

The background of the slide is a golden-yellow color with a dense, repeating pattern of various international currency symbols. These symbols, including the dollar sign (\$), euro (€), pound sterling (£), yen (¥), and others, are rendered in a 3D, embossed style that creates a textured, metallic appearance. The symbols are scattered across the entire background, with some appearing larger and more prominent than others.

Patrick J. O'Meara

RRC, CFP, CMA, CPA, MBA

The Innovative Scholar, Inc.

Foreign Exchange: Risk and Reward
for the Retail Investor

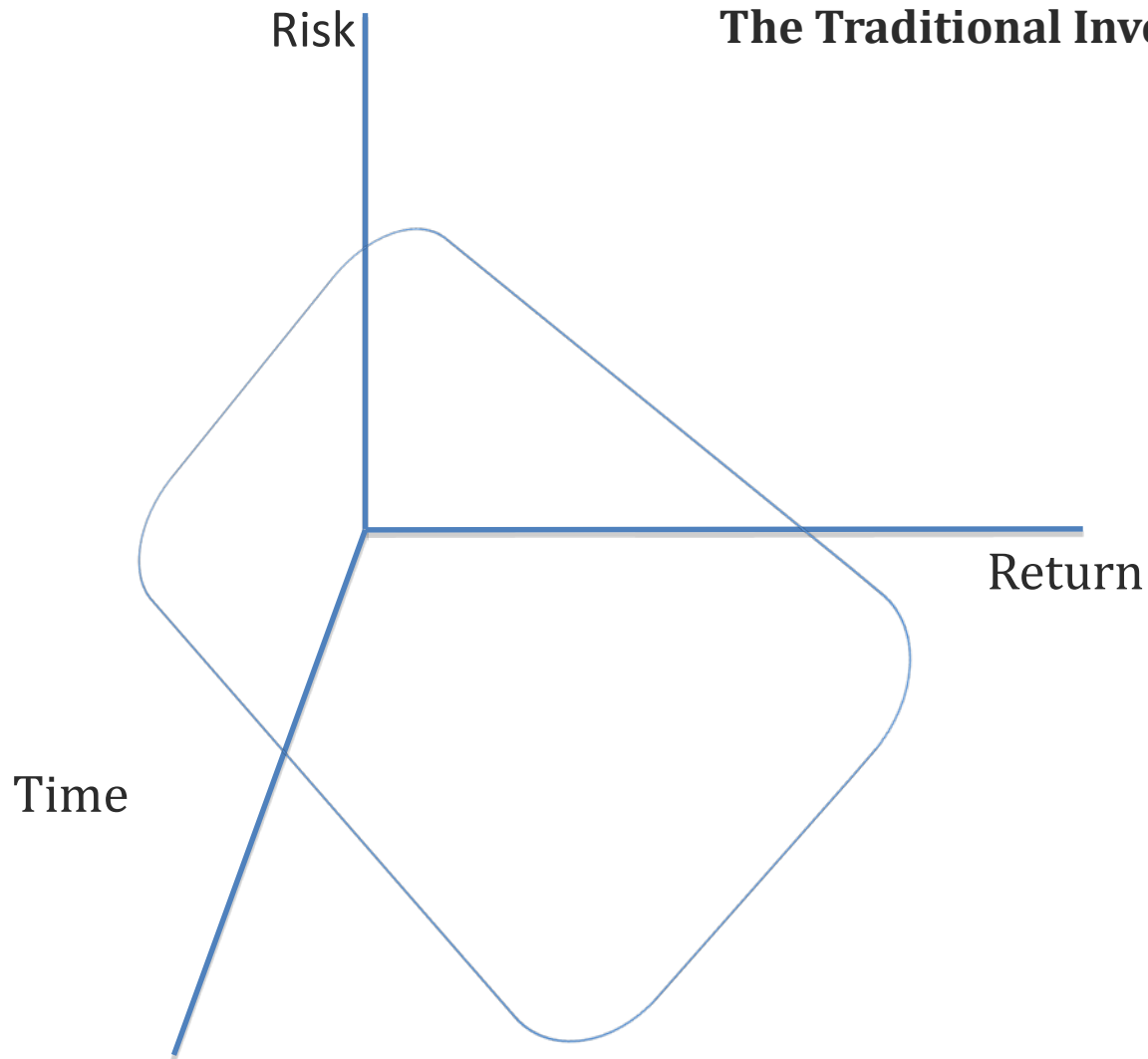
A vertical decorative bar on the left side of the slide, featuring a golden-yellow background with various 3D-rendered financial symbols such as the dollar sign (\$), pound sign (£), yen sign (¥), and Euro sign (€).

Presentation Agenda

- Introduction and Welcome
- Review of Risk and Return: The Traditional Investment Objectives
- Primer on Modern Portfolio Theory

