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# IT'S ALL ABOUT OPTIONS

Options are possibly the most powerful of all derivatives. They create a lopsided obligation. In other words, the seller's losses are potentially unlimited whereas the buyer's are limited to the premium paid. They are optional for the buyer but binding for the seller.

Options convey the right, but not the obligation, to engage in a future transaction on a futures contract at a guaranteed price. Options are traded by both retail and institutional investors.

There are two types of options traded on the JSE's equity derivative market, namely 'call' and 'put' options.

Call options give the buyer the right, but not the obligation, to buy an underlying asset when the buyer believes the underlying asset will increase in value beyond the strike price.

Put options give the buyer the right, but not the obligation, to sell the underlying asset when the option buyer expects a drop in value of the underlying share, below the strike price.

For example, a SEP09 ABCQ 150 call option gives the buyer the right to buy one futures contract in ABC Corporation for R150 per share on or before the expiry date of the option in September. If exercised, the seller of this option must sell one futures contract (100 equities) of ABC for R150 per share regardless of the price of the underlying security at expiry.

The option buyer pays the option seller a premium, which is the cost of the option. As stated previously, the buyer of the option is not obligated to exercise the option. The buyer can sell the option before it expires, or alternatively let the contract lapse at expiry and therefore lose the option premium paid.

## FEATURES OF AN OPTION

Option contracts have a number of components. These components include:

### Expiry date

This is the day on which all unexercised options for the specified contract date expire. They generally expire on the third Thursday of March, June, September and December. These dates correspond with Safex's futures market close-outs when all the contracts for that expiry are settled.

### Underlying securities

Options may be traded on any company with a Single Stock Future (SSF) listed or over an index listed on the JSE's equity derivatives market. Options trade like other derivatives, with buyers making bids and sellers making offers. You can trade options on most of SA's largest companies, including firms in the TOP 40 index. Options are also available on the FTSE/JSE ALSI 40 Index.

### Exercise/Strike price

This is the pre-determined price at which you buy (call) or sell (put) the underlying asset if the option is exercised.

### Premium

The premium is simply the price the purchaser pays in order to obtain the right and not the obligation. It serves as an insurance premium for the seller of the option.

### Initial margin

This is a deposit which is calculated by the exchange's estimate of the maximum one day's loss. It is sometimes referred to as a performance bond or a good faith deposit. You will earn a competitive interest rate on it and it will be returned to you upon the expiry or closure of the contract.

### Voting rights

Options do not convey voting rights.

Options can be traded by placing an order through your broker, just as you would with futures or shares

### WHY TRADE OPTIONS?

#### Protect the value of your shares

Put options allow the investor to protect their shares against a declining price. Buying a put option locks in the sale price of the investor's shares for the duration of the option contract, no matter how low the share price may go. This strategy therefore allows the investor to hedge against unwanted risk as a result of volatility in the market.

#### Speculate

Options can be used to profit from a movement in the underlying share without the costs of trading the shares themselves. They provide exposure to movements in the share price for a fraction of the cost (the premium) of purchasing the shares themselves. Because of the small initial outlay on margin, you can obtain geared exposure to price movements.

#### Time to make sure

There may be times when you are not certain you should go ahead with the purchase or sale of an asset. Buying an option enables you to defer your decision until the option's date of expiry. When you buy a call option you lock in the price of purchase for the derivative. You then have until the expiry date to decide whether or not to exercise the option. Similarly, by purchasing a put option you ensure a fixed selling price, and give yourself time to decide whether or not to proceed with the sale. In both cases, the most you can lose is the premium you have paid for the option.

# Options can be used to profit from a movement in the underlying share without the costs of trading the shares themselves

### HOW ARE OPTIONS TRADED?

Options can be traded by placing an order through your broker, just as you would with futures or shares. The broker will then try to find a counterparty to sell you the desired option.

In order to trade options, clients will have to open an equity derivatives and options account with a broker, and sign a client agreement form and a risk disclosure statement. A broker will provide the necessary documents.

The JSE's options on equities and equity indices are options on futures. This means that they are exercisable into futures contracts over the life of the contract, only settling at expiry. They are also margined over the life of the option. This margining helps to ensure that market participants are protected from defaulting counterparties.

Brokerage and transaction fees apply when trading and exercising option contracts. These calculations exclude the initial margin (which is a good faith deposit upon which the investor earns interest as it is returned when the deal is closed or the contract expires).

Like any investment, options have risks that you need to understand before investing. Please consult with your broker before investing.

*For additional information please contact JSE  
Options on Equities on 011 520 7000 or visit the  
JSE Safex Equity Derivatives at [www.safex.co.za/ed](http://www.safex.co.za/ed).*

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