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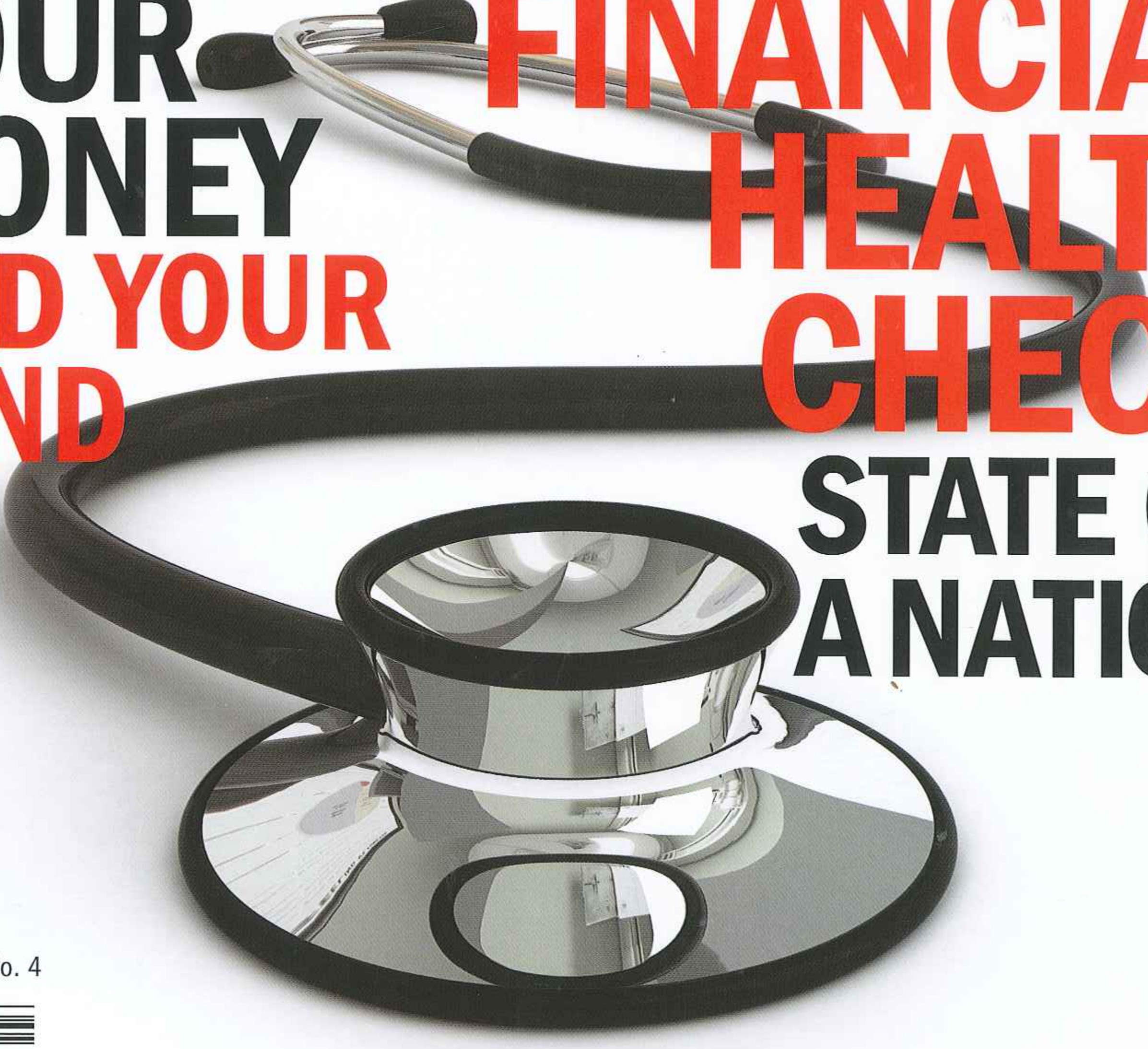

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TRADING LIFE

Wai-Yee Chen on what she has learnt from trading options, and her current trading strategy.

Some people use options for gearing or trading; I use options for enhanced returns and protection, as part of an overall share investment strategy. This is sensible, but I have not always been so. My options strategies are shaped by past experiences, two of which left indelible marks.

CSL Limited is a major listed healthcare company currently trading at around $32 a share. In December 2001 it was trading at $17, before it fell over a one-and-a-half year period to an abysmal share price of $4 (a 75 per cent plunge!).

No investor would like to be in the position of holding such a losing share. How much worse for an options trader who had shorted or wrote naked puts (an obligation to buy shares at a strike price which is now 75 per cent higher than the market price) and geared many times over with just sufficient cash to cover margin requirements.

A shareholder can simply hold on to the shares and wait for their eventual recovery; and CSL did recover, to almost double nine years later. But it's not the same for an option writer. The trader cannot just sit and wait; every further slide in the share price requires a top up of cash or shares to meet margin obligations. These obligations are constant and every call needs to be met immediately (or risk losses being realised at the worst possible price). This continuous feeding of money to a losing venture (and not knowing when it will stop) is like throwing good money after bad, into an abyss.

The second event was with a share rising strongly. Whilst this is normally a positive event for a shareholder, that can't be said for an options trader who sold naked call options on the stock (a naked call writer punts that a share price will fall and that he or she will benefit from buying back the call more cheaply). BHP Billiton launched a takeover bid on Rio Tinto in November 2007 and its share price jumped 22 per cent in a day. A naked Rio call writer was placed in a huge paper loss position, with a large margin call to make up the increased risk. The trader had no way of knowing what the maximum loss would be, as the share could rise further from counter bids. Loss of control and being forced to act are factors that often cause traders to make less than optimal investment decisions.

These two events exemplify the side of options that people often talk about – out of control margins and large losses locked in. When I first started as an investment adviser, I asked a more senior adviser if I should trade in options. His comment set me back a year in my foray into options. He said: "Yes, if you want to lose your clients and their BMWs." Well, I did my own research and ventured into options anyway.

I found that options are a very tempting tool for leveraging. Spending a small sum of money buying options allows potentially huge gains. But I soon discarded this strategy (unless it's for hedging), as I found it almost impossible to get both the direction and timing of the share right.

I then quickly caught on to the idea of selling or writing options for punting and gearing. I found this strategy much more exciting. Income gets generated quickly. That is, until I experienced events like the two above. These experiences shaped how I invest with options now.

I no longer consider the income first; instead, I look at the maximum potential downside. I take steps to mitigate risks that I am not willing or able to handle up front. I have learned to determine a comfortable gearing level first, and then to cover the rest of the risk I am not willing to be exposed to. Naked positions are no longer taken lightly, without due consideration of the maximum exposure and my resources. I have discovered that despite having risk management in place, if a position goes wrong, the number of opened contracts can still be too many and the pre-set limit on maximum losses too. An investor who defends well is hard to beat when it comes time for scoring.

If a junior adviser asked me whether he or she should venture into options, my answer would be: "You can't afford not to."

As for investors, not having this tool at their disposal is like playing tennis with one hand tied behind their back – they may still win their game, but imagine how much more power, precision and control they could have had at their disposal.

***Wai-Yee Chen** is the author of 'OptionsWise: how to invest sensibly'. She is Head of Derivatives for RBS Morgans' Sydney Asian Desk and a mother of three. Wai-Yee will be speaking at various seminars throughout the year. For more information email admin@optionswise.com.au or visit www.optionswise.com.au.*