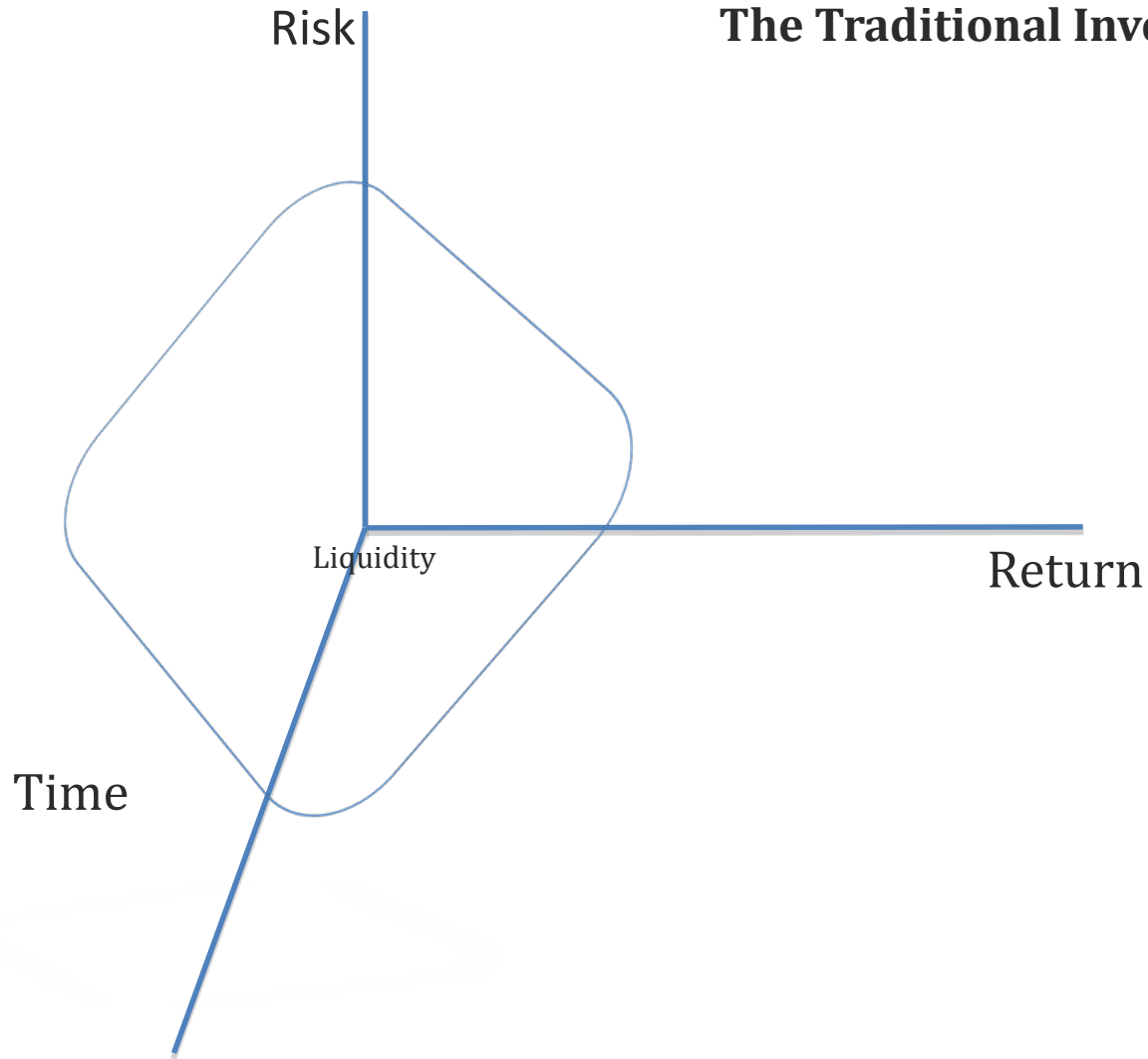


The Traditional Investment Objectives



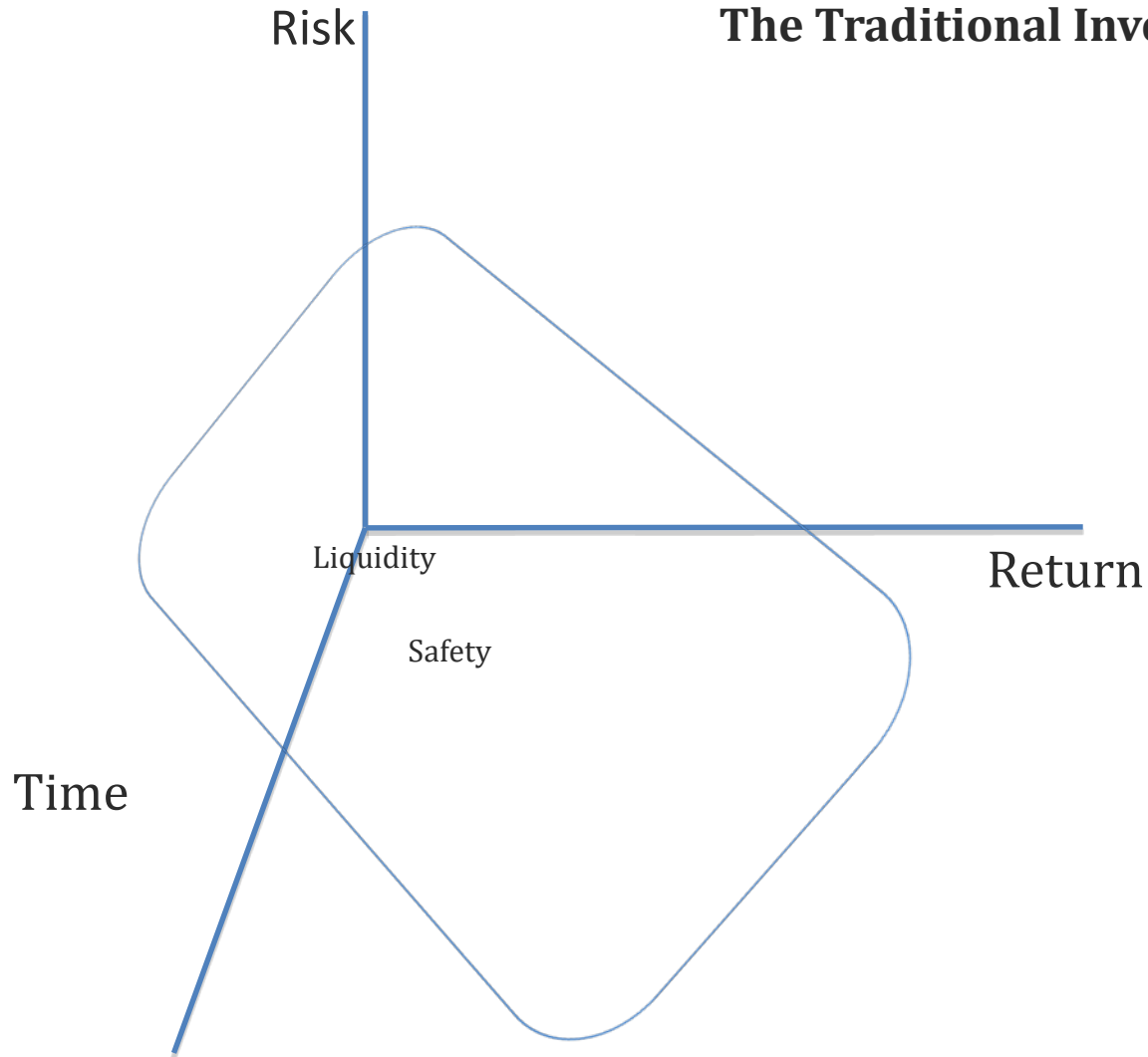


The Traditional Investment Objectives



