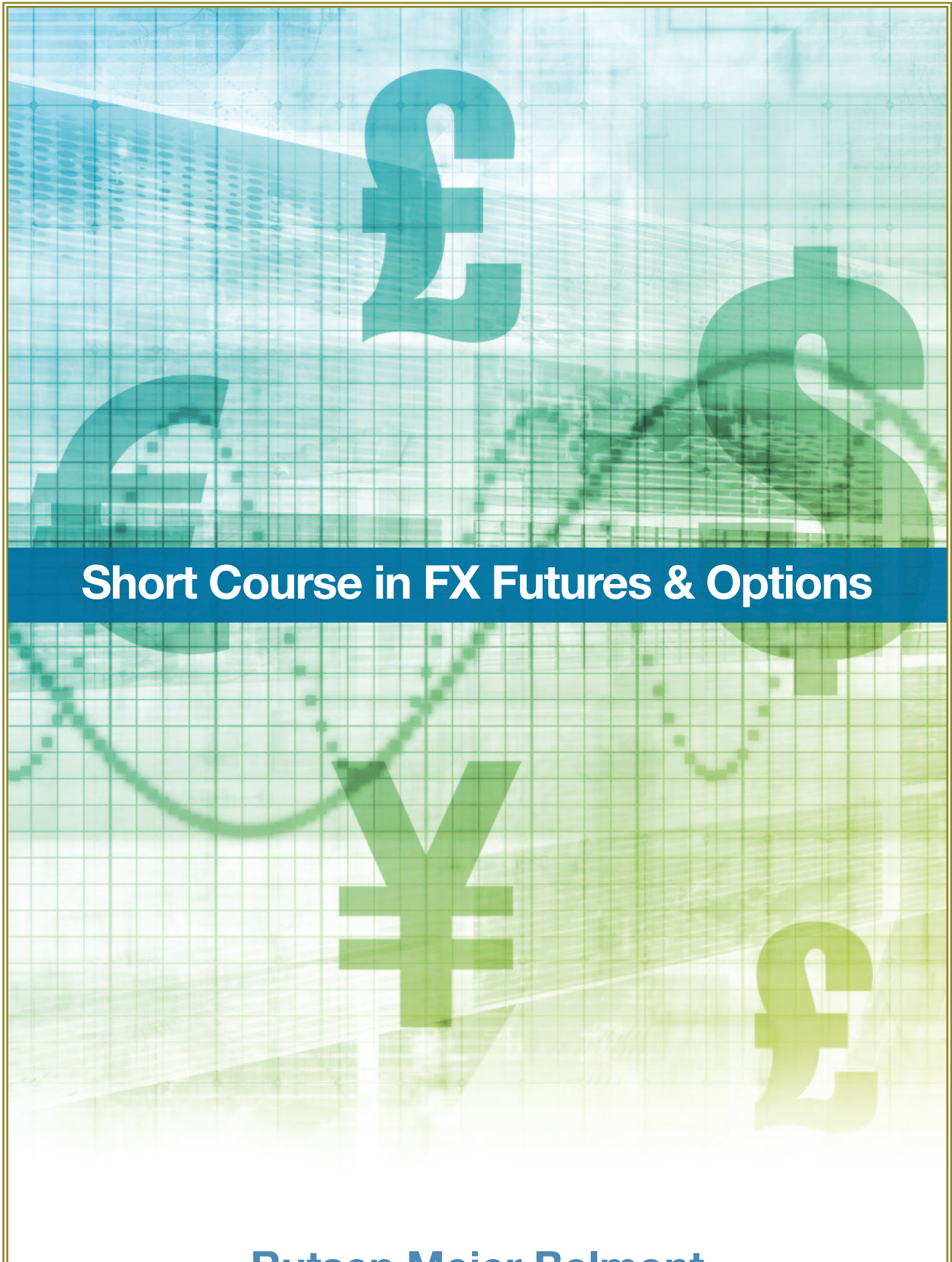


The background of the slide features a light green grid pattern. Overlaid on this grid are several large, semi-transparent currency symbols: a blue pound sterling symbol (£) at the top center, a green Euro symbol (€) on the left, a green dollar symbol (\$) on the right, a green yen symbol (¥) at the bottom center, and a green pound sterling symbol (£) at the bottom right. A dark blue horizontal band is positioned across the middle of the slide, containing the title text in white.

Short Course in FX Futures & Options

**Rutsen Meier Belmont
(RMB) Group**

WELCOME TO THE EXCITING WORLD OF FX FUTURES & OPTIONS

In just a few short years, foreign exchange (known as Forex or FX) trading has exploded. The global foreign currency market is huge and extremely liquid — routinely logging transactions in excess of \$3.5 trillion every 24-hours around the world. Most of these transactions take place between large, institutional traders. Currencies trade in relation to each

“Trading currency pairs gives you dozens of brand-new diversification plays.”

other in “pairs” or “crosses”. **Because one currency is always rising or falling versus another, there is always a bull market somewhere in the foreign currency market.** Trading currency pairs gives you dozens of brand-new diversification plays.

The disruption of the bull market in stocks and low yields in bonds and CDs caused many investors to look for alternatives to traditional investments. This helped foreign currency trading become increasingly popular with smaller, less well-capitalized traders.

In order to enter the institutional (wholesale) foreign currency market — where transactions are routinely in excess of \$1 million per trade — smaller cash FX investors came to rely on a network of middlemen known as Forex or FX (retail) dealers to make markets in smaller lot sizes more suitable to their available capital. Both are Over-the-Counter (OTC) markets; no government regulated exchange is involved.

Most cash Forex dealers take the other side of customer trades and provide their own in-house trading platforms where they supply the quotes for currency trading pairs to their customers.

This report highlights critical differences between trading currencies using the over-the-counter dealer system and using regulated exchanges. The sidebars on the next three pages give you a quick overview of the major differences.

ADVANTAGES OF FX FUTURES & OPTIONS

If you are trading with a private dealer or wondering whether trading currencies is right for you, you should know about FX futures and options. FX futures and options trade on government regulated exchanges and, unlike the retail cash FX dealer market, trade with full bid/ask price transparency. Prices are set by the marketplace, not just one dealer, and the latest bid/ask and last transaction price are publicly quoted by the second.

This levels the playing field by giving smaller traders access to the same prices and allied information, like volume, as the big boys. All transactions are cleared and guaranteed by the exchange Clearing Corporation – one of the great success stories of modern finance.

DEFAULT-FREE TRADES

The Clearing Corporation stands in the middle of every transaction, acting as the buyer to all sellers and the seller to all buyers. This eliminates counterparty risk by guaranteeing every trade, making sure all participants

CASH FOREX

Cash FX is OTC (Over the Counter) on the “Interbank” market — Bank-traded cash FX has minimum round lots of \$500K to \$1 million. Banks trade with each other. \$100K lots are considered “small.”

