

Writing Call Options within a Protected Loan to generate income



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Writing or selling an out-of-the-money call option over a parcel of shares held within a Protected Loan can be a relatively simple strategy to generate income. Generally, call writing is a popular strategy when volatility levels are flat or slightly rising because the money an investor receives for taking on the obligation to sell an underlying share at maturity is greater than in times of low volatility. Furthermore, call writing is a strategy usually undertaken when the outlook on a particular share price is neutral to mildly bearish.

Now available under Commonwealth Bank's Options and Lending Facility, you can write Over-The-Counter (OTC) call options over parcels of shares within your Protected Loan to generate income.

The following case study is a hypothetical example only and uses rates and figures selected by Commonwealth Bank to illustrate how the Call Writing feature within the Protected Loan works. The example should not be taken as personal advice or an indication of actual or future prices that may apply. It is not a recommendation to you to write a call option within your Protected Loan over the shares referred to and should not be regarded as an accurate statement of affairs concerning any listed company.

Introducing Suzanne

Suzanne is a 48 year old Optometrist for a leading Australian eyewear provider who recently drew down a \$200,000 Protected Loan under Commonwealth Bank's Options and Lending Facility. Suzanne chose the following shares to make up her Protected Loan portfolio:

Company Name	Loan Amount	Protected Price	No. of Shares
National Australia Bank (NAB)	\$50,000	\$24.77	2,018
Rio Tinto (RIO)	\$50,000	\$67.40	741
Westpac Banking Corp (WBC)	\$50,000	\$23.36	2,140
Woodside Petroleum (WPL)	\$50,000	\$43.15	1,158

Suzanne is able to write call options with an Exercise Price greater than the protected price. In doing this, Suzanne will be entitled to receive income, known as a Fixed Option Fee.

Generally, Suzanne would take into consideration the following prior to implementing a call writing strategy:

Term	Any term up to 5 years (not exceeding the expiry date of the Protected Loan) 1, 3, 6 and 12 month terms are most common
Share Outlook	Neutral to mildly bearish
Volatility outlook	The Fixed Option Fee Suzanne will receive when selling a call option is generally greater when volatility is high. The idea scenario is for volatility to fall after selling the call option
Minimum amount	\$50,000 notional per portfolio
Exercise Price	110% to 120% above the current market price
Option type	European
Settlement	Cash or Physical

If Suzanne were to sell call options over parcels of her shares, she would need to be aware that the outcome of her strategy will be dependent on the closing price of the parcel of shares at option expiry. Two possible outcomes could result if she were to implement this strategy:

Scenario 1 – Share price ↓

If the closing share price of a parcel of shares was below or equal to its Exercise Price, the call options written by Suzanne would expire automatically and all obligations under the options would end. Suzanne would retain the Fixed Option Fee payable to her for writing the call option.

Scenario 2 – Share price ↑

If the closing share price of a parcel of shares was above its Exercise Price, the call options written by Suzanne would automatically be exercised. If Suzanne had elected a cash settlement, she would retain her shares and the Fixed Option Fee. However, she would be required to pay a cash settlement amount which is equal to the difference between the share price at expiry and the Exercise Price multiplied by the number of shares. Alternatively, if she elected physical settlement, she would be required to sell her parcel of shares at the Exercise Price.

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The Strategy

Suzanne has considered the benefits and risks of implementing a call writing strategy. She decides to proceed with this strategy over her RIO and WPL shares because:

- Volatility levels are relatively high which means she can potentially receive a greater Fixed Option Fee;
- She believes that resource stocks may fall over the next three months due to uncertainty around the Government's proposed 40% mining tax.

To profit from her expectations Suzanne implements her call writing strategy based on the pricing below:

Share	No. of shares	Share Price	Exercise Price	% of Spot	# days	Fixed Option Fee	Total Fixed Option Fee	Annualised Return p.a.
RIO	741	\$68.25	\$75.07	110%	90	\$2.64	\$1,961	15.70%
WPL	1,158	\$44.30	\$48.73	110%	90	\$1.00	\$1,158	9.10%
							\$3,119	

Indicative rates as at 28 May 2010 exclude any adviser commission/brokerage.

The Result

If at expiry the RIO and WPL share prices are below their Exercise Prices of \$75.07 and \$48.73 respectively, Suzanne's call options expire worthless.

However, if either the RIO or WPL share prices are above their Exercise Prices at expiry, Commonwealth Bank would exercise the options that Suzanne sold to the Bank. This means that Suzanne would be obliged to sell her RIO shares at \$75.07 and WPL shares at \$48.73, a lower price than that available in the current market, or pay a cash settlement amount to retain her shares. She would, however, be entitled to keep her Fixed Option Fee in both instances.

In this scenario Suzanne's break even points would have been \$72.43 for RIO and \$47.73 for WPL (excluding any tax considerations with respect to the income generated on the strategy). This is the point where the rise in the price of RIO and WPL is equal to the income generated by the Fixed Option Fee.

In the event Suzanne did not wish to sell her shares or pay a cash amount to retain her shares, an alternative she could consider would be to roll her options for an extended term before or on expiry (costs may apply).

Getting the right advice

As with any financial strategy, implementing options strategies is not without its risks. One of the key risks of selling call options is that you may have to pay a cash settlement amount to retain your parcel of shares or sell your shares at the Exercise Price. That's why it's important to read the Product Disclosure Statement to ensure you are fully informed.

Speak to your Financial Adviser or call us on 1300 786 039 for more information about how utilising your Protected Loan to generate income can help you achieve your goals.

Important information

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