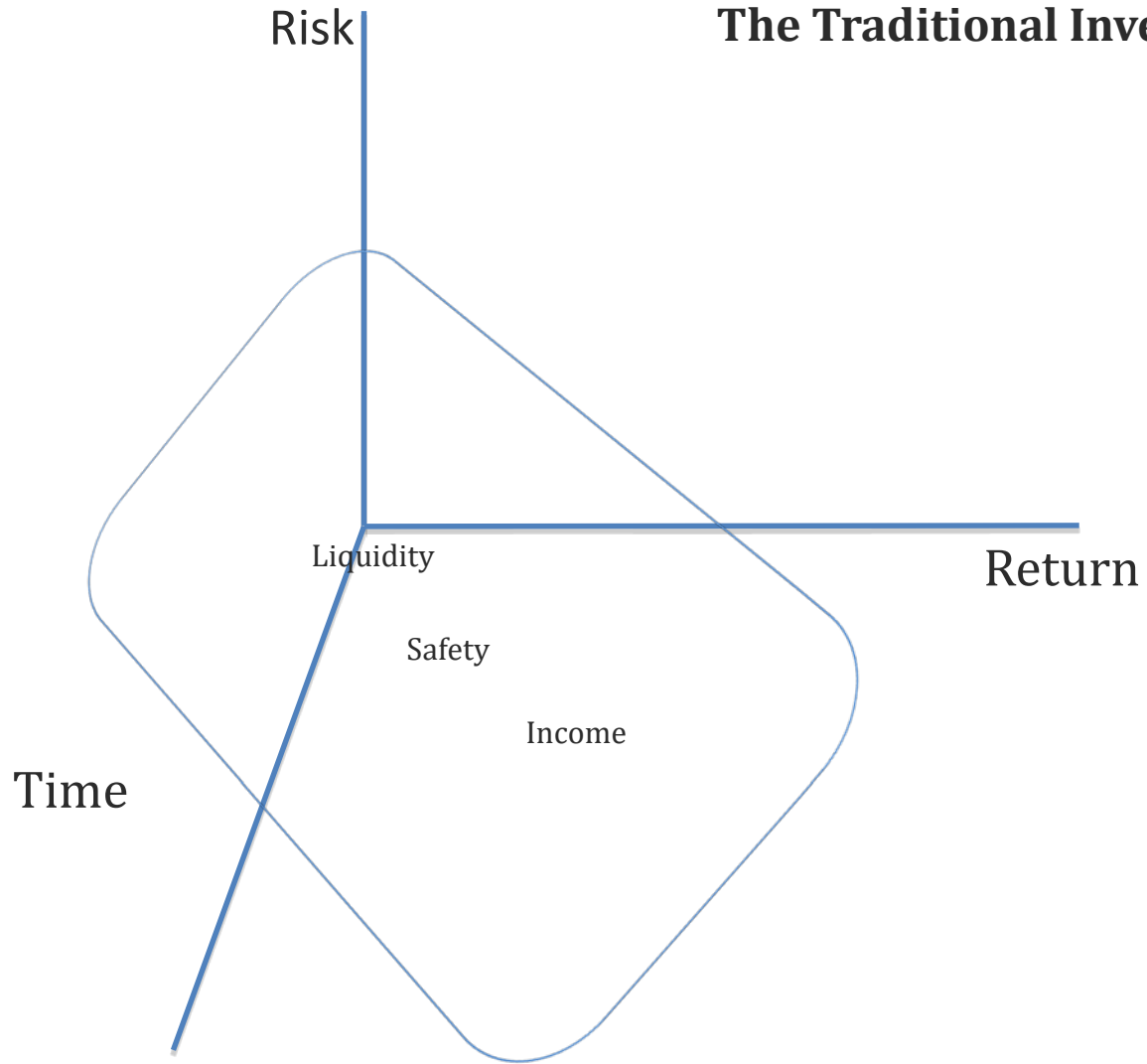


The Traditional Investment Objectives



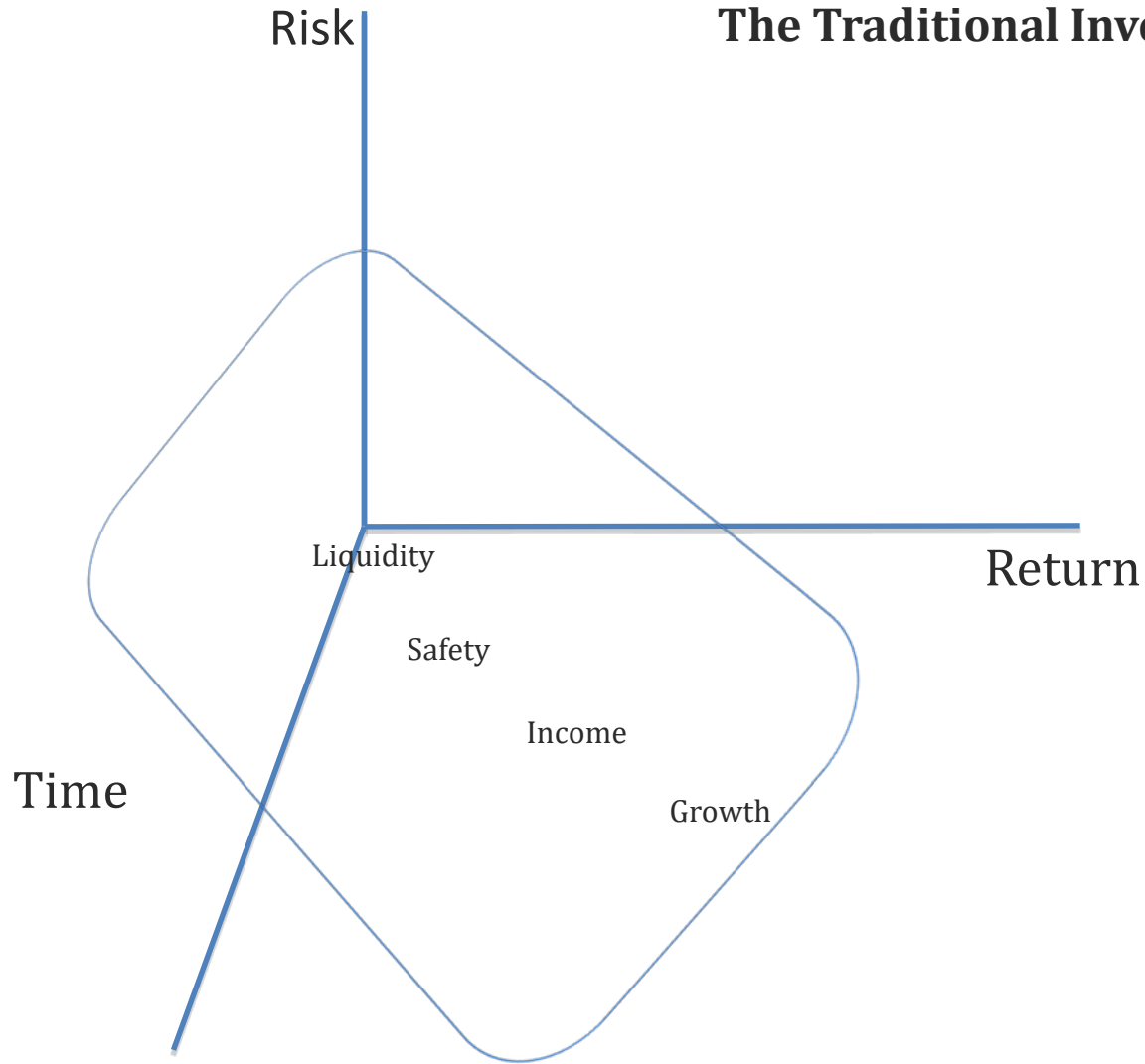


The Traditional Investment Objectives



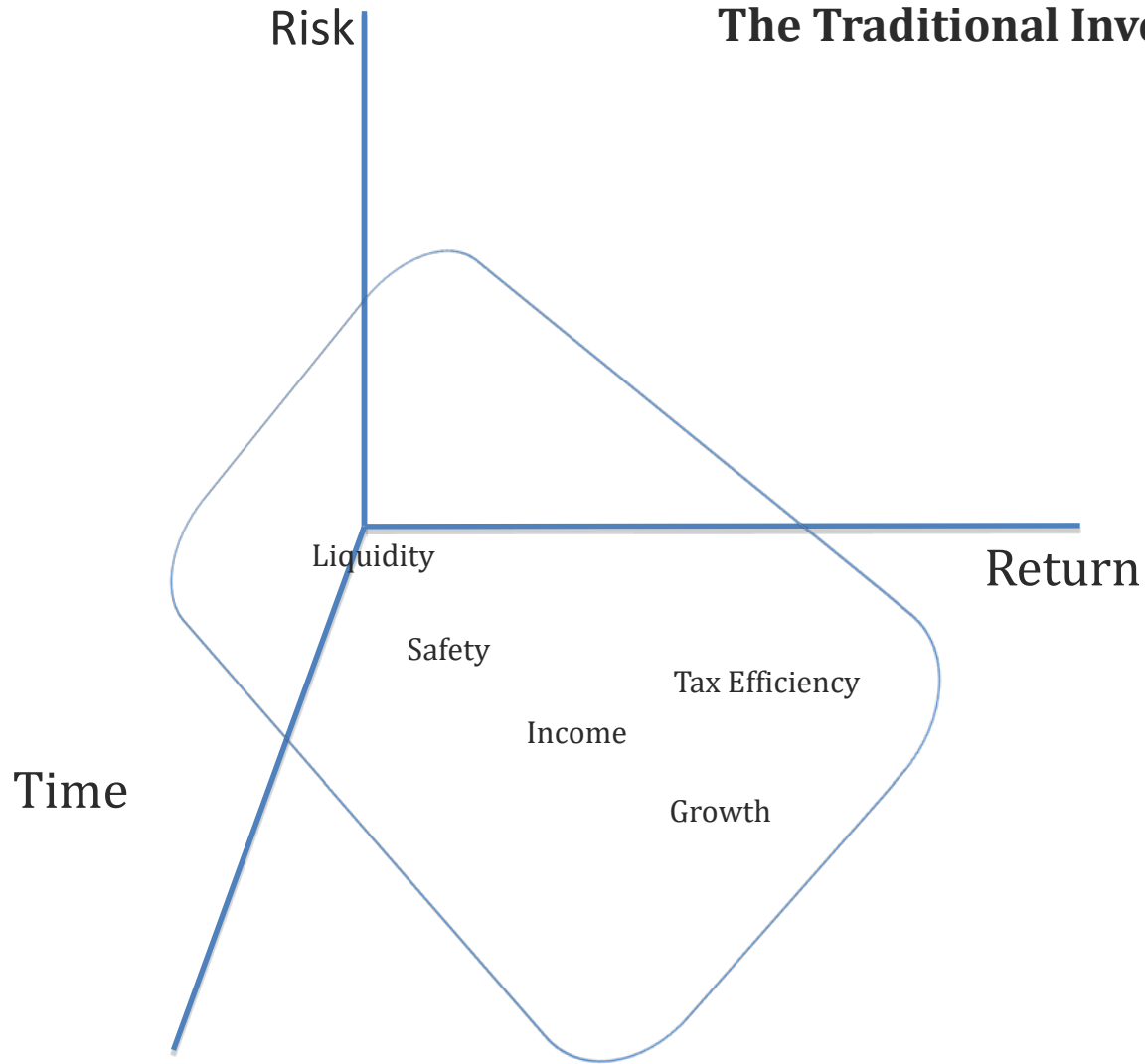