Smaller cash traders must use FX dealers — The FX dealer is the market maker. The dealer takes the other side of investors’ trades, consolidates smaller orders and lays off risk in the interbank market. Quotes may not match the interbank market – a potential to “run” stops – especially in exotics. FX dealers can make money “trading against” their customers.

FX dealers don’t charge commissions — Retail investors usually pay a “spread” of 3 to 5 “pips” when entering and exiting positions. A “pip” is 1/100th of a percent or roughly \$10 per traded lot, assuming an underlying currency value of \$100K. 3 pips in and out is the equivalent of a \$60 futures commission. Spreads for exotics and cross rates are often much higher, sometimes in excess of 100 “pips”.

pony-up enough capital in the form of margin to honor their obligations as prices change. *(For more on this, see the discussion of futures margin later in this report.)*

Since the advent of the modern Clearing Corporation in 1925, not one

penny has been lost in FX futures and FX futures options due to counterparty risk. This includes the Great Depression, when over half of 30,000 banks were wiped out along with thousands of trusts, bond houses, insurance companies and foreign currency specialty dealers ...and the crisis starting in 2007 when over \$700 billion in various OTC contracts defaulted.

FX FUTURES & OPTIONS

Exchange traded market — This means the Clearing Corporation is buyer to all sellers and seller to all buyers; there is no counterparty risk. Not one penny has been lost due to counterparty risk since the advent of the modern Clearing Corporation in 1925.

Transparent market — All quotes are made public, so a customer trades with the world, not just his dealer. Futures brokers cannot run stops like FX dealers because everyone is using the same market info. FX dealers can use prices outside the ranges of the interbank market to fill customers. Futures brokers are bound by reality.

Option compatability — There are no options readily tradable in the over-the-counter (OTC) cash FX market. Consequently, most FX dealers do not offer option trading as an adjunct to cash FX. FX futures traders can use matched options to protect positions.

Greater liquidity than PHLX alternatives — This results in better fills. The SPAN margin system used for futures options means less margin required for spreads and other professional strategies than PHLX.

FUTURES & OPTIONS

In nearly every case, exchange-traded futures and option contracts are liquid and public. Prices are determined by the “open outcry” of trades in a “ring” or “pit” or through an electronic auction taking place at light-speed in a computer. While most trading today takes place on electronic exchanges, certain option transactions still require the expertise of a floor broker, trading on an exchange floor.

For most of their 2,000-year history, options have been a mystery to most investors. While that is changing, most individual investors have only a vague notion of options.

What we can do is remove some of the mystery by explaining options in clear and concise terms.

In many cases, these tools will work as well for investors with a few thousand dollars as they will for investors with millions. Don't worry if you don't "get it" right away. Read this report, put it down for a day or two, and then go over it again. A couple of careful readings can help clarify things for you.

FUTURES TUTORIAL

Myths and Realities — Risks and Rewards

There is a great deal of mystique surrounding futures contracts. Many stockbrokers and financial advisors will caution you against getting involved in futures and options or dismiss these markets as pure speculation. They are partly right.

If you use the traditional "roll the dice" methodology practiced by many beginning traders and brokers, your odds of success are very low. Because they can involve a high degree of leverage, futures and options entail a high degree of risk.

When used properly, futures and options may provide exciting and very substantial rewards – and in numerous cases prove to be the optimal strategy, even for the most conservative investor.

What is a futures contract? A futures or "commodity" contract is an agreement between two people. The "seller" of a futures contract agrees to deliver a specific item to the "buyer" for a certain price on a fixed date in the future.

The buyer of a futures contract agrees to take delivery of the same item under the same terms. The buyer of a futures contract is said to be "long" the market. The "seller" of a futures contract is said to be "short" the market.

FX futures contracts are essentially “paper transactions” as they do not involve the purchase and sale of actual investment instruments. They are contracts for *delivery* at a future date. Because no delivery takes place prior to a specified period, no money changes hands. The vast majority of FX futures contracts are exited prior to the delivery period, so actual foreign currency rarely changes hands.

Instead, both the buyer and the seller must post margin with their respective brokers. Margin requirements are set by the individual exchanges and, for the most part, based upon volatility and not price. Unlike stocks, the treatment of long and short futures contracts positions is identical. Unlike a short seller in stocks, the seller of a futures contract does not need to “borrow” his contract from another party — making it just as easy to sell as to buy.

Unlike stock margin, margin to trade an FX futures contract is not a down payment on a loan. It is a performance bond that guarantees your broker that you are good for a fixed amount of losses.

Not only do you not pay interest on a margin deposit, you can receive interest while using the money to back up your positions. How? By posting margin with your broker in the form of a U.S. Treasury bill. Since a T-bill is backed by the U.S. government, it is nearly as good as cash, so most brokers accept it. Meanwhile, you get to keep the interest.

PRACTICAL EXAMPLE

“Go Long” Emerging Markets Using Australian Dollar Futures

The two biggest macroeconomic stories of our generation are the growth of the global economy and the explosion of the Forex market. Not surprisingly, they are related. As world trade grows, so does the importance of exchange rates. **FX futures and options offer investors a direct way to profit from changing exchange rates, letting them make both pro-dollar and anti-dollar bets with relative ease.**

There are liquid, easy-to-trade futures and options contracts on the Australian dollar, British Pound, Canadian dollar, Eurocurrency, Japanese yen and Swiss franc. These currencies are quoted in relation to the dollar, but can

be traded against each other – a practice known as “cross trading” or “cross rate trading”.

For instance, if an investor believes the European economy will perform worse than the British economy, he or she could buy the British Pound and simultaneously sell the Euro, betting the Euro would decline in relation to the Pound or that the Pound would rise faster than the Euro.

For our example, let's consider the Australian dollar contract – a direct play on global growth. Countries like China and India are growing by leaps and bounds. As they become more affluent, their demand for consumer goods grows. Greater demand for more houses, cars and gadgets means greater consumption of raw materials like iron ore, copper and other industrial metals.

“When used properly, futures and options contracts may provide exciting and very substantial rewards – and in numerous cases prove to be the optimal strategy, even for the most conservative investor.”

More affluence also correlates with a varied diet that includes meat. Meat requires a lot more grain than a diet of grain itself – 10 times more for chicken, many times that for beef and pork. Where will the expanding populations of China and India find these resources? The first place they'll look is close to home.

Australia is geographically close to the fast-growing nations of Asia. It is also rich in mineral and agricultural resources. Demand for Australian dollars to purchase these resources should help maintain fundamental buying support under the currency from “down under” as long as the global growth story remains intact. Strong demand for its natural resources means more foreign capital pours into Australia, causing the Australian central bank to keep interest rates high to guard against inflation, increasing the desirability of its currency even more. Why hold US T-bills yielding a paltry 0.25% when you can own Australian T-bills earning 4.25%?

