

How To Use The Buy And Write Option Strategy With Your **Investment Loan**

A simple guide to effective
cash flow management

CommSec
Adviser Services



An increasing number of investors now look to options trading as part of their overall investment strategy. The buy and write option trading strategy has continued to generate interest among investors due to its potential to enhance returns when share prices are flat or falling. By using the buy and write strategy with a CommSec Adviser Services Investment Loan, investors have the potential to grow their wealth at a faster rate by increasing the number of shares on which they can sell call options.

How does the buy and write strategy work?

The buy and write strategy involves buying shares and writing (selling) a call option over the shares.

Selling a call option means you are giving the buyer of the option the right, but not the obligation, to buy shares from you at a set price, at a certain date or period in the future. The buyer of the option pays you for the right you are giving them. The amount they pay is known as the premium. If the buyer chooses to exercise their right to buy shares from you, you must sell them the shares you hold.

In this example, the person who buys the option contract has the right to buy 100 ABC shares from you for \$32.00 each. They have paid you a \$0.30 premium per share for this right. Generally, the buyer will only exercise their option if the share price at expiry is above the exercise price (ignoring transaction costs).

Profit and loss

The table below compares the profit or loss for the buy and write strategy with the alternative of just buying shares.

The profit or loss for just holding shares (assuming that no dividends are paid and no transaction costs) is equal to the share price at the option's expiry date less the \$30 you paid for the share.

With the buy and write strategy, you receive the \$0.30 premium from the option buyer regardless of whether the option gets exercised. If the share price is \$32 or less at expiry, the option will not be exercised and you have increased your return compared to just holding the shares.

However, if the share price is greater than \$32, the option buyer will exercise their right to buy the shares from you for \$32, as they can sell them immediately in the market for more than \$32. Therefore, your profit will be capped at \$2.30.

The chart on the right also shows the profit and loss for holding the shares compared to the buy and write strategy at the option expiry date.

It can be seen that:

- ▶ the profit of the buy and write strategy is capped at \$2.30 once the share price is \$32 or greater.
- ▶ if the share price at expiry is below \$32.30, you would have been better off with the buy and write strategy.
- ▶ if the share price at expiry is above \$32.30, you would have been better off not selling the call and just purchasing the shares.



- ▶ 1 option contract usually represents 100 shares
- ▶ Option expires in 3 months
- ▶ Exercise price of \$32.00
- ▶ Receive a premium of \$0.30 per share

Share price at expiry	BUY Shares only	Buy and write
↓ Decreases to \$29	\$29 minus \$30 = -\$1	\$29 minus \$30 plus \$0.30 = -\$0.70
↔ Unchanged at \$30	\$30 minus \$30 = \$0	\$30 minus \$30 plus \$0.30 = \$0.30
↑ Increases to \$34	\$34 minus \$30 = \$4	\$32 minus \$30 plus \$0.30 = \$2.30

Risks

Selling call options over shares bought with an investment loan can enhance your investments and returns, however it can also increase your losses. If the share price rises and the buyer exercises their right to purchase your shares, you will miss out on some of the benefits of the increased share price. However, you will receive the exercise price of the shares and the premium. Your financial adviser can help you understand the risks involved as well as how to minimise these risks.

Why use the buy and write strategy?

ENHANCED RETURNS

If you believe that certain shares have become overvalued you should consider implementing the buy and write strategy. If you have held shares that have risen in value and you believe that it has overshot its fair value you could sell the shares or alternatively, you could sell a call option with an exercise price at or above the current price. If the option is exercised, you will receive more than what you believe to be fair value as well as the option premium.

EXTRA INCOME

In a flat or declining market, the buy and write strategy will generally outperform the strategy of buying the shares only as you receive the premium but the option is not exercised.

