than an Exchange Traded Fund, where an individual company is just one of the holdings of the ETF. Groups of stocks tend to balance themselves out, as opposed to single companies that occasionally move in very unexpected ways. This is another example of how correlation works in the markets.

Your long term financial success is affected not only by your most profitable investment holdings but also by your most unprofitable holdings.

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With the markets extremely volatile in 2008, how can investors meet their short and intermediate term goals without “putting too many eggs in one basket”? One strategy that might diversify your investments is trading low-correlated trading instruments. What is correlation, without getting into an extensive amount of mathematics? One definition is: *the strength of a linear relationship between two variables*. An even more practical definition is the relationship of how one asset moves in relation to another. For correlation to exist though, the relationship must be somewhat linear in shape. A “perfect” correlation would be 1.00 and a “perfect” inverse relationship would be -1.00. The efficient market portfolio theory states that rational investors should seek undervalued assets with low correlations that will help “smooth” out investment results. One historic correlation example would be natural resources (commodities) having a negative correlation in most trading days to bonds due to inverse relationship to inflation the two asset classes contain. 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. Considering the versatility that the listed options market provides, investors might want to use some of their most popular options strategies in the ISE FX Options® market to reduce their correlation risk (*please refer to the table on the next page for the trading symbols and the details of the how the ISE FX pairs were constructed*).

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.

To expand on this theory of correlation, let me illustrate why moving into low-correlated markets makes sense. Let’s assume you have found a few options strategies that are very compatible with your own goals and risk tolerances. Instead of increasing your equity market risk with additional equity options positions (*if all your positions are moving alike*); you should consider trading ISE FX Options. This would allow you to use your favorite options strategies to reduce your correlation risk to the equity market. The benefit is that, historically, the foreign currencies market has had a very low correlation to the U.S. equities market (*please note correlations can dramatically shift, especially during shorter periods of time*). So far in 2008, the U.S. equity market has been extremely weak so if you had

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USD/CHF	SFC	100	104.96 (1.0496 X 100)
USD/JPY	YUK	1	107.57 (107.57 X 1)

implemented bullish equity strategies or even sold your U.S. equity volatility positions, they would have most likely performed very poorly. With the historic low correlation that the foreign currencies market provides, some bullish U.S. dollar (USD) option positions may not have lost as much money; in fact, some may have been profitable depending on when you implemented the trades. As of July 31 2008, the ISE pair symbols of EUI, AUX and SFC were lower in value in 2008 from the start of 2008. The ISE pair values of YUK and BPX were relatively unchanged; CDD was up slightly during that period. Remember the ISE FX Options are dollar relative, meaning the base currency is the USD. So, the USD has underperformed against the Australian dollar, euro and the Swiss franc. The yen and pound were stable against the USD with the USD actually gaining a bit against the Canadian dollar. A non-directional FX options strategy that could have performed even better than bullish USD forecasts was one that forecasted lower FX volatility. That particular forecast benefits from a reduction of volatility of the respective ISE FX pair. Although there was a spike in all of the ISE pair volatilities in mid-March that coincided with the Bear Stearns fallout, the FX implied volatilities have seen a dramatic drop in the last five months (*caution: this may or may not continue*). Options strategies that were nearly delta-neutral benefited from a decrease in the volatility by selling iron condors (selling out-of-the money call and put spreads) could have been very profitable, especially after March 17, 2008. More importantly, if investors implemented strategies using ISE FX Options trades, they would have reduced their correlated risk exposure. Does that mean a guaranteed profit, or a perfect arbitrage? No! There are very few (if any)

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

There are many ways to trade the ISE FX Options market. For those investors seeking protection from the falling U.S. dollar, *put options* offer that type of insurance at a cost. For investors with financial exposure to the yen, euro, Canadian dollar, pound, Australian dollar or Swiss franc and are looking for protection against the U.S. dollar rallying against their respective currency, *call options* offer that type of insurance at a cost. Investors looking to implement bullish forecasts on the USD can *buy calls*. Conversely, investors that are bearish on the USD can *buy puts*. Those investors comfortable with option selling strategies can earn additional income (*with limited risk if used with vertical spread strategy*). Even more advanced strategies can be implemented depending on your forecasts for volatility and the particular ISE pair value.

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The various exchange-listed asset classes provide dynamic trading alternatives for individual investors. For those looking for a low-correlated asset to trade relative to equities, **foreign currency options** are an important consideration. Investors should consider including in their trading plan the six ISE currency pairs that are currently available for options trading. Most important, investors should never risk more than they are willing to lose in any position. The concept of risk and reward should always be considered prior to entering any financial transaction. *Is the reward worth the risk?* Correlations between assets can change, so be prepared to actively manage both winning and losing trades, if necessary. The only certainty in the financial markets is uncertainty. A well structured options approach, that accounts for *uncertainty*, complements your overall investment portfolio. If used appropriately, ISE FX Options can help you meet your longer-term financial goals.