Given its rich natural resources, proximity to Asia and relatively high

interest rates, it's no wonder the Aussie dollar is one of the strongest currencies on the board. **A long position in the Aussie buck is a bet that global growth will continue – especially in the developing world – and that the demand for commodities will remain strong as a result.**

FUTURES CONTRACT MECHANICS

Let's take a look at the Australian dollar futures traded on the Chicago Mercantile Exchange (CME). Table 1 below is a reproduction of a daily price listing from the *Wall Street Journal's* website. Delayed FX futures and options quotes are free on websites like the CME (www.cmegroup.com). You can also access quotes for futures prices for contracts on all major exchanges by going to www.rmbgroup.com and clicking on the "Quotes and Charts" link.

Table 1: Australian Dollar (CME)-AUD 100,000; \$ per AUD

	Open	High	Low	Settle	Chg	High	Low	Open Int
Jun 10	.8111	.8345	.8065	.8241	-.0014	.9330	.8065	109,679
Sep 10	.8015	.8260	.7984	.8156	-.0015	.9230	.7900	4,468
Dec 10	.8200	.8200	.8050	.8079	-.0013	.9005	.8050	395

Est vol 201,362; vol Thu 250,812; open int, 114,551, +2,809.

Note that the contract size is 100,000 Australian dollars and quoted in US cents per Australian dollar. This type of quote is "American style." American style currency quotes use the foreign currency as the "funding currency" and the US dollar as the "quoted currency". All full-sized CME currency contracts are quoted this way. The settlement price of .8241 for the June contract means that on the close of trading that day, one Australian dollar was worth 82.41 American cents.

Note that the December futures contract has a lower settlement price. It closed at 80.79 cents per Australian dollar the same day the June contract closed at 82.41 cents. The 1.62 cent difference represents the extra interest an investor would make if he or she held Australian dollars rather than American dollars. The interest is discounted in the price. **If an investor held the December futures contract until expiration, he or she would collect the entire 1.62 cent difference.**

As of this writing, the margin (or performance bond) required to trade a full-sized Aussie dollar future contract is \$2,700. The value of this contract is 100,000 times the 82.41 cents settlement or \$82,410. \$2,700 is just 3.3% of the value of the underlying contract. Assume you purchased a June Australian dollar futures contract at 82.41 cents and the following day the Australian dollar rose 2% to 84.06 cents. How much would you make?

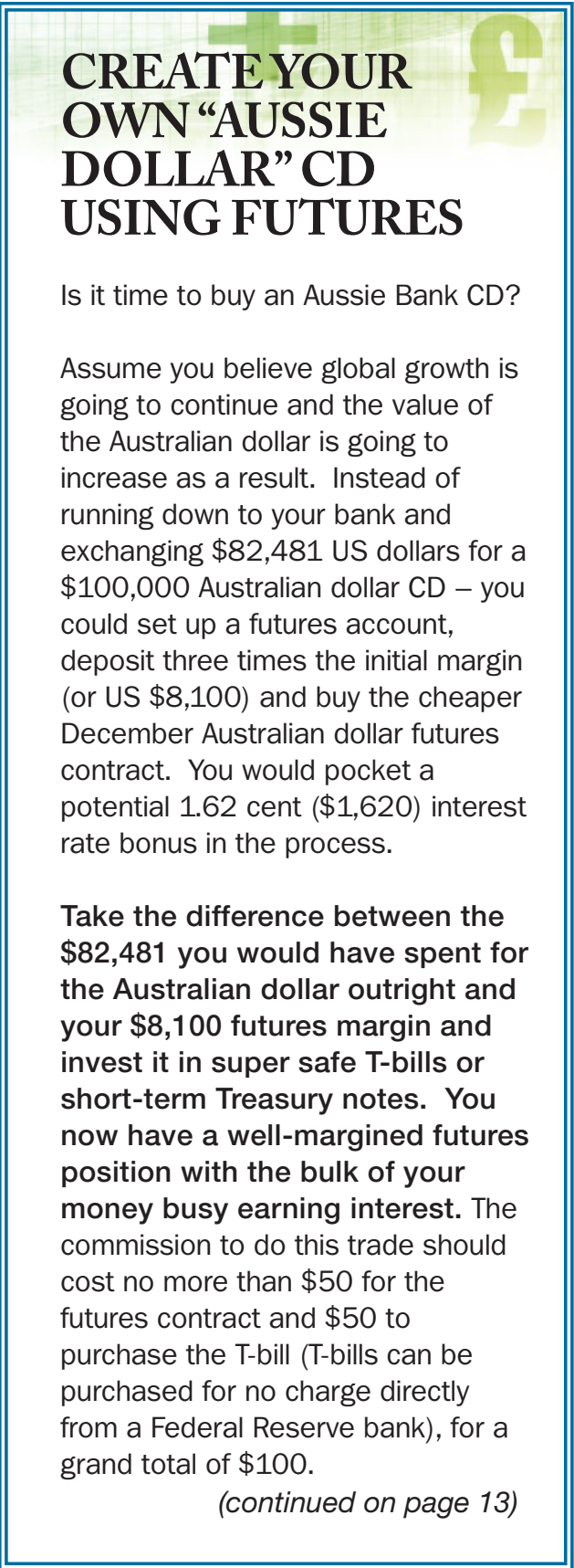
Simply subtract 82.41 cents from 84.06 cents and multiply by the contract size of 100,000 Australian dollars and you get 1.65 cents times 100,000 or \$1,650. **This return of 61% on your margin of \$2,700 would be *physically added to your futures account on the next trading day*.** You would be able to withdraw it and still hold the position. Conversely, if instead of rising, the Aussie dollar *declined* by 2%, that same \$1,650 would be *physically deducted* from your futures account.

IMPORTANT POINT: *Unlike stocks or the purchase of options, there is no such thing as a paper gain or loss in futures. Both are realized immediately.*

You may be required to add more money to the account to meet your minimum margin (performance bond) requirement or “margin call”. If the value of the Australian dollar dropped far enough to exhaust the cash in your trading account, your position would be liquidated and you would be responsible for any additional money to bring your account back to zero. (If all you have to trade with is \$2,700, then the full-sized Australian dollar futures are probably not for you.)

A good rule of thumb is to have at least *twice the minimum margin* required to trade any futures contract.

THE INFORMATION AND OPINIONS CONTAINED HEREIN COMES FROM SOURCES BELIEVED TO BE RELIABLE, BUT ARE NOT GUARANTEED AS TO ACCURACY OR COMPLETENESS. THE RISK OF LOSS IN TRADING FUTURES AND/OR OPTIONS IS SUBSTANTIAL. EACH INVESTOR MUST CONSIDER WHETHER THIS IS A SUITABLE INVESTMENT. WHEN TRADING FUTURES AND/OR OPTIONS, IT IS POSSIBLE TO LOSE MORE THAN THE FULL VALUE OF YOUR ACCOUNT. ALL FUNDS COMMITTED SHOULD BE RISK CAPITAL. PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS.