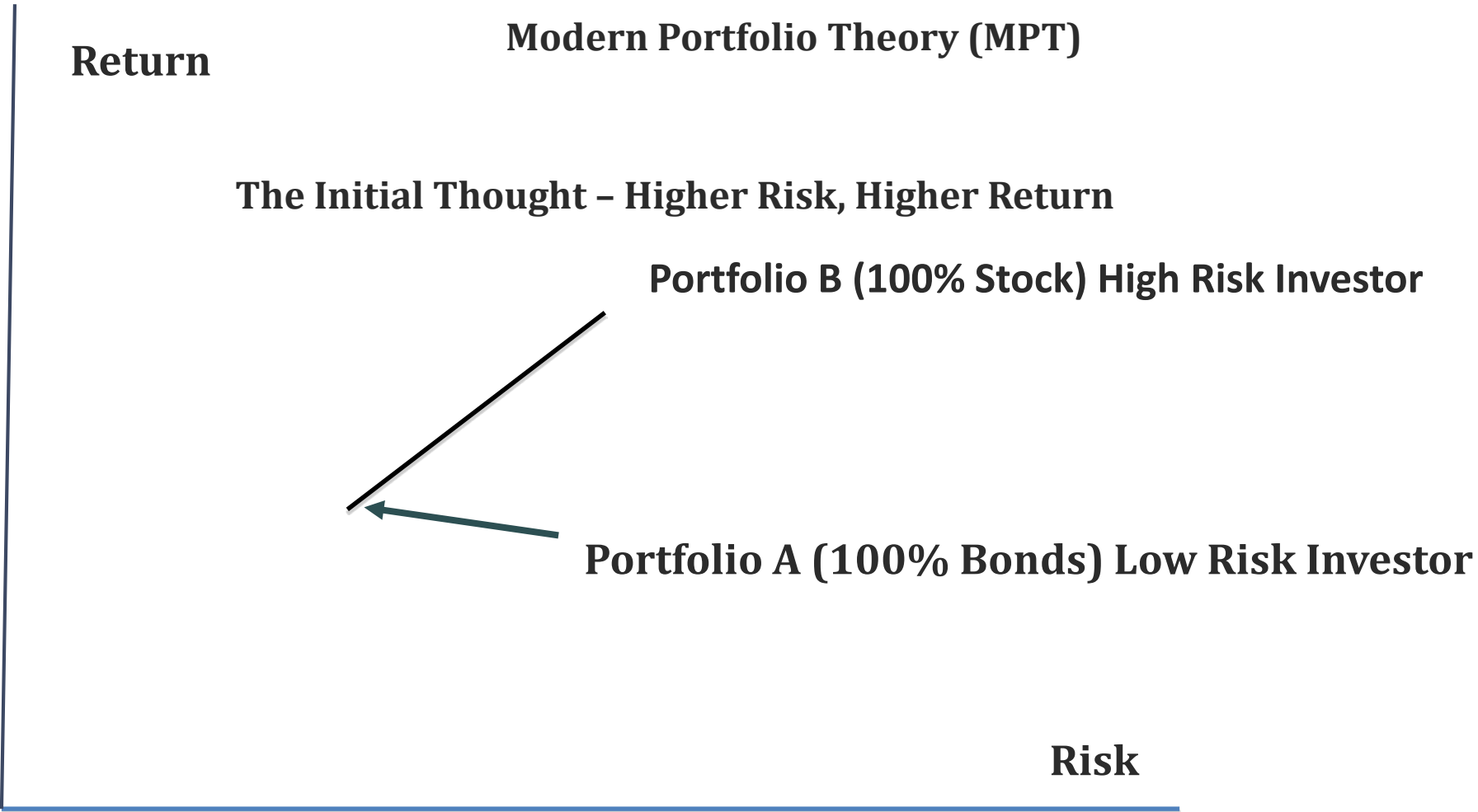
The Traditional Investment Objectives





The Traditional Investment Objectives

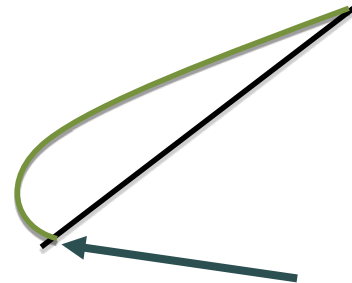




