CANADIAN EQUITY DERIVATIVES

Quaterly Newsletter - January 2014

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Richard Croft

Richard Croft, President of R. N. Croft Financial Group, Inc., a company that provides personal portfolio management and consulting services to individual investors, has been in the securities business since 1975. He has been collaborating with the Montréal Exchange as an instructor for several years in addition to developing two options writing indices (MX Covered Straddle Writers' Index and MX Covered Call Writing Index) and publishing options commentary on MX blog (optionmatters.ca). Richard is also a regular contributor to the *MoneyLetter*, where his articles focus on using individual stocks, mutual funds, and exchange-traded funds within a portfolio model. Most recently, he co-authored *Protect Your Nest Egg*, a Canadian best-seller on portfolio building.

Martin Noël

Martin Noël holds an MBA in Financial Services from the Université du Québec à Montréal since 2003. The same year, he received his Fellow of the Institute of Canadian Bankers and was awarded the Silver Medal for his superior level of performance in the completion of the Professional Banking Program.

Martin began his career in the derivatives industry in 1983 as an options market maker for various brokerage firms on the floor of the Montréal Exchange. He later became an Options Specialist and ultimately an independent trader. In 1996, he joined the Montréal Exchange as Options Market Supervisor where he had the opportunity to contribute to the development of the Canadian Options market. Since May 2009, he is President of Monetis Financial Corporation, which specializes in professional trading and financial communication.

Trading Calendar

PRODUCT	LAST TRADING DAY	EXPIRATION
Equity options	January 17, 2014	January 17, 2014
Options on ETFs	January 17, 2014	January 17, 2014
Equity options	February 21, 2014	February 21, 2014
Options on ETFs	February 21, 2014	February 21, 2014
Equity options	March 21, 2014	March 21, 2014
Options on ETFs	March 21, 2014	March 21, 2014

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OPTIONS CONFERENCE

for Investment Advisors and Portfolio Managers

Event hosted by TMX Montréal Exchange OIC The Options Industry Council

MONTRÉAL
March 27, 2014

TORONTO
March 26, 2014

VANCOUVER
April 3, 2014

Attend and obtain **CE credits**

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T.I.N.A.

By Richard Croft

T.I.N.A., which stands for "There Is No Alternative," has become a perverse acronym used by analysts on both Bay and Wall Street to explain the seemingly unstoppable rally in stocks globally. Despite a serious slippage in the metrics – i.e. revenue, earnings, price to earnings - that typically propel stock values major global markets have been riding a wave of liquidity. Canada being the notable exception to the rule!

Global sentiment is clearly bullish and based on the low volatility numbers coming out of the options market traders are not the least bit apprehensive. That leads us to the central theme that equity markets supported by positive sentiment are climbing a wall of worry. A very steep wall considering the fickle nature of sentiment and lackluster performance of liquidity infused economies!

Canada has been the poster child of how real economies recover from a deep recession. Slower than normal growth to be sure! But an undeniable positive trend rooted in a solid banking system and real consumer demand. Far removed from the steroid driven economies – notably Japan, the European Union and the US - that are clearly overdosing on liquidity!

In terms of real economic activity Canada's GDP grew at an annual rate of 3.5% year over year to September 2013. Not bad considering that the US economy did less than that despite three versions of quantitative easing. The one troubling area being Canada's exports which fell in September. Could that be an early warning sign of an impending US slowdown (Canada's largest trading partner) as the Fed begins to taper?

That is the major question facing Canadian investors as we enter 2014. Like it or not we are linked at the hip to our US cousins and a slowdown south of the border will affect Canada. It is a question of degree!

There are signs that the US economy is slowing based on some of the revenue warnings being issued by S&P 500 companies. Slowing growth already impacted the just completed third quarter revenue numbers. While many US companies were able to beat on the bottom line that had more to do with margin expansion driven by productivity improvements and share buybacks. Manipulative metrics that can benefit over the short term but longer term distort reality.

More to the point neither of these metrics will likely provide much support in 2014. Companies are being less aggressive with their share buyback programs and productivity has gone about as far as it can before companies have to embark on major hiring programs. The problem for North American companies is their reluctance to do anything amid so much uncertainty. Think about healthcare costs, tapering and politicians who simply cannot get out of the way.

So far the only resolution to come out of Washington was bi-partisan support for an increase in the debt ceiling in exchange for an agreement to agree about a tax and spending debate at some point in the future. In short nothing that will improve visibility or instill confidence. Without that bulls need to have faith that markets will continue following the path of least resistance in much the same way as avarice relies on the "greater fool theory."

