



Garry has a CommSec margin loan through which he purchased 1000 XYZ fully paid ordinary shares. Garry is generally bullish about XYZ in the long term, but is concerned due to the current market conditions that there may be a decline in the XYZ share price in the short term.

Garry is looking for a way to protect (hedge) his investment should his bullish outlook not prove to be correct. Garry is prepared to incur a small cost in order to do this.

This example is for illustrative purposes only. It has been compiled using our understanding of typical margin lending customers. The names and identifying features do not reflect any particular person and neither the basis nor the assumptions made for the recommendation are disclosed. The information contained on this site has been prepared without taking account of the objectives, needs, financial and taxation situation of any particular individual. For this reason any individual should, before acting on the information, consider the appropriateness of it having regard to their own objectives, needs, financial and taxation situation and, if necessary, seek appropriate independent financial and taxation advice.

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# Using Options to protect the shares you hold within your margin loan

When you're just starting out as an investor, it seems like it will take forever to build a decent portfolio. Even on a high income, accumulating the capital you need can be a slow process — especially if you want to enjoy life at the same time. But with a CommSec Margin Loan, you can invest now rather than later, and multiply your potential returns at the same time. A margin loan also helps you diversify your investments and access possible tax planning benefits. This case study example\* explains how.

## The challenge

Garry wants to limit his downside risk on XYZ and retain his profit potential given his bullish view of XYZ prevail.

## The strategy

Just as insurance is used to protect assets such as cars, home and contents, income and personal health, derivatives positions can protect Garry's exposure in underlying financial securities. One way of doing this is by purchasing Put Options.

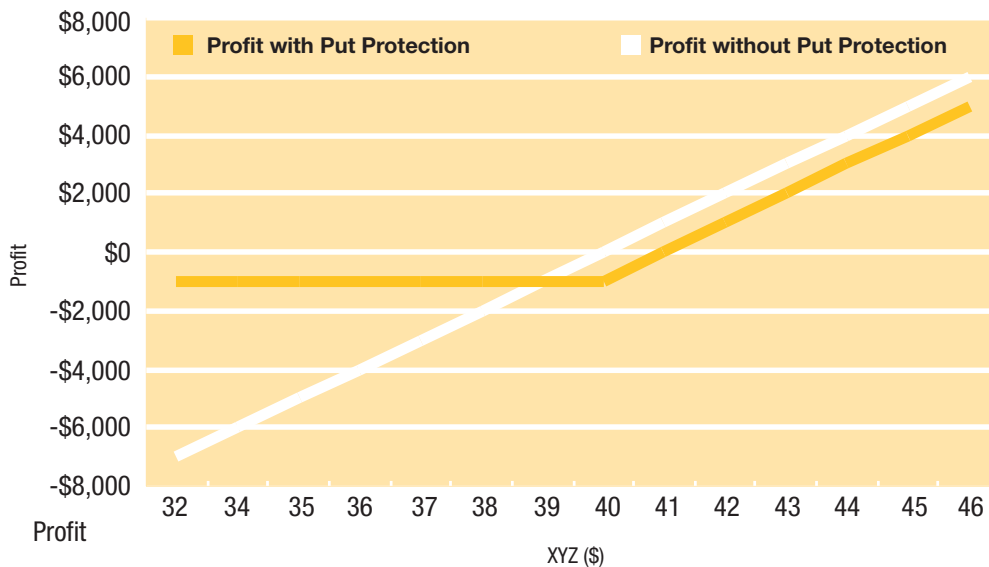
By buying a put option, Garry obtains the right but not the obligation to sell the underlying stock at a guaranteed price up until, and including, the expiry date of the option.

It is currently the 1st May and XYZ is currently trading at \$40.00. Garry would like to protect his investment in XYZ from market volatility over the next two months, so he purchases 1 XYZ June \$40.00 Put contact @ \$1.00 – which will expire on June 26.

This gives Garry the right to sell his 1000 XYZ shares for \$40.00 at any time up until, and including, the expiry date in June. For this right, Garry has paid a premium of \$1.00 per share to the writer (seller) of the option.

	Buy XYZ without Put option	Buy XYZ with Put Option
Cost of XYZ	\$40	\$40
Cost of Put Option	\$0	\$1
Total Cost	\$40	\$41
Value at Risk	\$40	\$1

## Buying a put option for protection and holding the underlying shares Garry retains an unlimited profit potential



### The result

By entering the strategy of holding the underlying shares and buying a put option for protection, Garry enjoys the following advantages.

- He locks in a sale price of \$40.00 for his 1000 XYZ shares.
- He is able to avoid a possible margin call if the share price of XYZ drops.
- He retains unlimited profit potential by holding the underlying XYZ shares
- He retains the benefits of stock ownership (dividends, voting rights etc)
- He has time to decide on a course of action
- He is able to keep emotions in check

The disadvantage, as with all insurance, is that protection comes at a cost. Generally 1 option contract is equal to 1000 shares in the underlying security. In the above example Garry has bought 1 contract at \$1.00. Therefore the cost he will incur to protect his XYZ shares is \$1000 (\$1.00 x 1000). To effectively break-even on this strategy, Garry will however require the underlying XYZ share price to rise to \$41.00 by June 26 – to cover his outlay of \$1.00 per share for the protection.

Garry's unlimited profit potential can therefore be realised when the XYZ share price reaches above \$41.00.

### Did you know?

- Margin lending is becoming increasingly popular in Australia. Since March 2000, the total value of margin loans in Australia has more than tripled from \$6,322 million to \$21,093 million in December 2008.
- By the end of December 2008, there were 204,809 margin lending clients in Australia, with holdings in shares and managed funds worth a total of \$41,996 million.<sup>1</sup>

\* Total costs are not inclusive of brokerage.

<sup>1</sup> Source: Reserve Bank of Australia.

### Who could use this strategy?

This strategy is ideal for investors who have a bullish view on the underlying stock but have some concerns about downside market risks and would like to protect their portfolio from this risk.

### Who could use this strategy?

If you require any further information about how to purchase options, please contact CommSec Options desk on 1800 245 698. Alternatively our Advisory team can be utilised to help you develop a protection strategy which is personalised to your needs. If you require further information on CommSec Advisory, please contact us on 13 17 09.