CREATE YOUR OWN “AUSSIE DOLLAR” CD USING FUTURES

Is it time to buy an Aussie Bank CD?

Assume you believe global growth is going to continue and the value of the Australian dollar is going to increase as a result. Instead of running down to your bank and exchanging \$82,481 US dollars for a \$100,000 Australian dollar CD – you could set up a futures account, deposit three times the initial margin (or US \$8,100) and buy the cheaper December Australian dollar futures contract. You would pocket a potential 1.62 cent (\$1,620) interest rate bonus in the process.

Take the difference between the \$82,481 you would have spent for the Australian dollar outright and your \$8,100 futures margin and invest it in super safe T-bills or short-term Treasury notes. You now have a well-margined futures position with the bulk of your money busy earning interest. The commission to do this trade should cost no more than \$50 for the futures contract and \$50 to purchase the T-bill (T-bills can be purchased for no charge directly from a Federal Reserve bank), for a grand total of \$100.

(continued on page 13)

FX OPTIONS SHORT COURSE

Options are not necessarily “better” than actual futures contracts, but they generally require less time, money and stress than futures. **While options are not a cure-all, they eliminate the need for stop loss orders, providing the investor with far more staying power. But this isn’t their only advantage.**

Options are largely misunderstood, as much if not more than futures contracts. The same people who tell you to stay away from futures will tell you to stay away from options. **Options are a favorite tool of professional investors precisely because they are one of the most flexible investment tools ever devised.**

The trading desks of central banks, multinational corporations and governments use options to lock-in the risks of their large investments and as surrogates for future investments. The phenomenal growth of FX global option markets is the direct result of the benefits they may provide. There are options on many, if not most, of the major Forex currency trading pairs.

Perhaps one of the biggest barriers to understanding options is the inability to understand their basic

premise. Investors get caught up in the jargon rather than what they are buying and selling. As a result, they lose their way when introduced to more advanced strategies – especially selling options.

Stocks and mutual funds are a little easier to get a handle on. When you buy and sell stocks or mutual funds, you buy and sell pieces of a company itself. The same goes for bonds, land or precious metal bullion. In all cases you are dealing with physical assets — something tangible.

When you buy and sell options you are not exchanging anything physical; instead you are exchanging rights and obligations. Remember this and options – all options – will make sense to you.

WHAT ARE FOREIGN CURRENCY CALLS AND PUTS?

There are two types of options: calls and puts. A CALL BUYER pays money in exchange for the right but not the obligation to buy something. A PUT BUYER pays money in exchange for the right but not the obligation to sell something. Conversely, a CALL SELLER receives money in exchange for the obligation to sell something. A PUT SELLER receives money in exchange for the obligation to buy something.

CREATE YOUR OWN “AUSSIE DOLLAR” CD USING FUTURES

(continued from page 12)

The futures commission is quoted "round-turn" which includes both the cost to buy AND sell...

This \$100 compares to a typical bank or trust company foreign currency CD that could ultimately cost you at least 3% or \$2,564 of the total invested ($3\% \times \$82,481 = \$2,564$) by way of the bid/ask spread on the buy and sell, possible add-on service charges; and, the prospect of early redemption penalties. On the other hand, a typical bid/ask spread in the Aussie dollar contract would be about 2 ticks or \$20.

You can buy and sell your futures “CD” as many times as you want without redemption penalties or holding time constraints. CME FX futures trade 23 hours every business day. The electronic session opens at 5:00 pm on Sunday and extends to 4:00 pm the next trading day. The domestic pit session and options market open at 7:20 am and close at 2:00 pm Monday through Friday.

(Note: Comparable FX CD strategies are also possible with options on futures contracts found in the options section)

IMPORTANT POINT: *When you buy and sell options you are not exchanging anything physical. Rather you are exchanging rights and obligations.*

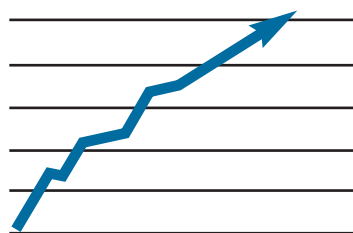
Think of it this way...when you hire someone and pay them a wage, you have a *right* to tell them what to do. When you work for someone and accept payment, you have an *obligation* to do the work assigned to you. Options buyers have rights. Option sellers have obligations. For every buyer there must be a seller, and vice versa.

Let's use two hypothetical examples to help illustrate how options work:

“The phenomenal growth of global FX options markets may be the result of the benefits they provide.”

LAND SPECULATOR: “CALL” OPTION POWER

Call Buyer Wants The Market To Go Up



Let's say a land speculator wants to buy 100 acres of land in an area he thinks is ripe for development, but doesn't want to lay out a large sum of money to purchase it outright. He approaches the owner of the land and offers \$50 per acre to grant him (the speculator) an option to purchase it for the going price of \$1,000 per acre, for one year. Assuming he accepts the speculator's offer, the owner now has an obligation to sell at that price.

If no development occurs by the end of the year, the owner gets to keep the \$5,000. The speculator loses \$5,000. However, the speculator AVOIDS the mortgage payments, closing costs, lawyer's fees and other expenses associated with a failed land speculation. With his working capital intact, he walks away from the deal free and clear, with plenty of capital to try again.

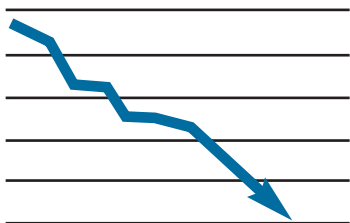
Let's assume, on the other hand, that a development company shows an interest in the land, and in the process, drives its market value up to \$1,300 per acre. Since the original owner is obligated to sell to the land speculator for

\$1,000 per acre, the land speculator reaps an immediate windfall of \$300 per acre. He doesn't even need to physically purchase and resell the land to profit! Instead, he can sell his option to someone else, perhaps the developer.

How much will he get? At least the difference between the \$1,000 per acre purchase and the new \$1,300 per acre market value. \$300 times 100 acres equals \$30,000...a six-time return on his original investment of \$5,000! The original owner has lost the opportunity to sell at \$1,300 per acre, but is still \$5,000 richer than had he originally sold the land outright. In this scenario, both he and the land speculator make out better than if they consummated the deal without the benefit of an option.

HOMEOWNER'S INSURANCE: "PUT" OPTION POWER

Put Buyer Wants The Market To Go Down



Did you know that every time you buy an insurance policy you are essentially buying a put option? It's true. Let's use a homeowner's policy as an example.

When you sign on the dotted line and write your check you are essentially buying *the right* to sell your house back to the insurance company for a certain value, under certain conditions, for a limited period of time. By accepting your money, the insurance company has taken on an obligation to buy your

house back from you under the same terms.