Return

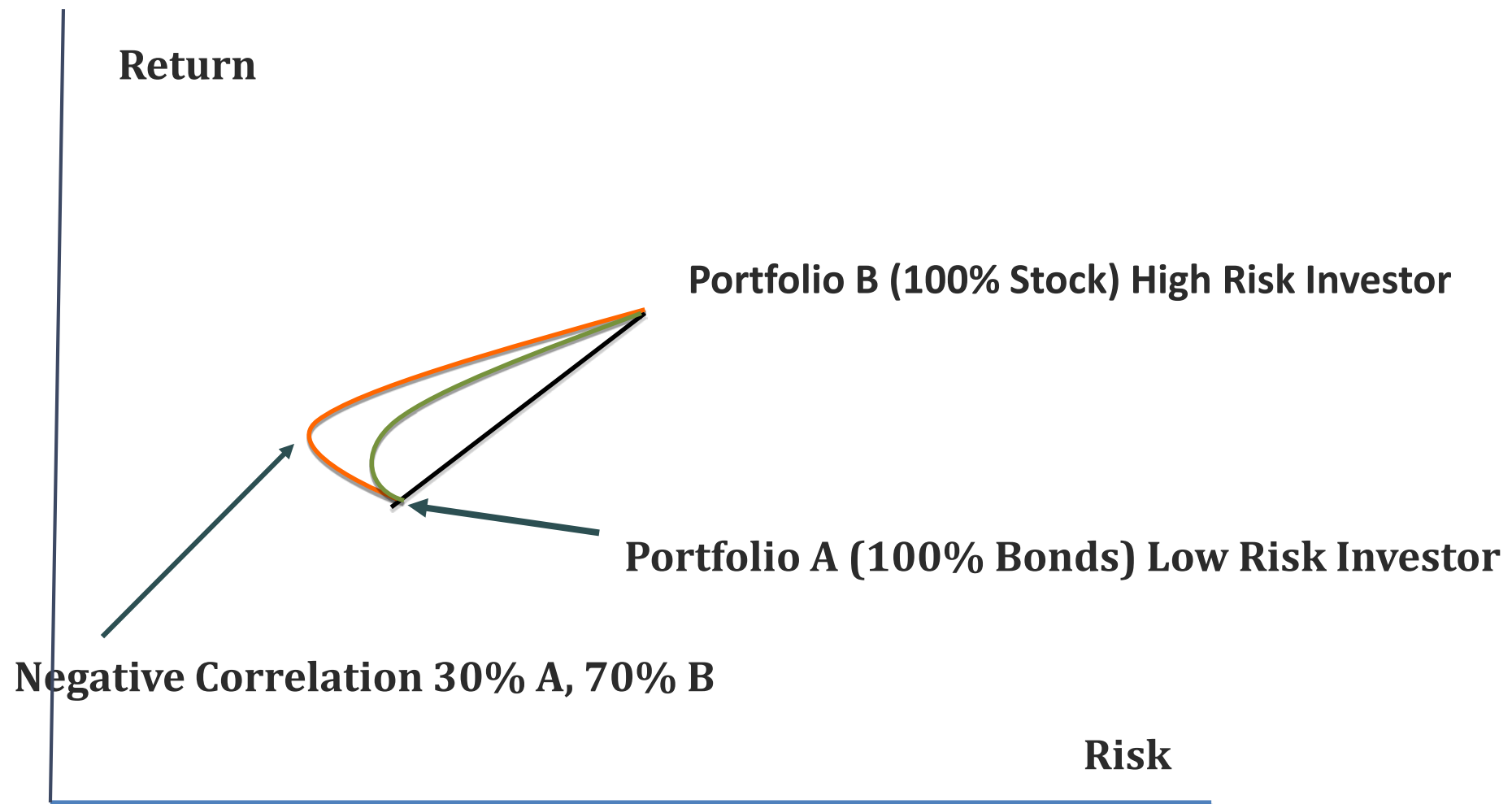
Correlation of Assets Moves from +1 to 0 and to Negative Values Risk Declines & Returns Rise

Portfolio B (100% Stock) High Risk Investor



Portfolio A (100% Bonds) Low Risk Investor

Risk



Asset Classes that have low positive or even negative correlations add to diversification and potential increase ROI.

