



Jodie is a 47 year old small business owner. After establishing a successful business providing her with a profitable income, she turned her attention to her personal investments to grow her wealth in the lead up to her retirement. Jodie has started investing through the share market.

She recognises that wealth is generated by establishing a long term portfolio and investing for the long term. However Jodie has concerns about sudden falls in the value of her share portfolio and is looking for a way to protect her portfolio from market volatility.

This example is hypothetical and for illustrative purposes only. CommSec does not specifically recommend the stock used in this example and does not warrant that it will be available for OTC CFDs. Past performance is not indicative of future performance.

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Individual Share Hedging

When investors hold securities for a long term whether it be in their CommSec account, or as part of their margin loan portfolio, they may expect to have a capital gain. This is of course, the ideal outcome, but in times of market volatility or correction, they may realise potentially short-term paper losses.

The challenge is to protect the accumulated value of an investment without selling the investment and realising a capital gain event.¹ The answer may be individual share hedging. Let's look at an example.

The scenario

Jodie, a CommSec client, bought 2,000 BHP Billiton (BHP) shares at \$10.30 on 15 August 2003. It's now 6 January 2009 and the opening price of BHP is \$31.81. Jodie believes that BHP could sustain a fall over the following weeks, but she also believes that BHP will resume its gains in the long term.

The strategy

Selling an identical Contract for Difference (CFD) position to the underlying share position makes it possible to protect against anticipated falls in the value of a share position. While a paper loss occurs on the physical share position, the losses are offset by a virtually identical amount of profit in the CFD market.

In Jodie's case, she short sells 2000 CFDs over BHP at \$31.81, creating an offsetting position to the physical 2000 units of BHP and effectively locking in her profit on her BHP position at \$31.81.

The result

Over the next two weeks Jodie proves to be correct, with BHP falling approximately \$3.45 per share to \$28.36 on 23 January 2009 at the open.

She has made approximately \$6800 profit on her CFD position, and lost \$6900 on her physical share position. Jodie chooses to close out the short 2000 CFDs at \$28.36.

So Jodie has managed to maintain her current asset position (wealth), as she has profited from a short-term correction from the short CFD position and protected her investment from a potentially larger fall.

Who could use this strategy?

Investors with long term objectives, looking to protect against corrections in the market or uncertainty in the performance of their share portfolio.

How the Individual share hedge helped Jodie

This strategy allowed Jodie to protect her unrealised capital gain, without selling the underlying position and realising a capital gains tax liability on this position.

The benefits of individual share hedging with CFDs

- A simple way of hedging a single stock.
- It doesn't require payment of an insurance premium for hedging position.
- There is no time decay. You can remove the hedge at time of your choosing.
- Volatility doesn't affect the cost of the hedge, so you can implement the hedge in volatile markets.
- Revenue stream from the short position – interest paid on the short.

Risks

- While the downside risk is offset via the hedging strategy, if the price of BHP were to rally instead of fall, the profits on the physical position would be offset by losses in the CFD position.
- Using CFDs can have an effect on a clients' individual tax situations².
- Please consult the CFD Product Disclosure Statement (PDS) for a detailed list of Operation, Credit and Market risks that could affect a CFD position.

Important Information

- CFDs are a leveraged trading tool that carry significantly higher risk than general share trading, and as such are not suitable for all clients. Clients should consider the OTC CFD Product Disclosure Statement issued by CommSec, available from www.comsec.com.au, and their own individual circumstances before making any decision about using OTC CFDs through CommSec.

¹ No tax advice is implied or dealt within this paper. This example does not show taxation consequences for the client. Please seek your own tax advice before considering this strategy.

² 100% hedging could result in the loss of franking credit(s) under the ATO 70% at risk rule. Please seek professional taxation advice in this regard.

Facts and figures

Item	Rate	Amount	Notes
Open Short Position			
Short Sell Quantity		2,000	BHP – to match current holding BHP Shares
Price		\$31.81	Opening price BHP 6 January 2009
Contract Value		\$63,620	Units * x entry price
Initial Margin	12.5%	\$7,952	Margin rate at the time of example
Brokerage	0.125%	\$79.53	
GST		0	
Initial Outlay		\$8,031.53	Brokerage + Initial Margin
Close Short Position			
Buy back Quantity		2,000	
Price		\$28.36	Opening price BHP 23 January 2009
Contract Value		\$56,720	
Variation Margin		\$6,900	Paid to client in this case, mark to market profit on positions.
Brokerage	0.125%	\$70.90	
GST		0	
Financing Cost	Base rate -3%	\$35.48	Interest paid to the client daily, based on closing price of security. Base rate -3%. For this example 1.25%.
Profit on short trade		\$6,785.05	Net of all brokerage and finance fees.
Net Fees Paid		\$114.95	Brokerage (buy/sell) – interest cost

In this example, the short CFD trade has yielded a return of approximately 85% on the \$7,952 deposit. It is also important to recognise that this gain is an offsetting position that has been used to reduce risk to the downside, rather than add risk to a client's portfolio.