Weekly Options on Futures at CME Group

A HEDGE AT THE RIGHT PRICE

By Kevin Saunders, DipFin FINSIA Dux

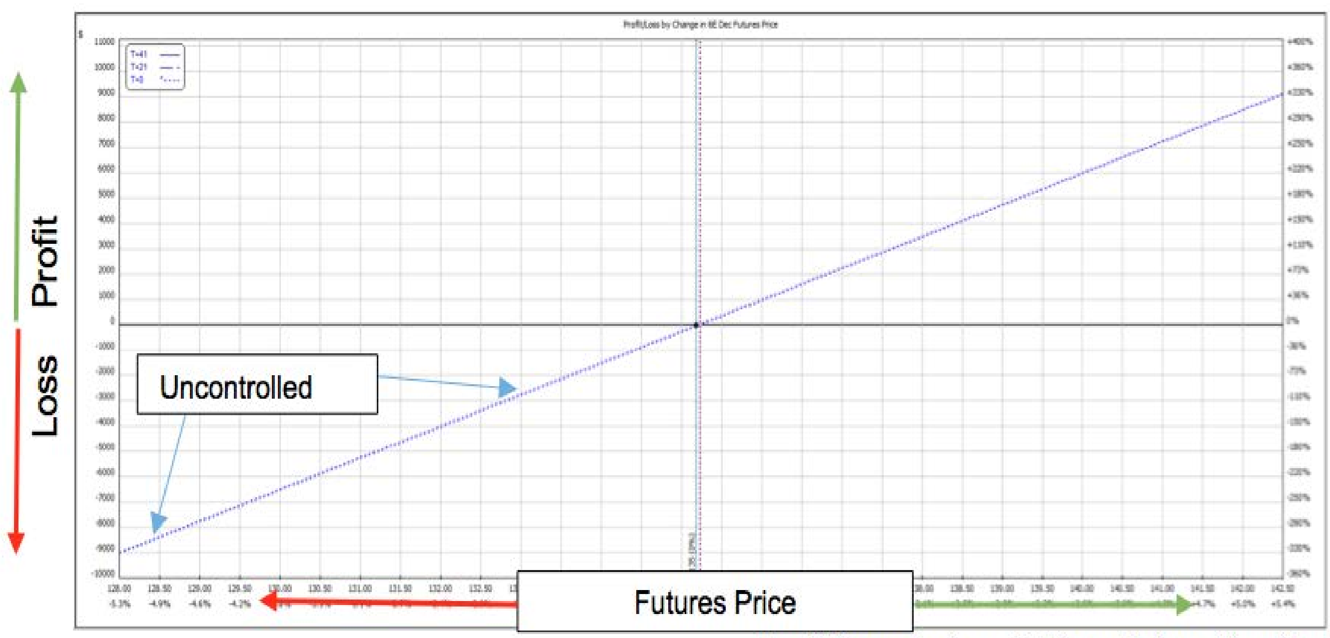
Weekly options have seen explosive growth over the past year. For those who utilise options for the purposes of hedging risk, Weeklys are an inexpensive way to insure against short-term volatility. The recent ECB minimum bid rate announcement (November 7, 2013) resulted in a surprise rate cut. This was a perfect example of an event creating significant short-term price movement.

Market participants invested in the long term appreciation of the Euro, and those who use the EuroFX futures as a means to manage exchange rate risk, could have limited the risk of this most recent announcement by purchasing weekly puts on the electronically traded Weeklys. The cost of this protection is significantly less than what would have been required prior to this product becoming available.

On the afternoon of the day preceding the announcement, the December EuroFX futures contract, trading on CME Group GLOBEX, was trading around 1.3420.

Had a market participant been holding a long futures contract, the position's payoff profile could be depicted as in figure 1.

