option 1

SOPHISTICATED STRATEGIES MADE SIMPLE

## Spreading the risk

Deciding if we are at the end of a short term bear market or the beginning of a long term one is perhaps the most perplexing issue for an equities investor today. But what if there was an investment that did not rely on getting the direction of the market right?

One way to do this is by spread trading, which involves taking a position in a market and simultaneously taking an opposite position, creating an in built hedge, which is a long held secret of professionals who know that investing in a non-trending market can be a mug's game.

One common type of spread trading is seasonal commodity trading using futures, used by traders since the 1920s, where traders profit from a historically predictable annual change in a commodity's supply or demand.

However, for Australian investors to take full advantage of the attractive returns and risk management opportunities spread trading provides, investors need to access commodities normally traded outside Australia. Highly traded global commodities with long established supply and demand patterns provide increased confidence when seasonal spread trading.

One common example is crude oil. Oil demand is driven by the US, where large seasonal weather variations cause a spike in demand for gasoline in summer when guzzling consumers hit the road for the holidays. Refiners accumulate oil early in the year in anticipation of this driving season, and then stop purchasing as they use inventories into summer.

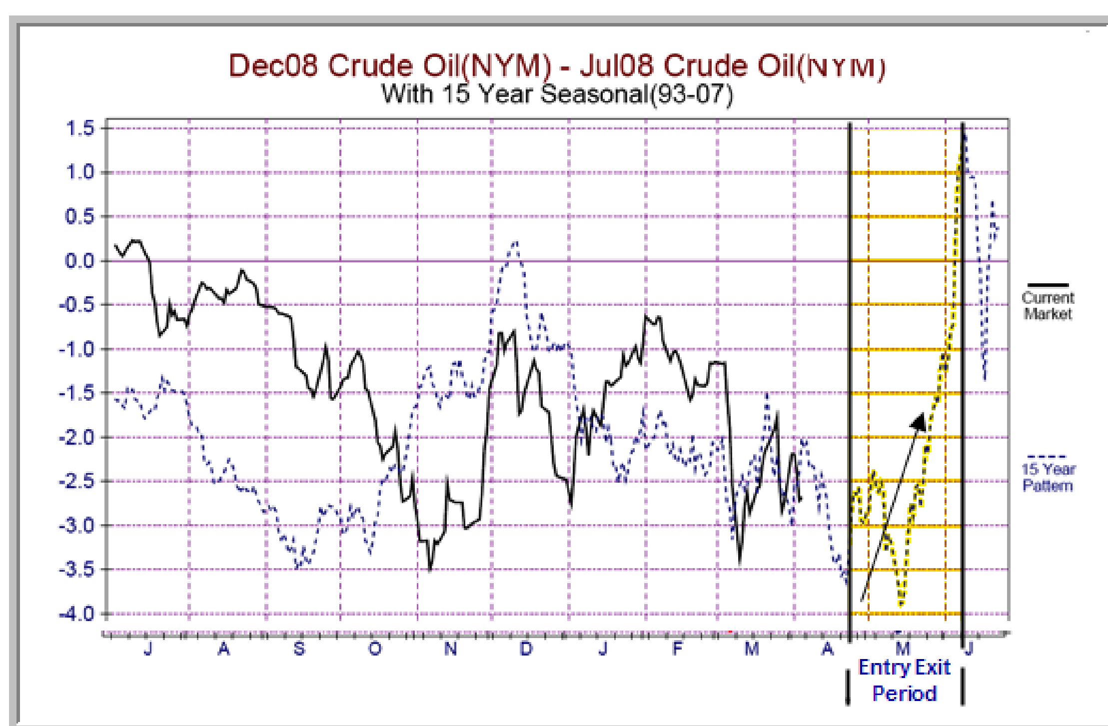
How can we profit from this predictable change in demand?

One way is to use futures, which, as the name implies, are standardised ways to buy or sell commodities at fixed dates in the future, usually through a broker with access to an established exchange such as the New York Mercantile Exchange (NYMEX).

By using two futures contracts, we can simultaneously buy oil in say December when the refiners start to accumulate, and sell it in July, when refiner buying slows. The difference in price between these two futures contracts is quoted and charted as a spread price.

The chart below tracks this spread price both this year and for the past 15 years. Historically, the spread has moved from -US$4.00 in late April up to +US$1.50 in June each year, creating the opportunity to buy the spread low and sell it high. Moreover, we can see that, this year, the spread price has followed the 15 year pattern closely since late February.

According to Option1 (www.option1.com.au), a trade advisory firm that makes global commodity spread trading accessible to Australian retail investors, this investment has proven profitable in previous years. By following Option1's risk management guidelines, investors would have made between two and a half to fifteen percent each year for the past four years, a significant annualised return.




The beauty of this trade is that it makes money regardless of the overall direction of the oil price, which can change trend, track sideways or even become unstable, and the spread can still make money, as it is only the relative change in price from one part of the year to another which is important. Exchanges recognise that spreads carry greatly reduced risk because of this and reduce the cash deposit required for spread trading by up to 90%.

Seasonal patterns exist in most markets because of production, weather, planting and harvest cycles. These patterns have existed for decades and can be highly predictable.

If spreads create an in built hedge and are based on reliable patterns, doesn't spread trading make the volatile world of futures trading safe for retail investors?

Steve Britt, principal of Option1, says "the spread is only one component of our risk management strategy. We also provide education and a hand holding service that advises on the timing of entry and exit, which contracts to trade and how much capital to allocate, even what to tell your broker. All futures trading, however, involves some risk, and we recommend that only risk capital be used, and only a fraction of this capital is placed at risk on any one trade".

Spread trading can also be done using options on any security with a liquid market, such as the ASX/S&P 200, the top 50 ASX stocks as well an international indices, stocks and commodities.

"Options are complex products which are difficult to trade without guidance and education" says Britt. "The profile of typical investors who have adopted a guided involvement in spread trading are those who want to avoid the high risk of futures and options while receiving advice on trades they can execute themselves".

So when looking to reduce risk in volatile markets, there is a spread of alternatives to consider.

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