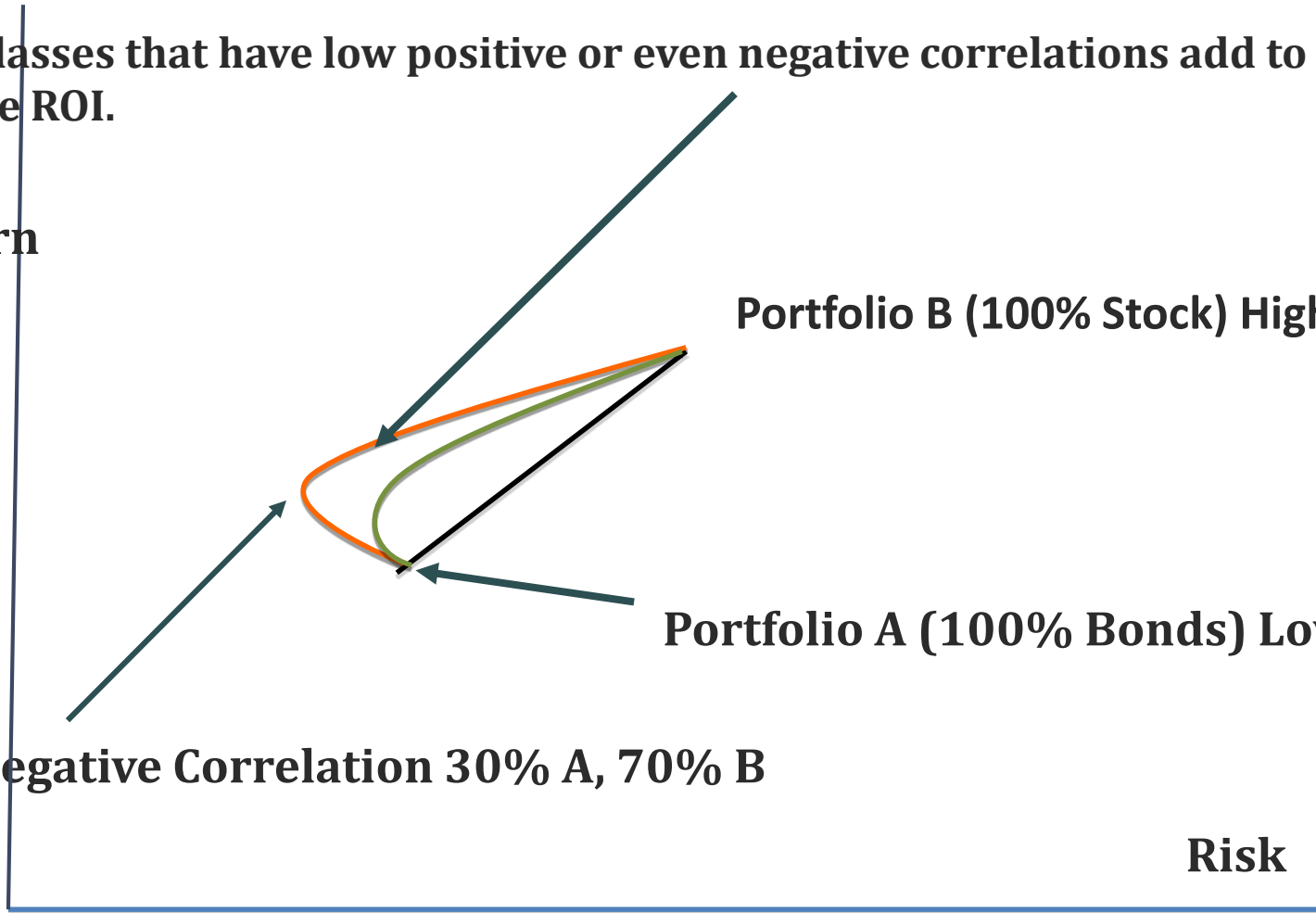
Return

Portfolio B (100% Stock) High Risk Investor

Portfolio A (100% Bonds) Low Risk Investor

Negative Correlation 30% A, 70% B

Risk

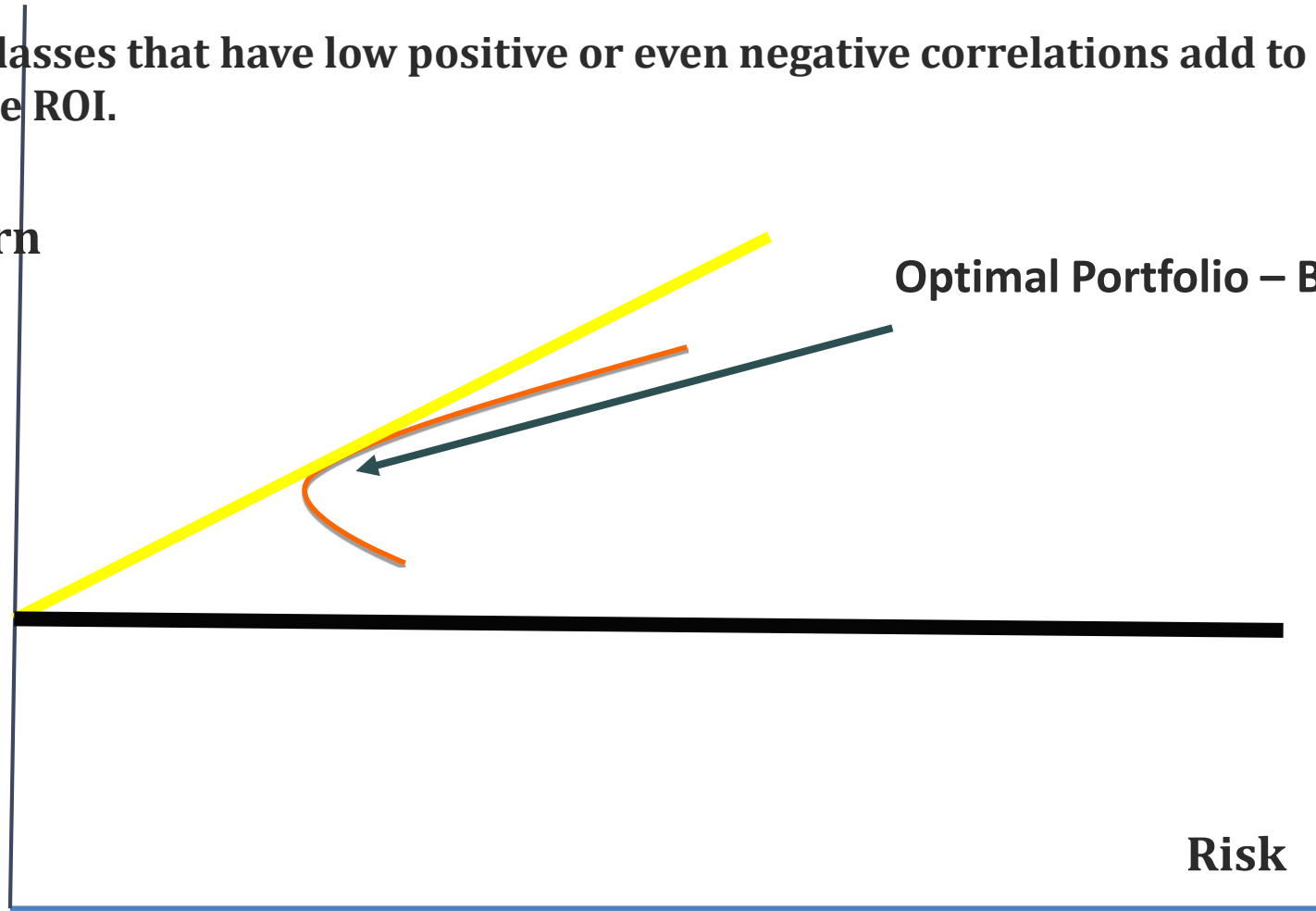


Asset Classes that have low positive or even negative correlations add to diversification and potential increase ROI.

Return

