
Fixed Return Optionss

FROs

Hedging Long Puts



Fixed Return Options

Hedging Long Puts with Long Finish High FROs

Finish High FRO

A Finish High Fixed Return Option is similar to a standard listed call option in that an investor purchasing a Finish High Option is bullish on the underlying security.

- At expiration, the holder of a Finish High FRO will automatically receive \$100.00 per contract if the Finish High FRO finishes in-the-money.
- For a Finish High FRO to be in-the-money the expiration Friday Amex FRO Settlement Index^(SM) must be above the strike price. For example if the all day expiration Friday Amex FRO Settlement Index^(SM) was \$25.01 or higher, the \$25.00 strike price Finish High FRO would be in-the-money.

Long Finish High FRO

- Maximum Loss is equal to the total purchase price.
- Maximum value of \$100.00 is achieved when the Amex FRO Settlement Index^(SM) is above breakeven at expiration.
- Breakeven = strike price + \$0.01.
- Automatic exercise when the expiration Friday Amex FRO Settlement Index^(SM) is above the Finish High FRO strike price.

The table below illustrates the value of a long \$25.00 strike price Finish High FRO at expiration.



Underlying AFSI* @ Expiration	Long Finish High FRO Value per Contract
\$20.00	\$0.00
\$22.00	\$0.00
\$25.00	\$0.00
\$25.01	\$100.00
\$26.00	\$100.00
\$30.00	\$100.00
\$35.00	\$100.00
\$40.00	\$100.00

***Amex FRO Settlement Index^(SM)**

Hedging Long Puts with Long Finish High FROs

Buying enough Finish High FROs to hedge the initial cost of the standard long puts

- Eliminates the risk above the long put strike price.
- Increases maximum loss.
- Decreases breakeven point (increases the downward movement of the underlying needed to achieve breakeven).
 - The total cost of the long Finish High FRO / the long put share equivalent.

Hedging Long Puts Example

Buy 5 of the \$30.00 strike price puts expiring in 20 days for \$2.50 (500 x \$2.50 = \$1250.00).

- Maximum loss equals \$1250.00.
- Maximum gain is \$13,750.00 $((\$30.00 - \$2.50) \times 500)$ below breakeven until expiration.
- Breakeven is \$27.50 $(\$30.00 - \$2.50)$.

In order to determine how many Long Finish High FROs to buy follow these steps:

1. Divide the total cost of the long puts by \$100.00. This will yield the initial number of FROs needed.
2. Multiply the initial number of FROs needed by 100 then by the current trading price. This yields the cost of the number of FROs needed to pay for the hedge.



3. Divide this number by 100. This yields the number of FROs needed to pay for the hedge.
4. Add the initial number of FROs needed and the number of FROs needed to pay for the hedge. This yield the total number of FROs needed for the hedge.
5. Compare the maximum value of the long FROS to the total cost of the trade and adjust the FROs purchase as necessary.

Example:

1. $\$1250.00 / 100 = 13$ (12.5 rounded up).
2. $13 \times 100 \times \$0.15 = \195.00 .
3. $195 / 100 = 2$ (1.95 rounded up).
4. $13 + 2 = 15$ FROs needed.
5. $\$1500.00$ (FROs maximum value) will cover $\$1475.00$ ($\$1250.00$ (long put cost) + $\$195.00$ (long FROs cost)). No adjustment needed.

Hedge the long puts by buying 15 of the \$30.00 strike price Finish High FROs expiring in 20 days for \$0.15 ($1500 \times \$0.15 = \225.00).

- Maximum loss increases to $\$1475.00$ ($\$1250.00 + \225.00).
- Maximum gain is now $\$13,525.00$ below breakeven until expiration.
- Breakeven is now $\$27.05$ ($(\$30.00 - \$2.50) - \$0.45$).

The breakeven change is determined by dividing the total cost of the FROs by the long put share equivalent.

- $\$225.00$ (long FROs cost) / 500 (long put share equivalent) = $\$0.45$.
- $\$30.00$ (long call strike price) - $\$2.50$ (long put premium) - $\$0.45$ (Finish High FRO cost) = $\$27.05$.

The table below illustrates the profit / (loss) potential of the combined long puts and long Finish High FRO hedge at various expiration Friday Amex FRO Settlement Index^(SM) prices.



AFSI* at Exp.	Long 15 \$30.00 Finish High FROs Value	Long 5 \$30.00 Puts Value	Total Cost	Total P&(L)
\$20.00	\$0.00	\$5,000.00	(\$1,475.00)	\$3,525.00
\$25.00	\$0.00	\$2,500.00	(\$1,475.00)	\$1,025.00
\$27.05	\$0.00	\$1,475.00	(\$1,475.00)	\$0.00
\$27.50	\$0.00	\$1,250.00	(\$1,475.00)	(\$225.00)
\$30.00	\$0.00	\$0.00	(\$1,475.00)	(\$1,475.00)
\$30.01	\$1,500.00	\$0.00	(\$1,475.00)	\$25.00
\$35.00	\$1,500.00	\$0.00	(\$1,475.00)	\$25.00
\$40.00	\$1,500.00	\$0.00	(\$1,475.00)	\$25.00

Summary

Long Finish High FROs offer the investor a unique opportunity to hedge long standard listed put options. An investor has the ability to buy enough Finish High FROs to protect against an upward move in the underlying stock, which would cause the long standard listed put position to decline in value. Buying the Finish High FRO will increase the breakeven point of the long put option and increases the amount of capital invested in the trade. There will be a range from long put option breakeven down to the long Finish High FRO breakeven where the investor still has risk. However, at the long Finish High FRO strike price less \$0.01, the Finish Low FRO would achieve its maximum value and any loss from the long call position would be reduced.



For the sake of simplicity, the examples shown do not take into consideration commissions and other transaction fees, tax considerations, or margin requirements, which are factors that may significantly affect the economic consequences of a given strategy. An investor should review transaction costs, margin requirements and tax considerations with a broker and tax advisor before entering into any options strategy.

Fixed Return Options (FROs) involve risk and are not suitable for everyone. Prior to buying or selling a FRO, a person must receive a copy of *Characteristics and Risks of Standardized Options*. Copies may be obtained from your broker, one of the options exchanges or The Options Clearing Corporation, One North Wacker Drive, Suite 500, Chicago, IL 60606 or call 1-888-OPTIONS or visit www.888options.com.

FROs exercise and assignment is based on an all day expiration day Amex FRO Settlement Index^(SM) so it is possible for the standard listed options to be in-the-money at expiration and the FROs to be out-of-the-money or for the FROs to be in-the-money and the standard listed options to be out-of-the-money. An investor must understand FROs settlement before entering into any FROs transaction.

Any strategies discussed, including examples using actual securities and price data, are strictly for illustrative and education purposes and are not to be construed as an endorsement, recommendation or solicitation to buy or sell securities. Supporting documentation will be supplied upon written request.

Copyright © 2007 American Stock Exchange LLC. All rights reserved. No part of this publication may be reproduced in any form or by any means without the express prior written permission of the American Stock Exchange LLC.

Fixed Return Options^(SM), FROs^(SM), Finish High^(SM), Finish High FROs^(SM), Finish Low^(SM), Finish Low FROs^(SM), HiFRO^(SM), LoFRO^(SM) and Amex FRO Settlement Index^(SM) are service marks of the American Stock Exchange LLC