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The Credit Crisis and the Foreign Exchange Market: What's Next for the U.S. dollar?

Despite the current global economic crisis, demand for the U.S. dollar has increased. What alternative investment opportunities are there in the foreign currency market?

The global financial markets have recently experienced extreme selling pressure. Investors are left to ponder why are the financial markets so weak? Where and when did this contagious "financial disease" start? Do the financial markets really affect me? How will it run its course and when will it end? What's amazing is that the foreign exchange markets are handling this "financial earthquake" very different from what investors would have expected just a year ago.

Stock, bond, commodity and real estate markets are under a selling siege. Financial experts are saying that "financial deleveraging" are one of the primary reasons for the global asset sell-off. I will attempt to explain how the markets became so over-leveraged and its implications. In finance, leverage is using given resources in such a way that the potential positive or negative outcome is magnified and/or enhanced. It generally refers to using borrowed funds, or debt, in an attempt to increase equity returns.

Stock, bond, commodity and real estate markets are under a selling siege.

So the use of leverage is bad, right? No, not necessarily, it is the amount of leverage that amplifies the returns for assets. With the over-use of leverage, even the smallest setback can wreak havoc on the financial systems. Without any leverage, the world's economy would grow at a much slower pace than its potential growth rate. The real issue is how much leverage is appropri-

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ate. There may be economic “bumps in the road”; the question is can the economic shock absorbers handle the bumps. The markets are currently trying to transition from a highly leveraged environment to a substantially reduced environment in a relatively short period of time. This transition has not occurred in an orderly fashion.

How did this economic mess start? That is a tough question to answer, but many experts believe that the markets allowed too much capital to be allocated to questionable projects. There are a multitude of reasons why there was an abundance of capital available, including very low interest rates for a relatively long period of time in many major banking centers (Tokyo and New York are two examples), securitization of the mortgage market without proper documentation of qualified residential mortgages and insufficient regulation of the non-transparent OTC derivative markets. But probably the most important factor in the current economic situation was the asset-liability mismatch. Borrowing short-term to invest long-term makes sense as long as there is capital to be borrowed. Many models assume you can “earn the spread” by utilizing this strategy. Again this “appears” successful from a modeling standpoint, but if you can’t fund the short-term, there isn’t any long-term. Be careful of models, the weakest part of mathematical models are the assumptions used. The modeled world cannot possibly replicate the “real world” 100% of the time. .

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The current economic crisis may have started as far back as the late 1990’s, when the U.S. housing industry gained strength relative to the general economy. In 1999, the U.S. banking and insurance industries were further deregulated with the repeal of the Glass-Steagall Act. The following year, the Commodity Futures Modernization Act of 2000 was passed, barring regulation of the OTC swap market. This may have been the watershed event that that dramatically and negatively impacted the current economic environment. As the dot-com recession receded, the U.S housing bubble started to gain momentum. In 2004, five U.S. investment banking firms were permitted to increase their

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financial leverage with the so called net capital rule. This allowed them to increase their maximum capital leverage from 12:1 to 40:1. By 2005, large parts of the U.S. market were experiencing a “real estate pricing bubble” and 2006 is the top of that bubble. Home prices only began to fall in early 2007. As prices fell, lenders began to pull back from their lenient lending practices, which only exacerbated the decline. This was the beginning of the credit crunch or what is now known as the “re-pricing of risk”. By September 2007, the first large financial casualty appeared; a large bank in the U.K. was experiencing a “run-on-the-bank.” Northern Rock was the first large financial institution to experience this panic. Depositors became nervous about their money and withdrew their savings, this behavior feeds upon itself. This was the origin of the vicious financial deleveraging cycle, banks, brokerage firms, insurance companies have all been affected in various ways. The financial world is now learning to live with much less leverage, possibly more regulation and most importantly, learning how to effectively balance their asset-liability mix.

What happens in the financial markets really does matter to people on “Main Street.” Capital markets were created to efficiently allocate financial resources to those entities that use capital from those that are looking to invest their excess capital at varying rates of return. This allocation process does not always work without flaws, as we have seen recently, but it is the preferred mechanism for capitalism. The financial markets create jobs, they allow for excess capital to be saved. The capital markets also allow individuals to borrow money for higher priced items such as cars or even homes over longer periods of time. Without financial intermediation, both borrowers and lenders would be worse off. The borrowing costs would increase dramatically and the general economy would suffer due to those higher borrowing costs. The financial markets affect all individuals, regardless if you are a borrower or a lender. In fact, most individuals start off as borrowers earlier in their life, and, as they mature, they usually gravitate to become lenders to facilitate borrowing.