Still I am reminded of an old saying attributed to Sir Winston Churchill where he said – and I am paraphrasing - that the "US tends to do the right thing… eventually." I too believe that US politicians will do the right thing… eventually. But in the interim investor emotions will be subjected to a tsunami of political grandstanding that will cause short term sell-offs, spikes in volatility and perhaps one could argue, longer term gains.

With that in mind investors might want to focus on Canadian stocks through the first half of 2014. Better to watch the political performance from this side of the 49th parallel. At least you have a buffer against a shift in sentiment caused by political tremors.

I am cautiously optimistic that the second half of 2014 will provide some signs of real economic growth. Any sign of a US recovery – regardless of size – without any serious inflationary concerns would boost Canadian stocks.

I also think Canada will play catch up to the US (note: Canadian stocks have lagged US stocks for the past two years) as Canadian sectors leveraged to the US recovery would likely out-perform the broader US market. Canadian stocks could rally on the back of P/E expansion related to potential revenue and earnings growth while US stocks simply hold their ground as economic reality catches up with hyped optimism.

Ripe for the picking in this environment are Canadian exporters, transportation companies and financial services. Enbridge, Trans Canada Pipelines, Canadian National Railway and Canadian Pacific could turn in some decent numbers in 2014. Even without that, blue chip Canadian names may be less risky as rich dividend payouts provide a homemade put option that can limit the downside.

On the other hand I am not enthused about commodity based stocks like Agrium and Potash, energy companies such as Suncor and gold miners like Barrick, Goldcorp and Agnico Eagle. Part of my concern is the lack of inflationary pressures which are key drivers for commodities, energy and most certainly precious metals.

Canadian banks are interesting from a couple of perspectives; 1) I expect them to be front and center during any economic recovery and 2) they benefit from a steepening yield curve. We know that rates will continue to rise as tapering gets priced into the market. And we know that higher rates are toxic for long term bonds and without any hint of inflation pose a significant threat to real return bonds.

More importantly higher rates create a serious problem for conservative portfolios that typically hold a sizeable bond weight. The takeaway; clients who need a fixed income allocation need to shorten their duration which dampens return or augment their bond portfolio with some dividend paying Canadian banks.

And there's the rub! We are witnessing a marked shift in risk metrics where bonds may carry greater risk than equities. As we have been saying… There Is No Alternative to stocks.

Sale of covered call options on BCE Inc.

On November 29, 2013, the share price of BCE Inc. (BCE) traded at a price of $47.25 after dipping to $40.58 on June 28, 2013, for an increase of nearly 15%. At this level, the price falls just short of the historic peak of $48.90 reached on May 24, 2013. This level should represent a resistance zone given the fact that the RSI 5 (Relative Strength Index over 5 sessions) is in an overbought zone. The combination of these two factors leads us to believe that BCE may see a slowdown in its growth rate and even the start of a correction, the extent of which remains to be determined. In such a context, investors with BCE stock in their portfolio could benefit from a defensive strategy that would take advantage of a continued upswing, while providing a slight protection in case of decline. Covered call writing on BCE shares consists in selling one call option contract for every 100 shares held.

The level of the strike price for call options sold is a compromise between the desired capital gain and the sought degree of protection. In this case, while BCE is trading at $46.15 on January 10, 2014, the sale of $47 BCE MAY call options at $0.65 per share would generate a maximum profit of $2.67 per share, including two $0.58 dividends, by the expiration month of May 2014 (strike price of $47 - BCE current price of $46.15 + premium of $0.65 + dividends of $1.16) for a return of 5.9% (16.8 % annualized). The breakeven point of $44.33 provides protection against a decline of 3.9%. The sale of $46 BCE MAY call options at $1.10 per share provides protection against a decline of 4.9% with a breakeven point of $43.88 and a potential maximum profit (with dividends) of 4.7% (13.5% annualized).

Purchase of long-term call options on TransCanada Corporation

The price of shares of TransCanada Corporation (TRP) has just completed a so-called “head and shoulders” pattern and, if the buy signal is confirmed, TRP could reach a target price of $53.50 over the coming months, for a potential increase of 12% from the closing price of $48.03 at the close of markets on Friday, January 10, 2014. The stock’s slight decline since the beginning of 2014 ended just shy of $47 and as long as this level does not take a significant drop, we can consider the buy signal based on the “head and shoulders” pattern to still be valid. An investor who has confidence in the growth potential of TRP and is ready to assume the risk that this support level may be invalidated, could establish a limited-risk bullish position by purchasing long-term call options maturing in January 2015. The choice of call option strike price should take into account the growth potential considered reasonable by the investor.

