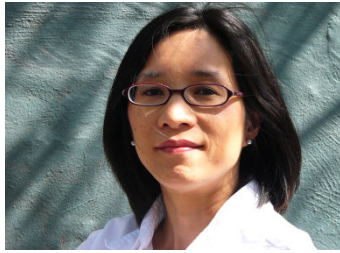


By Wai-Yee Chen
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Learned optimism - Unlearning negative attitudes in investing

"I have not been more disappointed in the 20 years I have been investing in the share market; I have now a sense of loss of control in my investments since the GFC." commented Dr Wong to his Adviser. "I lost money through no fault of my own and despite my best efforts." added Dr Wong.

Have you ever felt the despair of having your years of hard work and savings evaporated, caused by something called CDO which you have never even heard of? The rippling effect of this loss is not just confined to the financial world, but with families having to postpone home renovations, overseas holidays and older workers deferring retirements. Many investors have lost confidence in the financial systems since the GFC, some have vowed never to return to investing in shares and others sold out and are sitting on cash. If you have had similar experiences, you are not alone.

When faced with an adverse or hugely disappointing situation, it's not uncommon for us to give up, stop trying or accept our fate. We feel powerless to change it and efforts in changing it seem futile, though the situation may well be changeable.

This psychological state is called *learned helplessness* and was first discovered by Dr Martin Seligman in experiments carried out on animals, which were found not to run away even when they could have; after being conditioned earlier to think they couldn't (by restraining one of their legs). The animals have learned to be helpless.

Not surprisingly, this mental state has been found to pervade humans too. A student who has been failing in his maths exams, remarking "I am stupid" or a person trying to lose weight complaining "I keep putting the weight back on". Both feel they have failed and want to quit as they feel "they can't win" and accept their conditions as unchangeable.

Similarly, an investor who has lost a large sum of money may think "I always lose money in shares" and may feel it's not within his control to change the performance of his shares and any effort to do so had been futile. Such a mental state can drive an investor to fall into the trap of *learned helplessness*.

Can this mental state of *learned helplessness* be addressed or unlearned? Psychologist Dr Seligman seems to think so. We can turn learned negative mental attitudes to those of positive ones by changing the way we explain the bad situations to ourselves. It's our *explanatory style* that can help us switch from a *learned helplessness* mental state to that of *learned optimism*. The student can attribute the failure to the extremely high bar the teacher has set in the last few exams (hence study harder) and the investor can attribute his investment losses to an unprecedented financial crisis (and learn to protect downside risk to his portfolio). This is called *learned optimism*, which actively reverses and unlearn the behavior of *learned helplessness*. We have all suffered financial losses (either directly or indirectly through the rippling effects) with the GFC, but how we move

forward as investors from here depends on how we explain that adverse experience to ourselves, which can determine how or if we will bounce back. Will we resign to fate or learn to take more control?

If you belong to the latter group, options will be the tool you want to know about. The word "options" may currently conjure an image of trading, speculating or big losses; but the truth is it can be used as much, as a tool for hedging, to protect portfolios from losses in share value.

Bill is an investor in the latter group, learning to take more control. Like many investors, Bill has and still is suffering from a lost of confidence since the GFC which has taken a portion of his retirement income from him. Two years on since the crisis, his portfolio is still down by some 30%. As retirement is approaching in less than a year, Bill needs to make the important decision of how he wishes to manage his retirement savings going forward in order to be protected from further erosion to his capital.

Bill made the decision to arrest his current "resigning to the volatility" investment attitude to that of wanting to implement portfolio downside protection strategies. After attending several seminars and ploughed through some investment books, he has decided to use options strategies to protect his portfolio.

How can options protect Bill's portfolio?

Options are derivatives that derive value from the underlying asset; and put options have the characteristic of rising in value when the price of the underlying asset falls. An investor who owns put options is compensated from the loss of value of the underlying asset by the increase in the price of the put options.

In short, when shares fall in value (1) put options rise in price (2). See diagram 1 below.