Options and your CommSec Adviser Services Investment Loan

A benefit of the buy and write strategy is that you can use it on shares securing an investment loan. When you sell call options you have to provide either the underlying shares or a margin to ASX Clear as security. However, when you use shares that are also securing your investment loan, CommSec Adviser Services will arrange for shares to be lodged with ASX Clear as security for you.

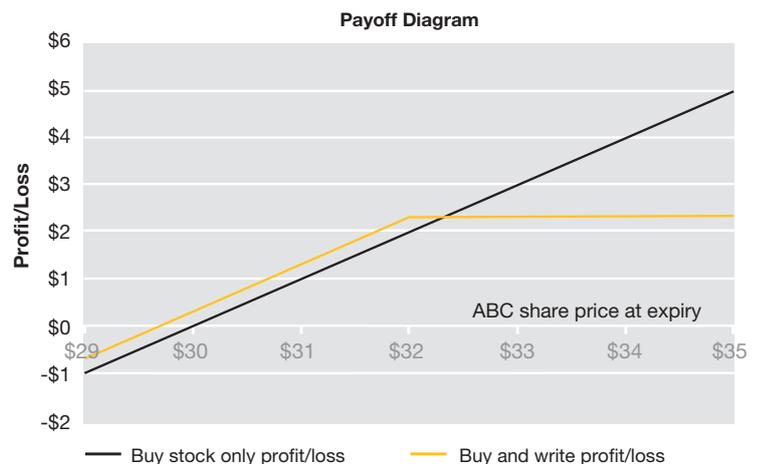
By using a CommSec Adviser Services Investment Loan you gain the benefits of leverage as you are able to increase the number of shares and also the number of calls you are able to sell.

This creates the potential to grow your wealth at a faster rate. It is important to remember however, that gearing can increase losses as well as gains.

Key Issues

WHICH CALL OPTION TO SELL?

There are over 70 companies that you can write call options on and for each of these companies the ASX has a number of options that you can trade. Our Accepted Securities List indicates which shares have options traded on the ASX.



EXERCISE PRICE AND EXPIRY DATE

Once you have selected the shares you wish to buy and write calls on, the key decisions are the option expiry date and the exercise price. As the seller of call options, you will be forced to sell your shares at the exercise price if the buyer takes up their right to buy.

AMERICAN OR EUROPEAN OPTIONS

Options can be European or American options. European options can only be exercised on the expiry date. American options can be exercised at any time up to and including the expiry date. Therefore, American options may be exercised before a dividend and so that the buyer can receive the dividend and imputation credits. Generally, there is a greater chance that the option will be exercised prior to the shares going ex-dividend.

How has the strategy performed?

The ASX has created the S&P/ASX Buy Write Index. The Buy Write Index tracks the performance of the buy and write strategy over the S&P/ASX 200 Accumulation Index, so it assumes that you buy all the shares in the S&P/ASX 200 Index and sell a just out of the money¹ call option over the S&P/ASX 200 Accumulation Index.

The following chart shows the growth of a \$10,000 investment in the Buy Write Index and the S&P/ASX 200 Accumulation Index from June 1996 to August 2015. The \$10,000 investment in the buy write index increased to \$70,700 compared to \$51,300 when invested in the S&P/ASX 200 Accumulation index. There is reasonable evidence that the buy and write strategy can enhance returns on a share portfolio over the long term. However, it is important to remember that past performance is no indicator of future performance.

Getting started

If you have a CommSec Adviser Services Investment Loan and want to begin trading options:

USING COMMSEC AS YOUR BROKER

Complete the CommSec Exchange Traded Options Product Disclosure Statement Application Booklet including the investment lending section.

USING AN ACCREDITED BROKER OTHER THAN COMMSEC

Complete the CommSec Adviser Services Investment Lending Covered Call Agreement and Schedule 1 and 2 of the ASX Clear Master Priority Deed.