As a result, we will evaluate three possible growth scenarios, that is, an increase of 6%, 8% and 10%. The strike price chosen will be the one that achieves the best return from among all the strike prices of the maturity month of January 2015 for each scenario. In the case where TRP achieves the target price of $50.90 (+6%) by the January 2015 maturity date, the best choice would be to purchase TRP 15 JAN 44 C call options at $4.90 for a potential return of 42%, if the investor succeeds in selling his call options at $6.90 by the maturity date. In the case of an 8% increase, the target price would then be $51.90, and the best choice would be to purchase TRP 15 JAN 46 C call options at $3.50 for a potential return of 68%, if the investor succeeds in selling his call options at $5.90 by the maturity date. Lastly, based on the scenario of a 10% increase, the target price would be $52.80, and the best choice would then be to purchase TRP 15 JAN 48 C call options at $2.35 for a potential return of 107%, if the investor succeeds in selling his call options at $4.80 by the maturity date.

Top 10 Most Active Option Classes

RANK	SYMBOL	2013 VOLUME	INSTITUTIONAL	RETAIL	INSTITUTIONAL %	RETAIL %
1	XIU	2,188,991	1,587,646	601,345	73%	27%
2	MFC	739,071	445,841	293,230	60%	40%
3	BB	738,794	73,682	665,112	10%	90%
4	TD	731,069	377,986	353,083	52%	48%
5	BMO	718,570	402,831	315,739	56%	44%
6	RY	707,499	346,220	361,279	49%	51%
7	BNS	695,384	368,978	326,406	53%	47%
8	CM	663,778	389,020	274,758	59%	41%
9	ABX	611,562	212,712	398,850	35%	65%
10	CNQ	574,947	386,910	188,037	67%	33%

Options Trading Volume by Sector

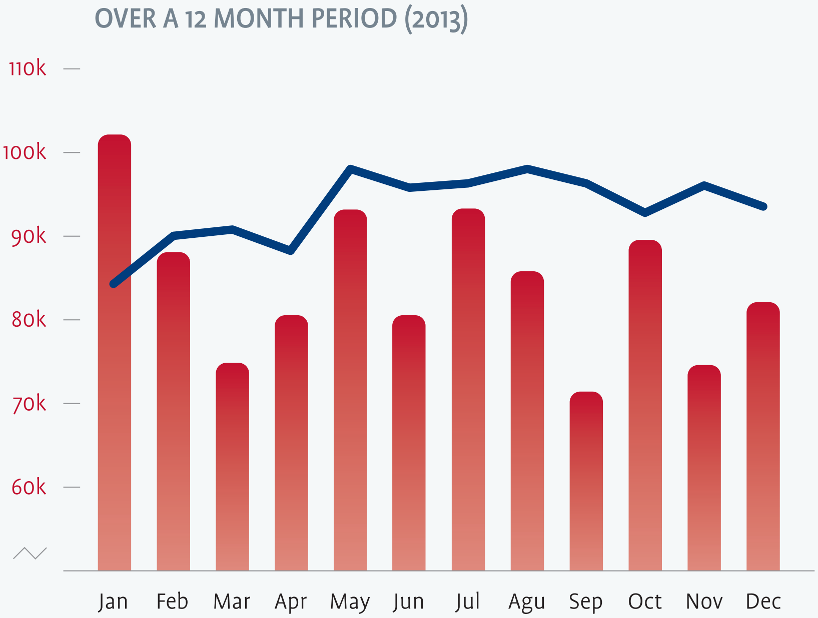
SECTOR	% CHANGE
Energy	26.99%
Materials	26.29%
Financials	25.75%
Industrials	5.26%
Information Technology	4.15%
Telecommunication Services	3.96%
Consumer Discretionary	3.31%
Utilities	2.27%
Consumer Staples	1.49%
Health Care	0.52%
Grand Total	100%