The longer your policy has to run, the more the insurance company will charge you. (A six-month policy costs less than a twelve-month policy.) It works the same way with options.

IMPORTANT POINT: *The amount a buyer pays or a seller receives for an option is called the "premium" – the same terminology used in insurance.*

Similarly, in order for you to collect on your policy, certain conditions must be met. Most policies require a catastrophe before they pay off. The more vulnerable your home is to one, the more you will pay. In order for put

options to pay off for the buyer, the underlying market must go down. The more negative the market outlook, the more the put buyer will have to pay. *(We will revisit the insurance analogy again, precisely because options and insurance have so much in common.)*

CALL BUYER — wants the market to go up. The call buyer PAYS MONEY in exchange for the right but not the obligation to BUY the underlying currency at a specified price for a limited period of time.

- The call buyer is like the land speculator in our example.
- He makes money only if the underlying market goes up.

CALL SELLER — does not want the market to go up. The call seller RECEIVES MONEY in exchange for granting the right to buy to the call buyer. The call seller has an obligation to SELL the underlying currency to the call buyer at a certain price for a limited amount of time.

- The call seller is like the landowner in our example.
- He makes money if the underlying market does not go up.
(Note: the market does not need to go down. It just can't go up a lot.)

PUT BUYER — wants the market to go down. The put buyer PAYS MONEY in exchange for the right but not the obligation to SELL the underlying currency at a specified price for a limited period of time.

- The put buyer is like the homeowner in our example.
- He makes money only if the price of the underlying instrument goes down a lot.

PUT SELLER — does not want the market to go down. The put seller RECEIVES MONEY in exchange for the obligation to buy the underlying currency from the put buyer at a specified price for a limited amount of time.

- The put seller is like the insurance company in our example.
- He makes money if the underlying instrument does not go down.
(Note: the underlying instrument does not need to go up. It just can't go down.)

EXCHANGE-TRADED FX OPTION ADVANTAGES

An FX option buyer has two big advantages over an insurance policy: first, most exchange-traded options are not subject to the rigorous terms and conditions of many insurance policies. A disaster is not necessary for them to “pay off”. In the case of a foreign currency call, the underlying currency has to go up. In the case of a put, the market has to go down. It’s that simple.

Exchange Traded Option Prices
Are Determined By “Open
Outcry” of Traders in a
“Pit” or “Ring”



Secondly, unlike the policyholder in the previous example, buyers and sellers of exchange-traded foreign currency options are free to offset or add to their positions at any time during market hours. If you change your mind about a position for any reason, you can exit by simply selling it at the going rate. (Try doing that with your homeowner’s policy!)

You do not need to spend time searching for someone to take the option off your hands. The exchange acts as the middleman — it is the seller to all buyers and the buyer to all sellers. Prices of options are determined by an open outcry of traders in a “pit” or “ring” or by the interaction of buyers and sellers on an electronic exchange.

For the most part, foreign currency options are as easy to buy and sell as stocks. This makes them an ideal investment for investors who wish to take advantage of or protect themselves from big market swings. It can be done without the expense and risk of buying or selling these markets outright. This is why the pros use them.

IMPORTANT POINT: *Since movements in the underlying market are reflected in the price of options, holders do not have to “exercise” their options to take profit or cut losses. Taking profits and cutting losses is as simple as calling your broker and exiting your option.*

Call Buyer

- Pays premium.
- Has right to exercise resulting in a long position in the underlying futures.
- Time works against buyer.

Call Seller

- Collects premium.
- Has obligation if assigned resulting in a short position in the underlying futures contract.
- Time works in favor of the seller.

Put Buyer

- Pays premium.
- Has right to exercise resulting in a short position in the underlying futures.
- Time works against buyer.

Put Seller

- Collects premium.
- Has obligation if assigned resulting in a long position in the underlying futures contract.
- Time works in favor of the seller.

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BASIC OPTION TERMS

The Underlying Instrument: what you have the right (or the obligation if you are an option seller) to buy and sell. It could be shares of stock, foreign currencies, or a futures contract on crude oil, gold or soybeans.

IMPORTANT POINT: *No matter what the underlying instrument, options work the same way — they are all affected by the same factors.*

The Premium: the amount you pay when you buy an option and the amount you receive when you sell an option.

The Expiration Date: the date that the option expires. It is important to know the expiration date because time until expiration is a major factor in determining an option's fair price. An option is known as a "wasting asset". It loses value with the passage of time.

The Strike Price: the price at which you can exercise your option. This price is based on the underlying instrument. Call option buyers have the right to buy and call option sellers have the obligation to sell the underlying instrument at the striking price. Put option buyers have the right to sell and put option sellers have the obligation to buy at the striking price.

In-The-Money: calls are "in-the-money" if the price of the underlying instrument is HIGHER than the striking price. Puts are "in-the-money" if the price of the underlying instrument is LOWER than the striking price. Using our Australian Dollar example, an 83 cents call is "in-the-money" with the Aussie dollar at 88. An 83 cents put is "in-the-money" with the Aussie dollar at 78 cents.

At-The-Money: the price of the underlying instrument is identical to the striking price. The same is true for puts and calls.

Australian Dollar, Continuous Futures



Out-Of-The-Money: calls are “out-of-the-money” if the price of the underlying instrument is LOWER than the striking price. Puts are “out-of-the-money” if the price of the underlying instrument is HIGHER than the striking price. Again, using our example, an 83 cent put is “out-of-the-money” if the Aussie dollar is at 88 cents. An 83 call is “out-of-the-money” if the Aussie dollar is at 78 cents.

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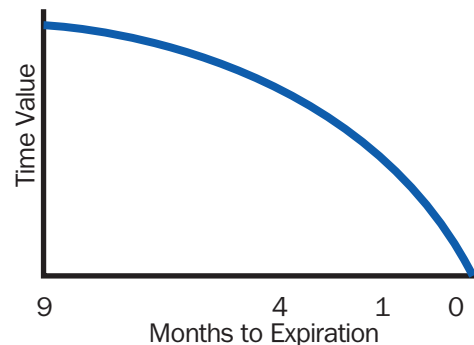
THREE KEY FACTORS THAT DETERMINE THE PRICE OF OPTIONS

1.) Distance Of The Strike Price From The Market Price — for out-of-the-money options, the closer the market is to the option's strike price, the more valuable the option will be.

2.) Time Until Expiration — the longer an option has to work, the more expensive it will be. A one-year home-owner's policy costs more than a six-month policy. Time is money and option prices reflect this. All things being equal, a September option will always cost more than a June option with the same strike price.

Dissipation of Time Value

The figure below shows the decay in an option's time value over time.



Note that the decay is not linear. Time erodes much more quickly in the last few weeks of the option's life than it does in the first few weeks.