Figure 1 – Long Future Payoff Diagram



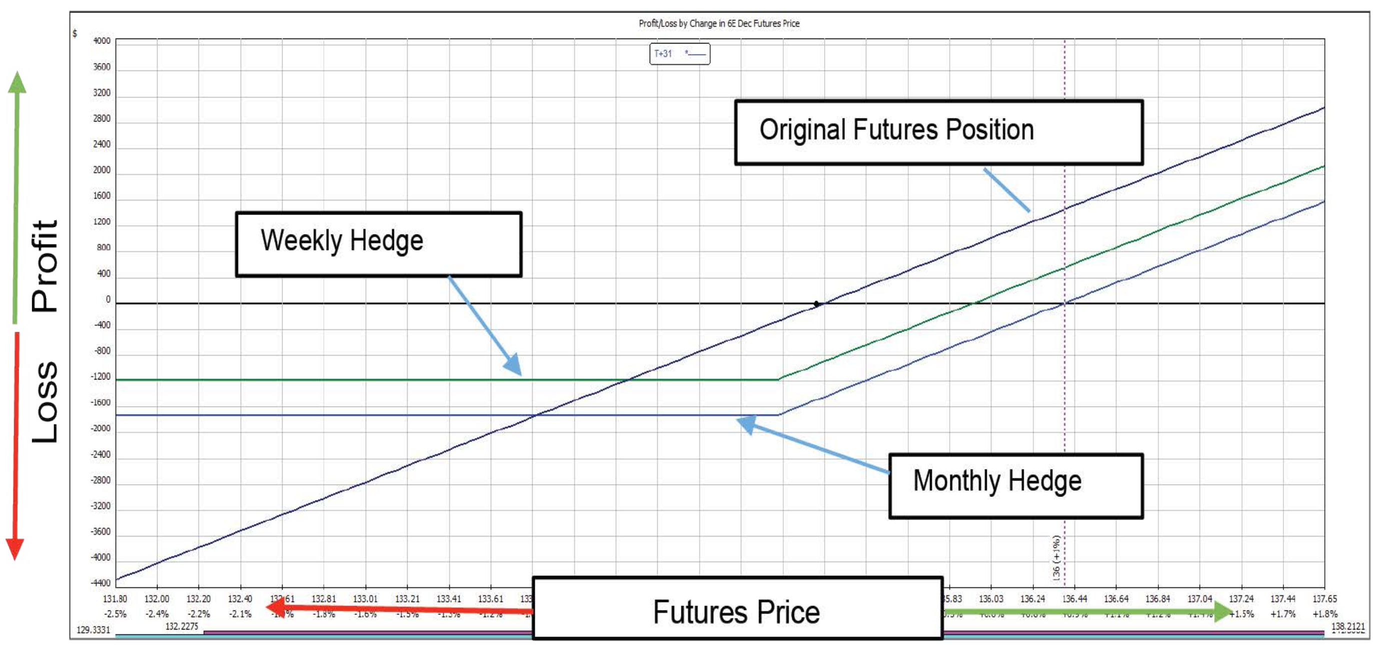
Payoff Diagram courtesy of Optionvue Systems International

The market participant, concerned about the downside risk associated with the upcoming rate announcement, could have bought a put as downside protection.

Whenever options are utilised for the purposes of insurance, a large portion of the premium expense is set by the duration for which the cover is required. When you consider that the insurance may only be required to protect against the short-term risk of an unfavourable ECB announcement, the short dated Weeklys provide cover, at the right price.

Figure 2 shows the comparison between purchasing an at the money (ATM) put in the front Weekly option, on the day before the announcement, and purchasing the same strike in the nearby monthly expiry.