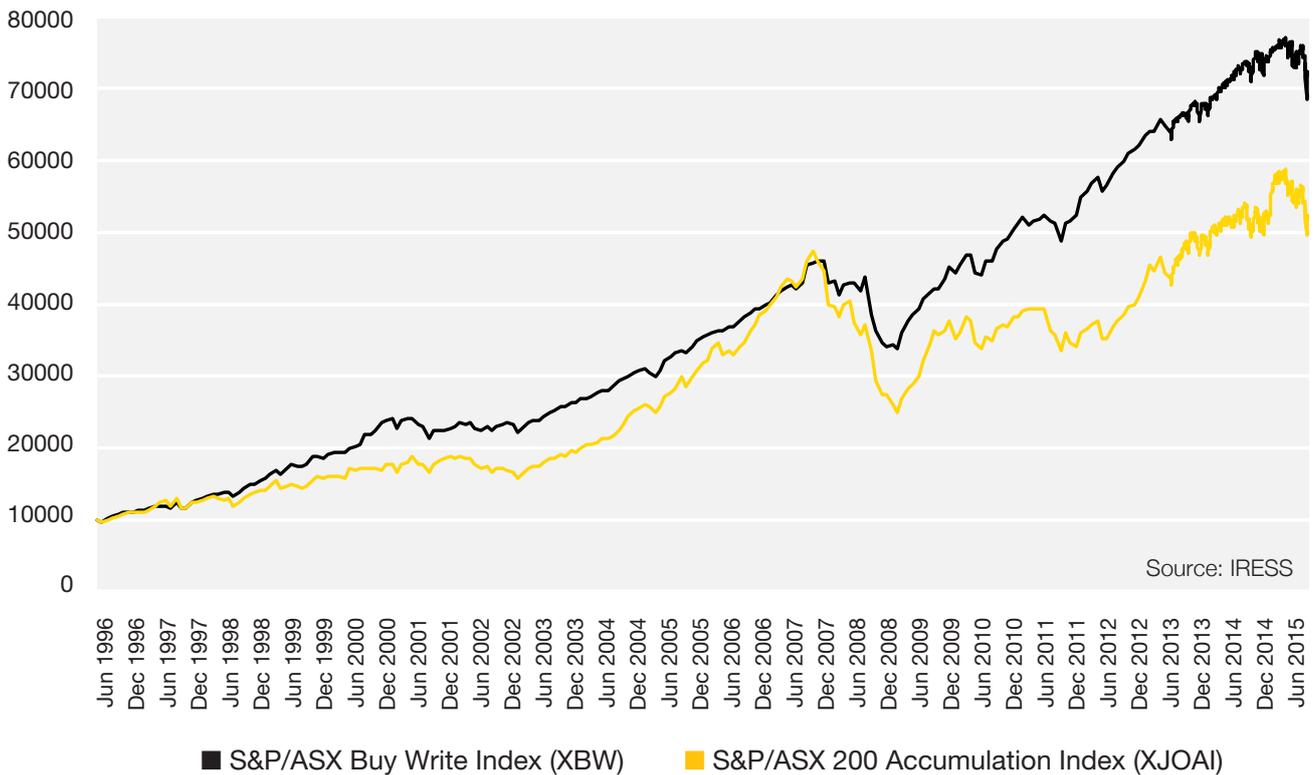
NEED MORE INFORMATION?

Speak to your financial adviser for more information. Alternatively, you can call our Client Service Team on **1800 252 351** between 8.30am and 6pm (Sydney time) Monday to Friday.

ASX WEBSITE

The ASX website www.asx.com.au is a good source of information on options including option trading strategies such as the buy and write strategy using shares purchased with an investment loan. You can also download booklets such as 'Understanding Options Trading'.

**Annualised returns:
S&P/ASX Buy Write Index vs S&P/ASX 200 Accumulation Index**



¹ A just out of the money call option is the option with an exercise price closest to current price. For example, if the current share price is \$10.50 and you were given a choice of \$9.00, \$10.00, \$11.00 and \$12.00 call option exercise prices, you would sell the \$11.00 call option as it is just out of the money.

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