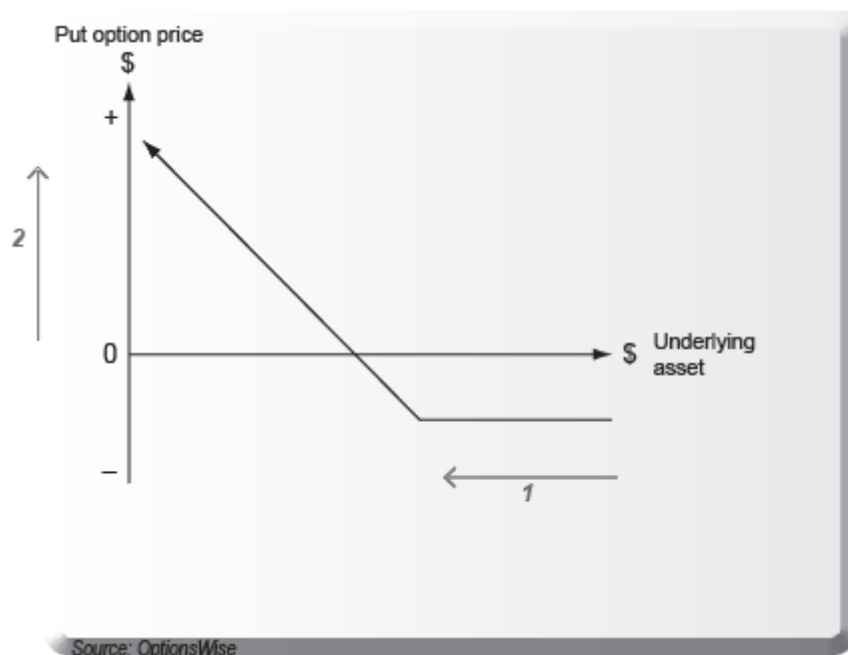


Diagram 1

Bill's options strategy

Bill buys ASX put options to protect his portfolio. Bill learnt that buying put options is like buying insurance on the home, giving him the confidence of value/loss recovery if anything goes wrong with his portfolio.

Bill has a choice of protecting the total portfolio value or specific shares within the portfolio. To protect an overall portfolio, he needs to buy put options on the market proxy, which is the XJO (ASX/S&P 200) Index. For specific shares, he needs to buy 1 contract of put options for every 1000 of the share he holds.

How much will it cost?

The cost of protection depends on the choice of the strike (exercise) price and the length of the contract. For put options, the lower the choice of strike and the shorter the contract, the lower the premium will be. Choosing a lower strike for a put protection is like choosing a higher excess on an insurance policy and hence lowers the cost of premium, but it's also a less effective protection.

How does Bill get protected?

If Bill has chosen a proxy portfolio protection and if the market falls, he can sell the XJO put options to realise a profit to compensate for the paper losses in his portfolio. Conversely, if he has taken specific share put protection, in addition to selling the put options for profit if the share falls, Bill can choose to exercise the put contract to sell his shares at the higher contractual strike price, hence giving him the certainty of a chosen exit price for his shares. This strategy provides Bill with total peace of mind and control.

Bill's protection experience

Bill decided to buy the XJO protection. One week after implementing his put protection strategy, the XJO Index fell more than 200 points and the put he bought has increased in price by 80% (detailed calculations below).

Bill is satisfied, not only from the financial reward of this decision but more so from the achievement of freeing himself from a mental trap that could have prevented him from being a successful investor.

Options is a tool that not only allow investors the advantage of limiting portfolio losses but also the opportunity of investing with confidence again. With the use of appropriate strategies, investors no longer need to feel lost of control or helpless but instead attain the strength of learned optimism and take control back in their hands. ■

Detailed strategy calculations

It is now the third week of June 2010 and the XJO index has a reading of 4450 points. Bill wants to be protected for the next 3 to 6 months from a 10% loss of value from the current level.