3.) Volatility — the more volatile the market, the more expensive the option. Because the probability the option seller will have to meet his obligation rises in direct proportion to volatility, he will demand more money. Hurricane insurance always costs more in Florida than Chicago. Options work the same way.

OPTIONS AS INSURANCE

Understanding what happens when you buy an insurance policy is essential to understanding options. Most of us spend a lot of money insuring the things we care about — our homes, cars, health and lives.

The typical insurance buyer doesn't expect to get into a car accident or have his house burn down. Most of us don't expect to get sick, at least not often. Yet we spend a large portion of our adjusted gross incomes on insurance to protect ourselves *just in case*.

Knowing we are covered frees us to plan for the long-term without the fear of unforeseen events. We may complain when we write checks to the insurance company, but we are willing to trade this recurring expense for peace of mind. What does this have to do with option investing? Plenty.

INSURING AGAINST THE LOSS OF OPPORTUNITY

A foreign currency investor can use options to protect against the potential loss of *opportunity*. Like most of us, you've probably experienced the regret that comes from not capitalizing on a solid investment hunch. By using options as a low cost replacement for cash positions you can take a position in nearly any currency for far less money (and generally far less risk!) than it would cost you to buy or sell that currency outright.

If you buy options and are wrong, the only thing you lose is the cost of your option *premium* plus transaction fees. *Note, however, that before expiry you can buy or sell your option contract to cut losses, lock-in profits or add to your position.* If you are right, you can make almost as much money as if you actually bought or sold the actual currency itself. *The similarity to insurance still holds, only now you are protecting yourself against the loss of opportunity — not the loss of capital.* Unlike the holder of a double indemnity life insurance, you WANT to collect on your policy!

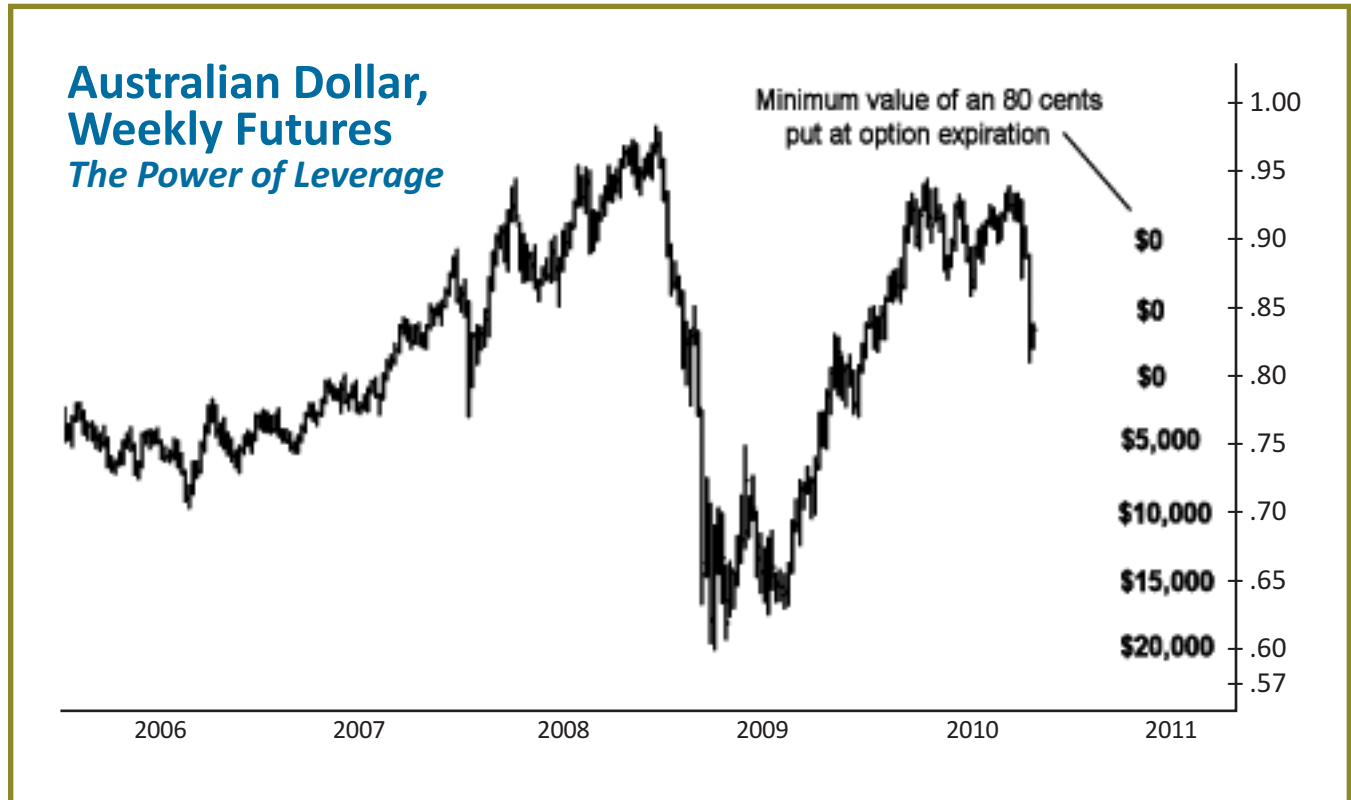
Since our premium is all we have at risk when we buy options, we get almost all the benefits of currency diversification without exposing a large portion of our portfolio to the market. Knowing a small portion of our capital is doing the work of a much larger amount frees us psychologically and financially, letting us focus on the bigger picture. Let's look at a quick example...

OPTION EXAMPLE

Use Australian Dollar “Put Options” to Hedge a Global Meltdown

Our bet here is exactly the opposite of the futures trader in our earlier example. Since its value tends to track the price of natural resources, the Australian dollar is often used as a proxy for global growth. **Let’s say we wanted to protect our portfolio against another 2008-like meltdown, but didn’t want to liquidate and risk being left on the sidelines by a reversal. A short position in the Aussie dollar could be a good bet.**

As we write this, front month Aussie dollar futures are going for approximately 82.5 cents. We can buy an 80 cent put option for 2.5 cents or \$2,500. For our \$2,500 we get the *right but not the obligation* to be short an Australian dollar futures contract worth \$82,000 (82 cents times the AD \$100,000 contract size) at a price of 80 cents. The key phrase here is “but not the obligation”. Since we are not obligated to actually sell Australian dollars, we can be wrong without losing our shirt.



If the Aussie dollar does not go below 80 cents, we won't exercise our right to be short, limiting our loss to the cost of our put option plus transaction cost. If the global economy collapses (as it did in 2008/early 2009) and the Aussie dollar tags along for the ride, our 80 cents put could offer valuable protection.

At the nadir of the 2008/2009 crash, the Australian dollar changed hands for only 60 cents. Should the same thing happen again, our 80 cent put options that we paid \$2,200 for would be worth at least \$20,000 — helping offset any other losses in our portfolio.

