Wiley Trading

THE FOREX OPTIONS COURSE

A Self-Study Guide to Trading Currency Options

- What Drives the Forex Markets
- Key Technical Set-Ups
- Cultivate a Winner's Mindset
- How to Use Fundamentals for High Probable Direction

ABE COFNAS

The Forex Options Course

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Preface

This book is designed to help forex traders build upon their knowledge and skills in trading forex and apply it to forex option strategies.

There are important differences between spot forex and options trading. In contrast to the spot forex trader, the options trader puts on trades “anticipating” a move over a longer duration of time. Whereas the spot forex trader concentrates on trades to achieve profits intraday and even intrahour, the option trader is liberated from the slavery of the screen and can set and let fundamental and market forces generate the intended profits. Position trading strategies become an important part of the repertoire of the forex option trader.

Forex option trading also is accompanied by an entirely different mind-set from spot trading. While neither one can claim superiority over the other, there are significant consequences to pursuing a forex option mind-set. The differences between the forex spot and option trading perspectives generate different strategies and goals and also a different need for information. For example, the spot trader often seeks frequent small moves and focuses on intraday and intrahour charts, avoiding the need for constantly absorbing information on fundamentals and the big picture. In contrast, the forex option trader’s decision to put on a trade is a result of a more intense evaluative process where the trade fits optimal conditions, since forex option trading is less frequent than spot trading. Forex option trading requires more experience evaluating broad market conditions and top-down analysis, while forex spot trading requires greater focus on trading itself with precision management of moment-to-moment trading.

The presence of high leverage exists in both spot forex and options on forex trading. However, the main difference is that many of the forex option techniques explored in this book provide high leverage without the associated risks of margin calls.

This book is different from the option literature that is available—a great deal on the Internet—because it places the concepts of option trading in a strict forex environment with examples to guide the reader. The book is also designed to prepare the forex trader for new option variations and intermarket choices for shaping and putting on forex options. Those individuals who are familiar with equity option or futures option trading will find the application of basic option principles to be straightforward. But it should be clear that in the coming years forex trading is going to occur in many venues. The rise of exchange-traded funds (ETFs) provides a rich new source of data on forex option price action. Those traders having equity platforms can immediately trade forex options through their equity accounts because of the increasing availability of currency instruments such as those currency options provided at The International Securities Exchange (ISE) and Philadelphia Stock Exchange (PHLX) .

It's also important to note that those forex traders staying in the spot side can use the access through equity accounts to analyze patterns relating to currencies and commodities. The forex option trader will improve the odds of winning by tapping into more than one market for information. The ETFs will certainly become a tool for trading. The futures markets are also improving their forex option product line. The CME's forex product line is expanding and offering new trading opportunities in options. The Chicago Board of Trade's (CBOT's) options on federal fund futures and the more recent binary options on federal funds provides unprecedented opportunities for forex traders to gain market knowledge about the probabilities of Federal Open Market Committee (FOMC) moves—without needing to trade those instruments. But this book is also designed to prepare the forex trader for these and even newer variations in forex options that are coming to the market. Binary options allowing traders to play touch, no-touch, double-touch, and double-no-touch are becoming available worldwide and in the United States. These binary options will revolutionize the ability of people to trade forex with limited risk.

For the serious forex trader, considering forex options and becoming skilled in forex options analysis is advisable because it is increasingly apparent that the world is, more than ever, interconnected. Many of us have heard the phrase, "No man is an island." Today, we can state that no market is isolated. Equity, commodity, and debt markets cannot be totally separated. They all tap into each other and generate a global liquidity market that fuels buying and selling. Today's trader in any of these realizes that currency price movements reflect more than a determination of the value of the dollar versus another pair. The forex market reflects the totality of market psychology versus the prospects of growth versus inflation.

The goal of this book is to provide a "get started" manual for understanding and trading forex options, from the basic plain vanilla calls and puts to the intriguing first-generation exotic binary options. Our goal is to provide the reader access to the right information to make the most well-informed decision. The challenge of trading forex is among the most exciting of all the markets, and this book is designed to help the trader meet those challenges.