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Looking at the current market malaise, how will it run its course? No market guru can accurately predict when the market will rebound or how this deleveraging process can be remedied. Some experts believe that the essence of the problem is asset deflation. Governments throughout the world are busy pumping money into the financial system to stem the decline in asset prices. The U.S. Fed has been lending USD to central banks in trade for their currency as investors sell out of foreign markets and go to cash and repatriate money to the U.S. This seems counter-intuitive to most investors; the US dollar has been rallying, despite such terrible fundamentals in the U.S. economy.

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The foreign exchange market prices the relative value of various currencies each day. The respective country's money markets (short-term money) and the foreign exchange market are interwoven. Investors must balance the growth prospects (including inflation) for the various currencies in relation to each other. Governments use fiscal policy (spending and taxation) and monetary policy to affect their economies. Monetary policy is implemented by the government central bank such as the US Federal Reserve, European Central Bank, Bank of Japan, Bank of England, Bank of Canada, Reserve Bank of Australia and the Swiss National Bank. These institutions are some of largest central banks in the world responsible for monetary policy, which consists of the supply and velocity of money, as well as the cost of money (interest rate). The primary tool for the central banks is open market operations. The Open Market Operations are done by controlling the quantity of money in circulation by buying and selling credit instruments (bonds and bills in US), foreign currencies and commodities. Central banks have been known to target various objectives such as a certain interest rate (US Fed funds), a foreign exchange relationship with another currency, or a relative value with a commodity such as gold. All of these operations affect either increasing or decreasing the amount of money in circulation to reach their stated objectives.

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CONSTRUCTION OF ISE FX PAIRS

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USD/AUD	AUX	100	107.10 (1.0710 X 100)
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The excessive weakness in the banking system in 2008 has created a paradoxical situation by increasing the demand for the US dollar. The inter-bank market has not been working effectively in 2008. After the failures, or near failures, of Bear Stearns, Fannie Mae, Freddie Mac, Merrill Lynch, Lehman Brothers, AIG, Washington Mutual, Wachovia and Fortis the LIBOR (London Interbank Offered Rate) is extremely high. LIBOR is the rate banks are willing to lend to each other. The higher the rate the greater the uncertainty about other banks ability to repay these loans. Short-term money transferal is paramount for a free market society. High LIBOR rates have decreased the steady flow of money to a small drip. If you cannot borrow short-term to finance payrolls, buy inventory or any other business essentials, this effectively freezes the economy. The entire free market becomes threatened.

Will the financial rescue by governments worldwide be sufficient? Only time will tell. Many experts believe that governments must work in an extremely coordinated matter to handle the current crisis. A big part of the problem is the lack of confidence between banks, insurance companies, pension funds, endowment funds and individual investors. Most market participants are unwilling to invest or even lend their spare capital. The foreign exchange market may be one market investors should closely watch for further clues on the credit crisis. The International Securities Exchange offers options trading on six currency pairs, ISE FX Options,

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which are completely transparent and allow investors to implement their view of the US dollar relative to the major currencies. Another terrific benefit to trading exchange-listed options is the near elimination of counter-party risk. Please refer to the table on the previous page for a further explanation of ISE FX Options.

The credit crisis seemed to worsen simultaneously with the US dollar strengthening in late summer of 2008. One explanation is that U.S. investors are selling large quantities of international stocks and bonds and bringing the USD back home to meet their current liquidity needs. If entities cannot roll their credit demands through short-term money markets, they may be purchasing those dollars in the foreign exchange market creating more demand for the US dollar. This encourages US investors to "sell any and all international bids in stocks and bonds." Once US investors receive the currency, they sell it and purchase USD to meet their obligations.

The credit crisis of 2008 is equivalent to a "financial earthquake." It has affected investors all over the world. Money centers in Tokyo, Sydney, Frankfurt, London, Toronto and New York have been affected as well as global investors all throughout the world. Investors can use ISE FX Options to implement their own specific U.S. dollar forecasts whether you are bullish, bearish or even neutral. Options allow investors tremendous versatility in implementing those forecasts. Since the ISE FX Options are a US dollar-based trading instrument, if you are bullish on the USD, you could simply buy call options. If you are bearish, you could buy puts. Spreads and other more complex strategies are also available.

The recent, unprecedented liquidity crisis in the global financial markets has created many unintended consequences, but the question of who is ultimately responsible is really irrelevant. Most experts can direct the blame to countless entities, so playing the "blame game" is moot. The current credit crisis affects everyone, some more than others. What is surprising for many market participants is that the USD has held up so well during this financial crisis. ISE FX Options gives investors the ability to hedge US dollar exposure or implement a certain view of the currency market. What is important is your view of the USD. Will demand continue to increase or will the US dollar experience a sell-off, either way, ISE FX Options are available for your investment portfolio.

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