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# Fixed Return Optionss

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## FROs

### Hedging Stock



# Fixed Return Options

## Hedging Stock with Long Finish Low FROs

### Finish Low FRO

A Finish Low Fixed Return Option is similar to a standard listed put option in that an investor can purchase a Finish Low FRO for downside protection on the underlying security.

- At expiration the holder of a Finish Low FRO will automatically receive \$100.00 per contract if the Finish Low FRO finishes in-the-money.
- For a Finish Low FRO to be in-the-money, the expiration Friday Amex FRO Settlement Index<sup>(SM)</sup> must be below the strike price. For example, if the all day expiration Friday Amex FRO Settlement Index<sup>(SM)</sup> was \$24.99 or lower, the \$25.00 strike price Finish Low FRO would be in-the-money.

### Long Finish Low FRO

- Maximum Loss (cost of the hedge) is equal to the total purchase price.
- Maximum value of \$100.00 is achieved when the Amex FRO Settlement Index<sup>(SM)</sup> is below breakeven at expiration.
- Breakeven = strike price - \$0.01.
- Automatic exercise when the expiration Friday Amex FRO Settlement Index<sup>(SM)</sup> is below the Finish Low FRO strike price.

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



<b>Underlying AFSI* @ Expiration</b>	<b>Long Finish Low FRO Value per Contract</b>
\$20.00	\$100.00
\$22.00	\$100.00
\$23.00	\$100.00
\$24.00	\$100.00
<b>\$24.99</b>	<b>\$100.00</b>
\$25.00	\$0.00
\$30.00	\$0.00
\$35.00	\$0.00

\*Amex FRO Settlement Index<sup>(SM)</sup>

## Long Finish Low FRO Hedge Example

- XYZ is trading at \$85.00.
- You are long 500 shares.
- The \$85.00 strike price Finish Low FRO is trading at \$0.12.
- You want to hedge down to \$75.00.

## Determining the Finish High FRO Quantity Needed

In order to determine how many Finish Low FROs to buy for hedging you will need to do the following:

1. Subtract the level of hedge desired from the current trading price of the underlying. This yields the level of protection.
  - a. \$85.00 (current trading price of the underlying) - \$75.00 (level of hedge desired) = \$10.00.
2. Multiply the level of protection by number of shares owned. This yields the total dollars of hedge desired.
  - a. \$10.00 (level of protection) x 500 (number of shares) = \$5000.00.
3. Subtract the per contract cost of the Finish Low FRO from \$100.00 (long Finish Low FRO in-the-money maximum value). This yields the total per contract profit potential.
  - a. \$100.00 (long Finish Low FRO in-the-money maximum value) - \$12.00 (cost of long Finish Low FRO (\$0.12 x 100)) = \$88.00 (maximum per contract profit potential).
4. Divide the total hedge desired by maximum profit potential of the long Finish Low FRO. This yields the number of FROs needed.



- a.  $\$5000.00$  (total hedge desired) /  $\$88.00$  (maximum per contract profit potential of the long Finish Low FRO) = 57 FROs needed.

Buy 57 of the  $\$85.00$  strike price Finish Low FROs for  $\$0.12$  for a total cost of  $\$684.00$  ( $\$0.12 \times 57 \times 100$ ).

- The total cost of the hedge (maximum loss) is  $\$684.00$ .
- Maximum profit is  $\$5016.00$  ( $\$100.00$  per contract – the cost of the Finish Low FROs).
- Maximum value achieved with the Amex FRO Settlement Index<sup>(SM)</sup>  $\$0.01$  below the strike price ( $\$85.00 - \$0.01 = \$84.99$ ).

The table below illustrates the profit / (loss) potential of the long Finish Low FRO at various expiration Friday Amex FRO Settlement Index<sup>(SM)</sup> prices.

<b>Underlying AFSI* @ Expiration</b>	<b>57 Finish Low FROs Value)</b>	<b>Initial Finish Low FROs Cost</b>	<b>Profit / (Loss)</b>
\$60.00	\$5,700.00	(\$684.00)	\$5,016.00
\$70.00	\$5,700.00	(\$684.00)	\$5,016.00
\$80.00	\$5,700.00	(\$684.00)	\$5,016.00
\$83.00	\$5,700.00	(\$684.00)	\$5,016.00
<b>\$84.99</b>	<b>\$5,700.00</b>	<b>(\$684.00)</b>	<b>\$5,016.00</b>
\$85.00	\$0.00	(\$684.00)	(\$684.00)
\$90.00	\$0.00	(\$684.00)	(\$684.00)
\$95.00	\$0.00	(\$684.00)	(\$684.00)

\*Amex FRO Settlement Index<sup>(SM)</sup>

## Summary

At expiration, hedging stock positions with standard listed put option may require the investor to take action. At expiration the holder of a long in the money put will either sell the long standard listed put option or exercise it and sell the underlying stock. These additional trades will carry additional transaction costs that will reduce the hedge or add to the loss incurred with original trade. Finish Low FROs are cash settled therefore, no additional transactions are necessary. If a Finish Low FRO closes in-the-money at expiration the holder would automatically receive  $\$100.00$  per contract. The



Finish Low FRO will allow the investor to hedge risk based on a dollar amount and will probably not offer as pure a hedge as a standard listed put would. However, since the breakeven point for the Finish Low FRO is the strike price less \$0.01, the Finish Low FRO will reach breakeven more quickly than a standard listed put option and will yield greater protection close to the strike price.

**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](http://www.888options.com).**

**FROs exercise and assignment is based on an all day expiration day Amex FRO Settlement Index<sup>(SM)</sup> 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.**

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**Fixed Return Options<sup>(SM)</sup>, FROs<sup>(SM)</sup>, Finish High<sup>(SM)</sup>, Finish High FROs<sup>(SM)</sup>, Finish Low<sup>(SM)</sup>, Finish Low FROs<sup>(SM)</sup>, HiFRO<sup>(SM)</sup>, LoFRO<sup>(SM)</sup> and Amex Settlement Index<sup>(SM)</sup> are service marks of the American Stock Exchange LLC.**

