Principles of Trading Series:

Critical Trading Strategy Components – Part 1b

By Thomas Poh - 30 Mar 2020

Last week I had highlighted to everyone that there is a lot more to a winning trading strategy than just determining the direction of the trade (click here for link to Part 1a). The relative performances between SHCOMP and HSCEI from 2014-2016 were used to illustrate how the underlying product chosen can determine the outcome of the trade strategy. In this follow up section on ***Product***, I will illustrate that there is also more than one way to go long (or short) on a stock.

The most obvious way to express one's bullish view on a stock is to buy it. This is what we called a physical or cash trade. However, depending on the circumstances, this may not always be the best way to express one's bullish view. Again, the choice of the Product is important here. So what are the other ways to have a long position? Using the purchase of S&P index ETF to go long the S&P index as an example, I will illustrate are 3 other ways to be go long S&P index besides buying the ETF.

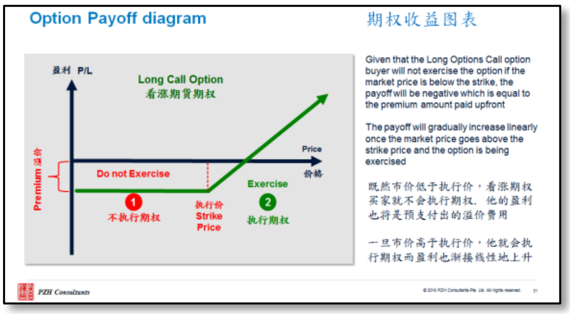
1) Buying the S&P Index Futures

There are quite a few advantages of using futures over the purchase of physical shares. The lower futures margining allows us a much higher leverage factor than normal shares margining. Brokers normally allows only up to 50% margining for shares but for futures the leverage factor can be a lot higher because margin requirements can be as low as 7%.

Futures also tend to have longer trading hours which is important as it does means we can manage our risks and capitalise on news events generated opportunities even when the stock market are closed. For example, equities index ETFs can only be traded during the normal stock market trading sessions. However, equities index futures such as the S&P index futures are literally open for trading 24 hours 5 days a week. You can understand more about futures trading from my previous Tiger webinar here.

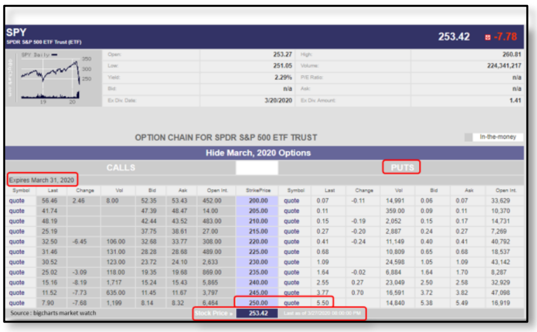
2) Buying S&P index ETF Call options on the stock

Buying call options gives us the right but not the obligation to own a stock at a pre-determined strike price on or before the option expiry. In return we will have to pay a premium for this right. In the event that the market is lower at the time of our option expiry, we can simply walk away and let the option contract expires. This is when the contract expires out-of-the-money. However, if the market is higher at expiry, we can purchase at the pre-determined lower price (the option is in-the-money). The advantage of owning an option is obvious especially when the market is very volatile and un-predictable as it did during this outbreak crisis. Therefore, options become very valuable as it offers unlimited upside profits with no downside losses except for the fixed option premium that we have paid for the option.



3) Selling S&P index ETF Put Options

We can also go long a stock by Selling Put options. Selling the put option gives the buyer the right but not the obligation to sell the stock to you at the pre-determined price on or before the option expiry. So you might ask why would you, with the intention of buying the stock want to give someone this optionality? How can this strategy be beneficial for you? The answer lies in the fact that as the seller of the option, you receive the option premium as compensation. As mentioned earlier, option prices go up dramatically during periods of high volatility. This means the premium receives from selling options are a lot higher. So selling Put options when the market is selling off allows you to own a stock at a pre-determined level (if it gets exercised) PLUS gaining the extra premium. Comparing this to just buying the stock outright, you do not enjoy that premium which could have reduce the breakeven cost of owning the stock. This strategy works the best when market is the most volatile as it was the last few weeks. Option prices went to historical highs. Seller of options executing this strategy collected high premiums while at the same time bought in the S&P index ETFs at levels which they were intending to buy in the first place.



Using the last Friday's closing prices to illustrate, selling a S&P ETF Put Option with a strike of $250 and expiring on 31Mar2020 will yield the seller a premium of $5.50. If at expiry, the market is lower than $250, the seller will be long the S&P ETF at $250 but at the same time collected an additional premium of 5.50. This effectively reduces his cost of buying the S&P ETF from $250 to $245.50.

Of course there is the chance that the market will be higher than $250 on 31 Mar 2020. In this situation, the seller will not own the S&P ETF and would have only collected the premium. However, as we have seen in the price action of the market over the last 4 weeks, a lot of buy orders were filled during the sell offs. Therefore, such a Sell Put Option strategy will result in having the same long ETF position but with an extra premium kicker collected.

The key here is to realise that there are more than one way to skin the cat. As traders, we must be able to use the most suitable product to express our view. It can related to choosing the correct underlying stock/index or using the correct trading product for any particular given stock. This in turn emphasizes the need for traders to constantly increase our product knowledge so that we will understand the functionalities, risks and rewards of each product.

In my next session, I will go on to explain the next Critical Trading Strategy Component after Direction and Product. To know what it is, stay tuned to my channel! In the meantime, good luck and happy trading!

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