Acknowledgments

This book became a reality because of the contribution of many people. Foremost are my students in forex who enabled me to evolve a deeper understanding of forex trading and in particular the potential benefits of understanding forex option trading. In the writing of this book, superderivatives.com deserves special recognition. Their advanced analytics engine was made available to me for the purpose of writing this book and it offered a rare opportunity to present dimensions of analysis that is usually attributable to institutional research. Udi Sela deserves acknowledgement for providing professional forex option trading insight and expertise to ensure that the strategies and tactics described had validity. The strategies and tactics however, reflect the author's judgment only. My student and colleague Reynolds Lee deserves recognition for generating a great deal of the charting in the book. His expertise in visual numerics is world-class.

Lastly my wife, Paula, needs to be acknowledged for providing an environment conducive to the work required to complete the manuscript.

About the Author

Abe Cofnas has been the forex trading columnist of *Futures* magazine since 2001 and has written over 10 columns. He has been a leader in designing and delivering forex training courses. He has conducted seminars in the United States, London, and Dubai as well as online training in all time zones. Mr. Cofnas founded www.learn4x.com in 2001 as the desktop forex trading industry started to provide education and training in this field and has been a consultant designing forex education and training material to many firms. He has since developed forex coaching with advanced performance analytics. He is head forex coach at secretsoftraders.com. Recently he founded fxdimensions.com, a forex proprietary trading team, and is the founder of www.currencygames.com, a forex trading game company. He has been in the financial service industry as an equity broker, futures, and forex trader since 1990.

Mr. Cofnas holds two master's degrees, in political science from the Graduate School of Political Science, University of California, and in public policy from the University of California, Graduate School of Public Policy. He currently lives in Longwood, Florida, with his wife, Paula, where he conducts research on artificial intelligence programs using cellular automata and enjoys digital photography. He has a daughter, Paige, and a son, Paul.

The Forex Options Course

PART ONE

Key Option Elements

The objective of Part One is to provide a knowledge base for learning about the key elements of forex options. This includes a description of plain vanilla options and how option premiums are impacted by volatility. To prepare the forex trader for shaping option trades, Part One also provides a detailed outline on the basic elements of "the Greeks," which are the components that provide insight on how forex option prices change with time and volatility.

CHAPTER 1

The Elements of an Option Trade

PLAIN VANILLA OPTIONS

This chapter provides a review of the key elements that comprise an option trade. The simplest form of option trading is called plain vanilla. Plain vanilla options in all markets include calls and puts and are exactly the same as in forex trading.

PURCHASING AN OPTION

First, let's talk about purchasing an option. Purchasing an option means holding an option. A trader purchases an option by paying a premium for it.

Calls

Once a trader has purchased (gone long) and is holding a call, he has the right but not the obligation to buy the underlying spot forex upon expiration. If it's a European-style option, exercising rights are on expiration and not before. If it's an American-style option, exercising rights are any time up to and including expiration.

The key concept is that a buyer of a call anticipates an upward move or is bullish. The trader selects a target called a strike price. If the price of the spot forex moves through and beyond the strike price, the position will be in profits. If the spot price is beyond the strike price at the time of expiration, the position is known as "in the money." We can see in the profit payout graph (see Figure 1.1) that a call option becomes profitable once

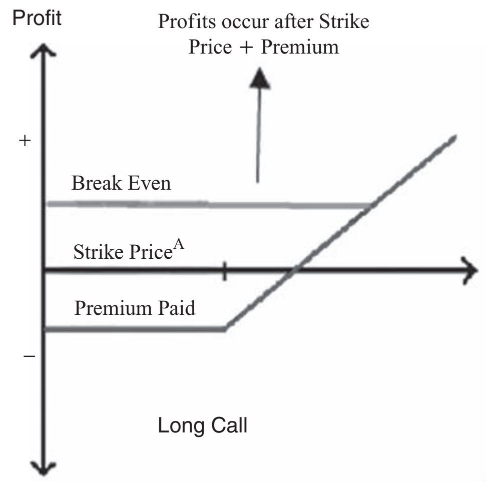

FIGURE 1.1 Currency Call Option Example

the price is beyond the strike price and beyond the cost of the position. This is a generic example for any call.

Let's begin to examine the elements of an option trade by looking at the following example involving the EURUSD.