“A relatively small amount of capital deployed in the Forex market using options can do an incredible amount of the heavy lifting in your portfolio.”

How is this possible? It's simple. Since our put option grants us the right to be short Aussie dollars at 80 cents, we could exercise our right to short the Aussie dollar at 80 and then turn right around and buy back (cover) the futures for 60 cents. Eighty cents minus 60 cents equals 20 cents. Multiply 20 cents times the AD \$100,000 contract size and you get US \$20,000. Better still, the fact that we

could do this means we probably don't have to. Our gains should be reflected in the cost of the option itself; so to take profits we simply sell our put option.

Classic Greek mathematician Archimedes said, *“Give me a lever long enough and a fulcrum on which to stand and I will move the world.”* A small amount of force placed at the end of a properly-constructed lever can do an incredible amount of work. **A relatively small amount of capital deployed in the Forex market using options can do an incredible amount of heavy lifting in your portfolio.** At no time was our risk greater than \$2,200, allowing us to keep the bulk of our hard-earned cash in safer harbors.

This same strategy can be applied to both the long and short sides of other currencies like the Euro, Japanese yen, Swiss franc, Canadian dollar and British pound. Imagine the type of currency diversification you can achieve with a small capital outlay. (Note: options are available on full-sized contracts only.)

CME E-MICRO FOREX FUTURES

One of the concerns with FX futures is that they are too big for individual traders. Many traders are willing to put up with opaque pricing and counter-party risk because their private OTC dealers let them trade in small sizes. ***But now there is a dynamic alternative: CME E-micro Forex futures. CME E-Micros are specifically designed for these smaller, individual FX traders.*** CME E-micro Forex futures are 1/10th the size of the full-sized futures contracts. They can be traded with far less capital, making them the perfect instrument for cash FX traders looking to jump to safer, more transparent, exchange-regulated foreign currency products. The chart below lists the most heavily traded E-micro and full-sized futures contracts and their trading times.

SPECIFICATIONS

	Pit Hours*	Electronic Hours*	Size	Months	Value	Option
Foreign Currencies						
British pound	7:20a - 2:00p	5:00pm - 4:00pm	62,500 BP	HMUZ	1tick=\$6.25	Yes
E-micro BP	Elect. only	5:00pm - 4:00pm	6,250 BP	HMUZ	1tick=\$0.625	No
Japanese yen	7:20a - 2:00p	5:00pm - 4:00pm	12,500,000 JY	HMUZ	1tick=\$12.50	Yes
E-micro yen	Elect. only	5:00pm - 4:00pm	10,000 US\$	HMUZ	1tick= ¥100	No
Swiss franc	7:20a - 2:00p	5:00pm - 4:00pm	125,000 SF	HMUZ	1tick=\$12.50	Yes
E-micro SF	Elect. only	5:00pm - 4:00pm	10,000 US\$	HMUZ	1tick=SF\$1.00	No
Mexican Peso	7:20a - 2:00p	5:00pm - 4:00pm	500,000 MP	HUMZ	1tick=\$5.00	Yes
Euro	7:20a - 2:00p	5:00pm - 4:00pm	125,000 €	HMUZ	1tick=\$12.50	Yes
E-micro Euro	Elect. only	5:00pm - 4:00pm	12,500 €	HMUZ	1tick= \$1.25	No
Canadian \$	7:20a - 2:00p	5:00pm - 4:00pm	100,000 C\$	HMUZ	1tick=\$10	Yes
E-micro C\$	Elect. only	5:00pm - 4:00pm	10,000US\$	HMUZ	1tick=C\$1.00	No
Australian \$	7:20a - 2:00p	5:00pm - 4:00pm	100,000 A\$	HMUZ	1tick=\$10	Yes
E-micro A\$	Elect. only	5:00pm - 4:00pm	10,000A\$	HMUZ	1tick= \$1.00	No
Dollar Index	Elect. only	6:00pm - 5:30pm	\$1,000 x Index	HMUZ	1tick=\$10	Yes

Notes: F=January G=February H=March J=April K=May M=June N=July Q=August U=September V=October X=November Z=December

*All market hours are Central Time and are subject to change.

For example, the value of the full-sized Aussie dollar futures contract in both our futures and option examples is currently \$82,000. The E-micro futures contract is currently valued at \$8,200. CME E-micro Forex futures trade electronically 23 hours each trading day, or through your personal, full service broker.

Many traders are willing to put up with opaque pricing and counter-party risk because their private OTC dealers let them trade in small sizes. But now there is a dynamic alternative: CME E-Micro Forex futures.

Unlike full-sized Forex futures, CME E-micro futures use quotations that are identical to those in the cash market, making the jump for cash FX traders even easier.

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AMERICAN VERSUS EUROPEAN-STYLE QUOTES

Full-sized FX futures contracts are quoted “American style.” The popular EUR/USD currency pair is an example of an American style quote. The first currency listed in the pair is the funding currency and the second currency is the quote currency. American style quotes are always quoted in US dollars and cents.

For example, a EUR/USD quote of 1.25 means 1 Euro (the funding currency) buys 1.25 US dollar (the quote currency.) Certain cash Forex currency pairs like EUR/USD (Euro/US Dollar), AUD/USD Aussie Dollar/US Dollar and GBR/USD (British Pound/US Dollar) are always quoted “American style.” That means cash FX quotes and quotes for *both* full-sized and CME E-micro futures are read the same way for each of these three currency pairs.

EUROPEAN STYLE

Other cash Forex currency pairs are quoted “European style.” The popular USD/JPY pair is an example of a European style quote. In this case, the funding currency is US dollars and the quote currency is yen. European style quotes are always quoted in foreign currency rather than American dollars and cents. A USD/JPY quote of 92.13 means one American dollar buys 92.13 yen. Other major cash currency pairs like USD/CAD (US Dollar/Canadian Dollar) and USD/CHF (US Dollar/ Swiss franc) are quoted European style *both* in the cash Forex market and in the CME’s E-micro futures.

Full-sized futures contracts for all currency pairs are quoted American style. Rather than yen per dollar, the USD/JPY pair referenced above will be quoted in dollars per yen. To convert from European style to American, use the reciprocal: divide 1 by 92.13 and you get 0.010854. This means each yen is worth 1.0854 cents. To convert back, use exactly the same formula. Using our yen example, divide 1 by .010854 and you get 92.13.

“ROLLOVER RATES” AND ACCRUED INTEREST

Futures quotes and cash quotes won't match exactly because of the way they treat interest. Cash FX positions held for more than 24 hours (12.00 am GMT is the cutoff) are either charged or credited with interest depending upon prevailing interest rates. For example, Australian (AUD) rates are currently 4.25% while US interest rates are below 0.25%. Long AUD/USD positions in the Interbank Market receive interest every day, while short AUD/USD (long dollar) positions have to pay interest.