Figure 2 – Options Comparison Payoff Diagram



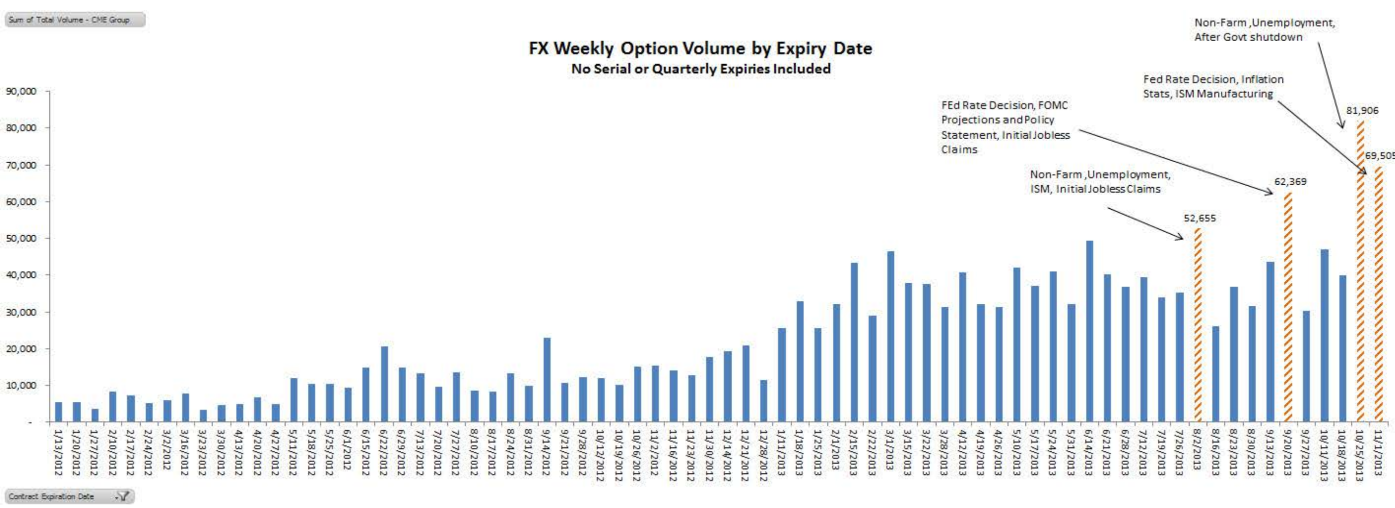
Payoff Diagram courtesy of Optionvue Systems International

The Weekly hedge provides greater protection due to lower cost (albeit for less time), which is ideal for hedging the short term price risk associated with economic announcements.

The added benefit is that the Weekly hedge can start participating in upside profitability earlier. Again, due to the lower premiums offered in the short term options.

Perhaps this is a reason for the growth in Weekly trading volumes shown in figure 3, especially around key announcement times.

Figure 3 – Volume Trends



OPPORTUNITIES AT THE RIGHT PRICE

A speculator can also benefit from the cheaper costs associated with buying Weekly options.

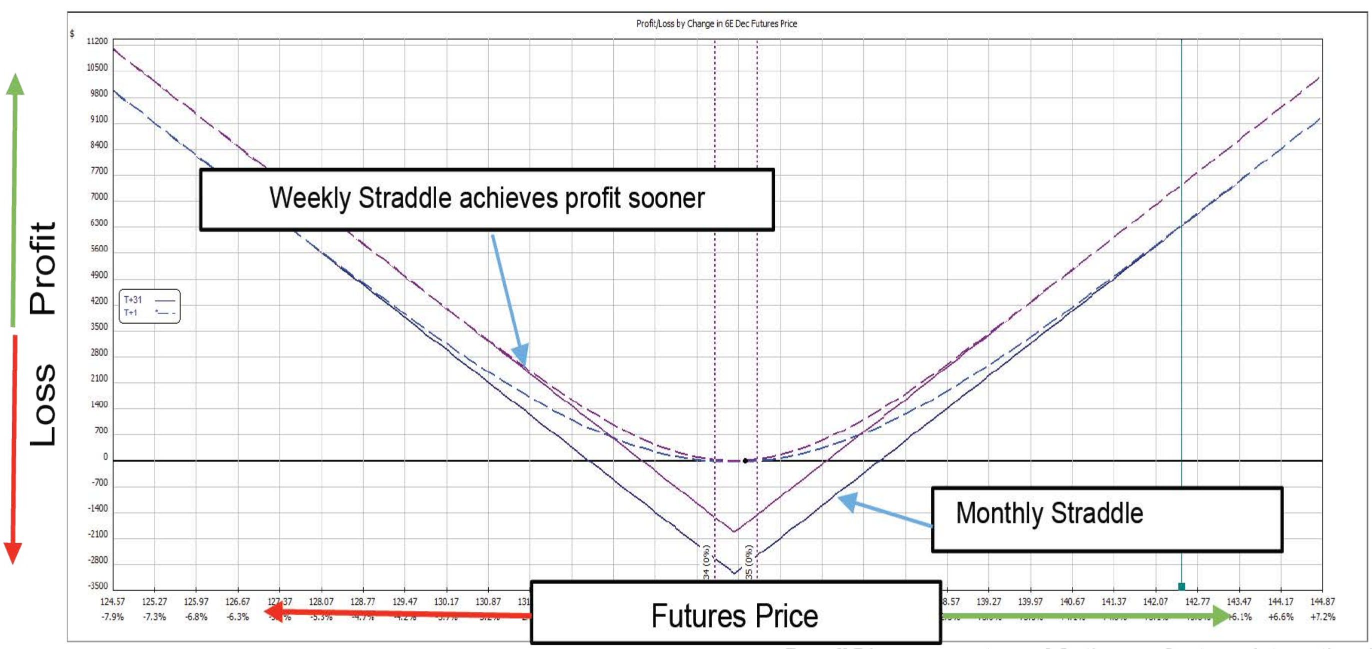
Using the same example above, a trader without a position may wish to try and benefit from the expected volatility of the ECB rate announcement.