After scanning the weekly chart of the EURUSD, a trader is anticipating a stronger EUR against the dollar and has selected a 1.47 strike price for a February 14 expiration. The premium charged for this is calculated to be $790 USD. Notice that the EURUSD spot position is at 1.4419. To be clear, the example as shown in Figures 1.2 and 1.3 would mean the trader expects the EURUSD to move to and beyond 1.47 by the expiration date. Actually, to be profitable if held to expiration, the spot position needs to be 79 pips beyond that, or 1.4779 to recover the costs of the premium since each pip is worth $10. But the most that the trader would lose is the premium paid and any associated other fees (source of the premium price example: www.ikongm.com).

Puts

Once a trader has purchased (gone long) and is holding a put, he has the right but not the obligation to buy the underlying spot forex upon expiration. If it's a European-style option, exercising rights are on expiration and not before. If it's an American-style option, exercising rights are any time up to and including expiration.

What is important about purchasing an option is the element of risk control. Once an option is purchased and the premium is paid (along with any other fees), this total cost is the maximum risk facing the trader. No matter what happens to the price action, the *most* the trader can lose is the cost of the premium paid.

The key concept is that a buyer of a put anticipates a downward move or is bearish. The trader selects a target called a strike price. If the price of the spot forex moves

FIGURE 1.2 Placing a Call on the EURUSD
Source: © ProRealTime.com, web-based charting software

Hypothetical Option Chain Data

Call Options			
Strike	**Bid**	**Ask**	**Delta**
1.4300	0.0251	0.0261	0.6090
1.4350	0.0221	0.0231	0.5680
1.4400	0.0192	0.0202	0.5255
1.4450	0.0168	0.0178	0.4823
1.4500	0.0147	0.0157	0.4398
1.4550	0.0127	0.0137	0.3983
1.4600	0.0109	0.0119	0.3584
1.4650	0.0093	0.0103	0.3202
1.4700	0.0079	0.0089	0.2843
1.4750	0.0066	0.0076	0.2507
1.4800	0.0055	0.0065	0.2195
1.4850	0.0046	0.0056	0.1910

Currency Pair :	EUR/USD
Expiration Date :	2/14/2008
Market Price :	1.4418
Option Premium Ask Price :	$790

FIGURE 1.3 Trader Expects EURUSD to Move Beyond 1.47

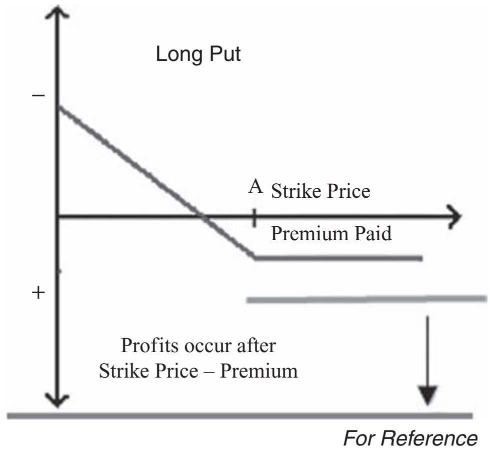

FIGURE 1.4 Profit Region on Puts

toward, and possibly through and beyond the strike price, the position will be in profits. If the spot price is beyond the strike price at the position is known as "in the money." We can see in the generic profit payout graph (see Figure 1.4) that a put option becomes profitable once the price is beyond the strike price and beyond the cost of the position.

In Figures 1.5 and 1.6 we see an example regarding the GBPUSD. The market price is at 1.9816. The strike price selected is at 1.9400. The expiration date is February 14. The cost of a put is $1290. The trader placing this put will pay in pip terms 129 pips if trading a standard lot of 100,000. This means that the break-even point will be 1.9400–0.0129, or 1.9271 if the trade is allowed to go to expiration. It is possible that the premium price could move up in value if volatility in the market increased and the GBPUSD fell quickly and early toward the strike point (source of premium price examples: www.ikongm.com).

The trader needs to always remember that time itself is important. The longer the time to expiration, the greater the risk that the strategy can go wrong and a new event will interfere and change the price direction. However, more time can allow the trade to work out and overcome periods where the price movements go against the trader. Time is a double-edged sword for the forex option trader.

Figure 1.7 shows an example of a put option on the EURUSD. The trader expects a fall in the EURUSD and has selected 1.46 for the strike price. The amount of the premium charged is estimated to be $580. Remember this is 200 pips away from the spot price which is at 1.4829 (see Figure 1.8).

Compare the premium price of this put to the call that was at 150 or 180 pips away, which was at 763. In other words, the market expected the move to be up because the price of an option almost the same distance was much higher for the call.