Bill's portfolio is valued at around \$500,000 and a 10% downside will potentially pull the XJO down to the 4000 index level, hence Bill wants to buy the 4000 strike XJO put. To protect a value of \$500,000 at the 4000 point level, Bill will need to buy 121 contracts of put options. To lower his up-front cost, Bill may choose to buy a lower strike of 3900, but he will need to buy a higher number of contracts (132) to cover the same amount of portfolio value.

¹ $\$500,000 / (4000 \text{ strike} \times \$10 \text{ per point}) = 12.5$ (round down to 12) contracts

² $\$500,000 / (3900 \text{ strike} \times \$10 \text{ per point}) = 12.8$ (round up to 13) contracts

Next Bill needs to consider the length of the contract. Options prices (premiums) are obtained from the Option Pricing Calculator provided in the OptionsWise website (www.optionswise.com.au/OptionsApplications) and are tabulated in Table 1 below for consideration.

At the 4000 strike, the cost of the 3 month put options was \$640 per contract whilst the 6 month options cost \$1,340, which will arrive at a total cost of \$7,680 or \$16,080 respectively for 12 contracts.

With the 3900 strike, the cost of the 3 month put options was for \$450 per contract whilst the 6 month options cost \$1,070, which will bring the total cost of protection to \$6,370 or \$13,910 respectively for 13 contracts.

After some consideration, Bill decided on the XJO 4000 put for a 3 month expiry date at the cost of \$7,680 which he feels reasonable (at 1.5%) for protecting a \$500,000 portfolio.

A week later, the XJO index fell to 4220 points and Bill's 3 month 4000 XJO put option was valued at \$1,180 per contract, a gain of more than 80% in a week.

Options Pricing Calculator

User Selection

Theoretical Implied
 Call Put Call & Put

Stock Code:

Last Price \$:

Strike Price:

ASX Sourced

Dividends: INTERIM FINAL

Ex-Dates:

Volatility:

Interest Rate:

Update on 25 Jun 2010

Trade Date:

Expiry Date: 16 Sep 10
 12 Dec 10
 17 Mar 10

Customise Expiry Date:

XJO, Last price: 4450 Today: 25 June 2010

| PUT | | | | | | | | | |
|-------------------------------------|--------------|--------|----------|---------|-------|------|---------------|-------------|--|
| Security code | Strike price | Action | Contract | Premium | Delta | SPC | Total Margins | Expiry date | |
| <input type="checkbox"/> | XJOY47 | 3900 | | \$450 | -0.19 | 1000 | | 16 Sep 10 | |
| <input type="checkbox"/> | XJOJB8 | 3900 | | \$1,070 | -0.19 | 1000 | | 12 Dec 10 | |
| <input checked="" type="checkbox"/> | XJOY77 | 4000 | Buy 1 | \$640 | -0.18 | 1000 | | 16 Sep 10 | |
| <input type="checkbox"/> | XJOJE8 | 4000 | | \$1,340 | -0.23 | 1000 | | 12 Dec 10 | |
| <input type="checkbox"/> | XJOY87 | 4100 | | \$900 | -0.23 | 1000 | | 16 Sep 10 | |
| <input type="checkbox"/> | XJOJF8 | 4100 | | \$1,650 | -0.27 | 1000 | | 12 Dec 10 | |
| <input type="checkbox"/> | XJOYB7 | 4200 | | \$1,180 | -0.29 | 1000 | | 16 Sep 10 | |
| <input type="checkbox"/> | XJOJ18 | 4200 | | \$2,000 | -0.31 | 1000 | | 12 Dec 10 | |

Check All

Source: www.optionswise.com.au/OptionsApplication.aspx

Table 1

Wai-Yee Chen is the author of *OptionsWise How to invest sensibly* and is the Head of Derivatives for RBS Morgans Sydney Asian Desk. Wai-Yee is a regular speaker and lecturer in the area of options and will be speaking at the Melbourne Trading and Investing Expo. To find out more or contact Wai-Yee, visit www.optionswise.com.au or email admin@optionswise.com.au. This article is contributed to *The Chinese Investor* to be published (in chinese) in its inaugural edition on 8 August 2010.