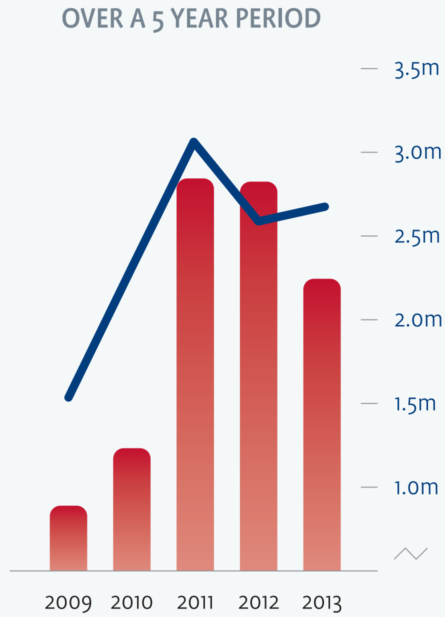
*Source Bloomberg
Note: Options volume from delisted or acquired companies are excluded.

Most Crossed Option Classes

RANK	SYMBOL	CROSS VOLUME
1	XIU	1,587,646
2	MFC	445,841
3	BMO	402,831
4	CM	389,020
5	CNQ	386,910
6	TD	377,986
7	BNS	368,978
8	TRP	354,470
9	RY	346,220
10	ATH	305,281

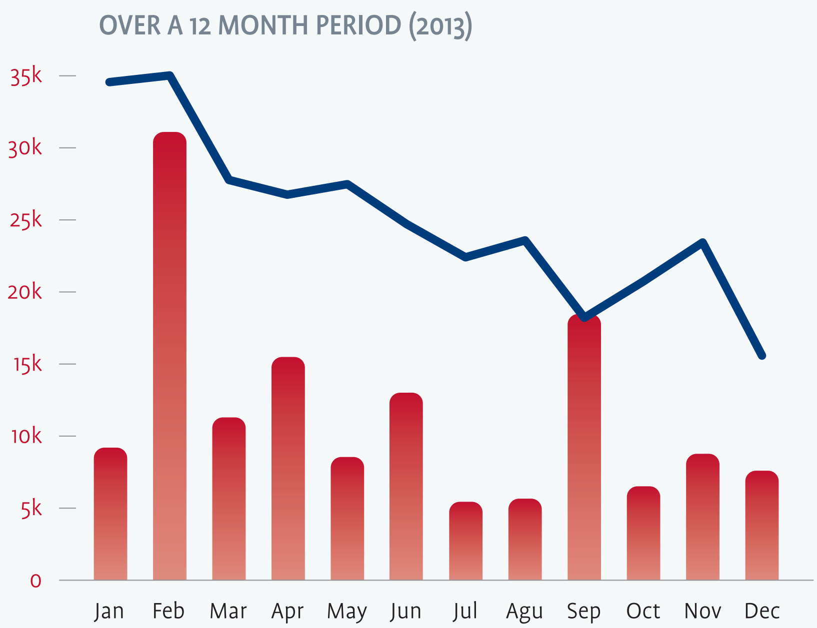
Equity Average Daily Volume and Open Interest

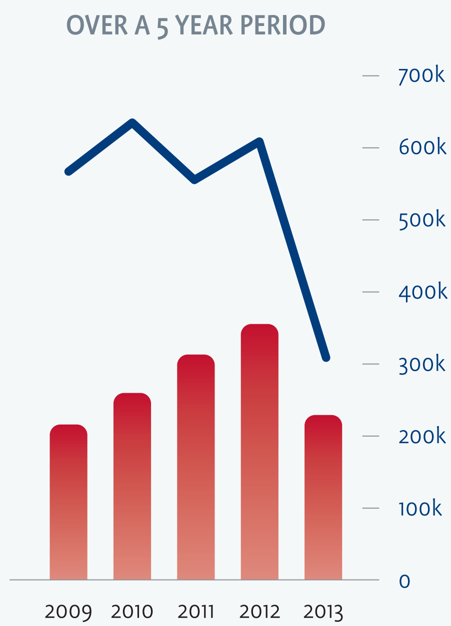




Average Daily Volume Open Interest

ETF Average Daily Volume and Open Interest





Average Daily Volume Open Interest

Trading Tools

COVERED CALL Calculator

OPTIONS Calculator

TMX Trading SIMULATOR

Useful Links

GUIDES

» Equity derivatives

» Index derivatives

» Currency derivatives

» Equity options tax regime

MX INDICES

» S&P/TSX 60 VIX Index (VIXC)

» MX Covered Straddle Writers' Index (MPCX)

» MX Covered Call Writers' Index (MCWX)

OTHERS

» Options List

» Put/Call Ratios

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