Without the need to pick direction, a trader can purchase a synthetic straddle position, using the front month Weeklys, far cheaper than the traditional monthly options series.

A short December futures position and two long ATM call options are initiated, on the night before the announcement. For the purposes of comparison, two straddles are analysed, one using the front Weekly call options and one using the nearby monthly expiry.

Figure 4 shows the comparison in cost and relative underlying movement required to achieve profitability.

Figure 4 – Straddle Comparison Payoff Diagram



Payoff Diagram courtesy of Optionvue Systems International

The purpose of this trade is for playing the announcement only. Should the market not react violently, then the position should be closed shortly after the announcement.

In this example, the announcement was the catalyst for a large price movement, and shortly after the announcement, the Weekly synthetic Short Straddle outperformed the monthly version, see figure 5.

Figure 5 – Comparison Payoff Diagram

Payoff Diagram courtesy of Optionvue Systems International

At this point, the options (pardon the pun) for the trader are wide open, depending on forward expectations. If the objective was to profit from the event, then the position should be closed. However, there are possible adjustments to be made which could garner further profits.

One such example, for traders with a risk appetite, selling the 2 lot of long Weekly calls and shorting a 2 lot of ATM Weekly puts would create a Short Straddle with a very wide profit zone. This position could easily double the profit, with only a two days to expiry. ***Note: Please do not trade short straddles unless you have experience in managing these kinds of positions.*** See figure 6.

Figure 6 – Short Straddle adjustment

Payoff Diagram courtesy of Optionvue Systems International

It is exciting times for electronic trading at CME Group. The Weekly options series are ideal vehicles to create trading opportunities for short term price events. For this reason, I expect the interest in these products to grow dramatically over the next two years. I hope this article will help you to see at least a few reasons why.

Kevin Saunders, DipFin FINSIA Dux

Kevin came to trading as a hobby in the late 90's during the dot-com boom. After making a lot of easy money in the internet bubble, he had the misfortune of losing a lot of money when the bubble collapsed. This formative experience marked the beginning of a journey to develop a more robust method for trading the financial markets. Kevin studied at FINSIA, Australasia's premier membership organisation for the financial services industry. On completion if his studies, he received the Dux of Victoria for the highest overall mark and the National Subject Prize for "Derivatives: Applying Theory to Practice". Kevin became involved with trader training organisations, creating educational materials, such as the "Live Trader Program" for TCT Australia. He worked at propriatry trading house First Continental Trading before co-founding Non Correlated Capital in 2009. Non Correlated Capital is a NFA registered CTA. Kevin is the Director of Tribelet Capital Management in Australia, a boutique investment house which is incubating a new trading strategy over several CME derivative products.