At the end of each trading day, cash FX dealers will automatically “rollover” all existing open positions to the next trading day by simultaneously closing the existing position and opening a new position. Cash FX positions held past 4pm Central Time (12:00 GMT) are automatically rolled forward. This will create either a debit or credit to the customer's account depending upon the position. Holders of currencies with higher rates of interest will be credited. Holders of currencies with lower interest rates will be debited. The amount credited or debited is known as the “Rollover Rate.”

As we write this, daily interest paid to institutional holders of long AUD/USD (long Aussie dollar) amounts to roughly \$11.50 per day for each AUD \$100K. Conversely, long dollar (short Aussie) positions will be debited the full amount — currently \$11.50 per day the position is open for each \$100K of exposure. This is not the case for individual cash FX traders.

IMPORTANT POINT: — *most FX dealers keep at least part of the “rollover rate” for beneficial, long positions. Individuals trading through a cash dealer holding currencies with lower relative interest rates will be debited the full amount. However, individual traders holding currencies with higher relative interest rates will be “clipped”; they’ll get part of, but not the entire rollover rate. The dealer will keep the balance.*

(We recently went online and found a relatively large cash FX dealer that was charging a full \$11.50 per day for a short Aussie dollar position, but only paying \$9.00 per day for a long Aussie position. This \$2.50 per day “haircut” can add up — \$75 if the position is held for a month and \$900 if held for a year.)

ACCRUED INTEREST IS INCLUDED IN THE PRICE OF FUTURES

How does the futures market handle interest rate differentials? They are discounted in the price. That why futures prices and cash prices may not match exactly. More distant contracts of a higher interest rate strategy will be lower in price than the near month.

Let’s look at an actual example by revisiting the Australian dollar quote we used earlier in this report:

If we multiply the contract size of AD \$100,000 times the June 2010 contract settlement of 82.41 cents we get a closing value of \$82,410 for the contract. The September contract settlement is 81.56 cents — 85 cents lower than June. Multiply the 81.56 cents September contract settlement times the AD \$100,000 and you get a contract value of \$81,560. The difference of \$850 between the June and September futures contracts is the accrued interest.

Australian Dollar (CME)-AUD 100,000; \$ per AUD

	Open	High	Low	Settle	Chg	High	Low	Open Int
Jun 10	.8111	.8345	.8065	.8241	-.0014	.9330	.8065	109,679
Sep 10	.8015	.8260	.7984	.8156	-.0015	.9230	.7900	4,468
Dec 10	.8200	.8200	.8050	.8079	-.0013	.9005	.8050	395

Est vol 201,362; vol Thu 250,812; open int, 114,551, +2,809.

The prices of futures and cash must converge as the delivery period approaches. If an investor bought a September futures contract and held it to expiration he would be \$850 richer than the holder of the June contract – all

“Unlike the payable interest in the cash FX market, accrued interest in the futures market cannot be ‘clipped’ by a dealer or middleman.”

(Note: Clipping can cost those with even modest cash FX accounts thousands of dollars a year in missed interest)

else being equal. Conversely, investors selling a September Aussie dollar futures contract and holding it until the delivery period would be \$850 worse off.

Buyers and sellers are treated the same in the futures markets. Unlike the payable interest in the cash FX market, the accrued interest in the futures market cannot be “clipped” by a dealer or middleman. **As a result, retail futures traders wind up**

paying and receiving the same treatment as institutions (and everyone else) when it comes to interest rate differentials, leveling the playing field.

LEVERAGE THAT SELF-REGULATES

Leverage of 100 to 1 is possible in the cash FX market. While this kind of leverage is great when an investor is on the right side of the market, it can be devastating when things go wrong. Cash FX traders plunking down as little as \$100 to trade contracts worth \$10,000 will find themselves out of money should the underlying currency manage just a 1% move against them. In today’s markets, a given currency can move 1% in a matter of minutes.

In the futures markets, the amount of leverage is determined by the volatility of the currency pair being traded and generally does not rise above 20 to 1. This works as a self-regulating mechanism – keeping traders more “balanced” when it comes to risk. Contrary to popular misconception, the investor has the power to set his or her own the margin levels within reasonable guidelines, helping to more precisely control risk. This is a vital futures benefit.

TAX TREATMENT

There are tax advantages to using FX futures and futures options in certain time periods. As we mentioned earlier, futures and futures options are regulated by the Commodity Futures Trading Commission (CFTC). Securities products like stocks, mutual funds and ETFs are regulated by the Securities Exchange Commission (SEC). Futures and futures options have a different tax treatment than stocks, stock options and ETFs.

As we write this, traditional investments like stocks have a two-tiered tax structure. Long term capital gains for investments held more than one year are capped at 15%, while short-term capital gains (held less than a year) are taxed at the investor's personal income tax rate.

Futures and futures options, on the other hand, have a single-tiered tax structure. Sixty percent of all gains are taxed at the long term rate and 40% at the short term rate *no matter what the holding period*. It could be one hour or one year; the tax treatment is the same.

If you buy an Aussie dollar put option for \$2,500 today and sell it for \$3,500 tomorrow, \$600 of your \$1,000 profit will be taxed at the long-term rate. The other \$400 will be taxed at the short term rate. Compare this to energy stocks, ETFs or options on either — if held for less than one year, your entire profit would be taxed at short-term capital gains rate. You would be better off using CFTC-regulated products like futures and futures options from a tax perspective, all else being equal.

FX futures and futures options are also “marked-to-the-market” for tax purposes at the end of each calendar year. Let's say you began the year with \$30,000 in your account, didn't add new money, and at the end of the year your account was worth \$40,000. \$6000 of your \$10,000 dollar gain would be taxed at the long term rate. \$4000 would be taxed at the short-term rate, whether or not you still owned the positions. \$40,000 would then become your new “tax basis” for the following year. Losses would be treated the same way: 60% would be long term; 40% would be short term.

What this means is you do not need to keep meticulous records of all your transactions for tax purposes, if you do not want to. Your broker will send you one form at the end of the year showing your gains and losses. Some of these statements will even tell you where to enter them on the IRS forms.

(Please be aware that the information in this section is subject to changing tax laws. Check with your accountant for the latest.)

HOW TO GET STARTED

You cannot trade FX futures and options in a stock trading account. You need a separate futures account to trade them. **The procedures for opening and trading an FX futures and options account are nearly identical to opening a stock account.** If you are new to futures and options, it is important to find a broker with the patience and experience to guide you. A discount trading platform offering only trade execution with no support probably won't meet your needs.

Sue Rutsen and her staff at the **Rutsen Meier Belmont Group (RMB Group)** have actively traded FX futures and options since 1984 and can help you get started. Their customers also receive the informative Forex newsletter, *RMB Currency Trader*, absolutely free. You can reach the **RMB Group** at **800-345-7026** toll-free or **312-373-4970** direct. You can also open an account online at www.rmbgroup.com.

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