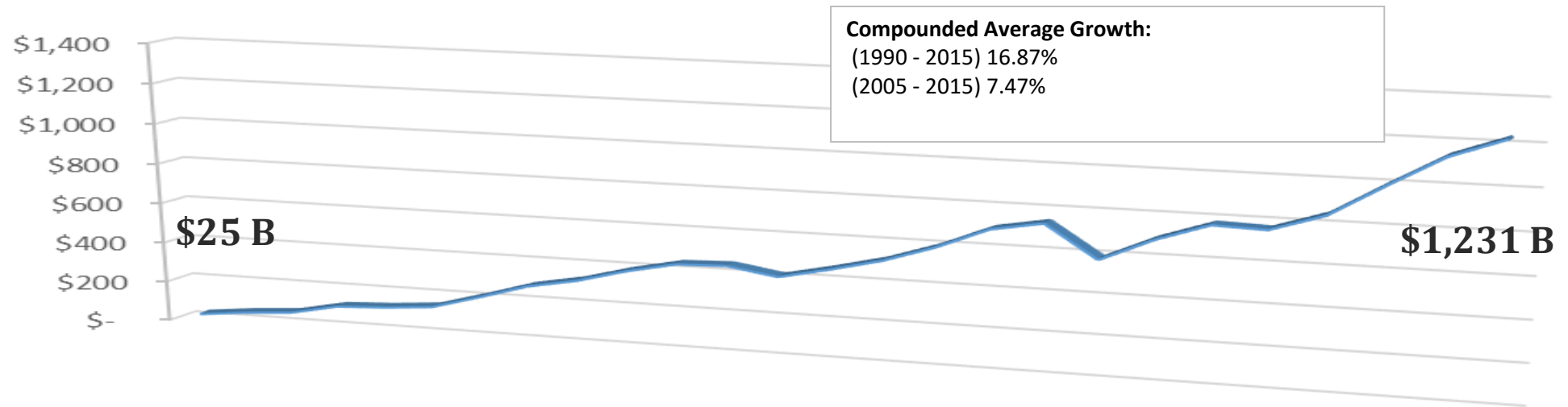
Optimal Portfolio – Best Risk/Reward Ratio

Risk



Growth in Investment in Mutual Funds Canada

Investment Funds in Canada
Assets Under Management (AUM)
1990 - 2015



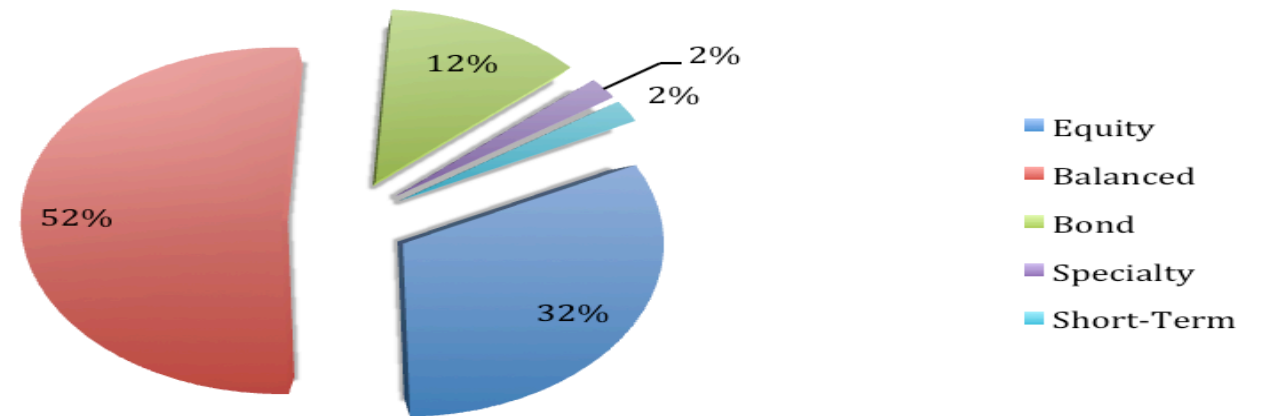
Source: www.ific.ca/en/stats (Date: April 5 2016) & author's calculations

The Profile of the Canadian Investor

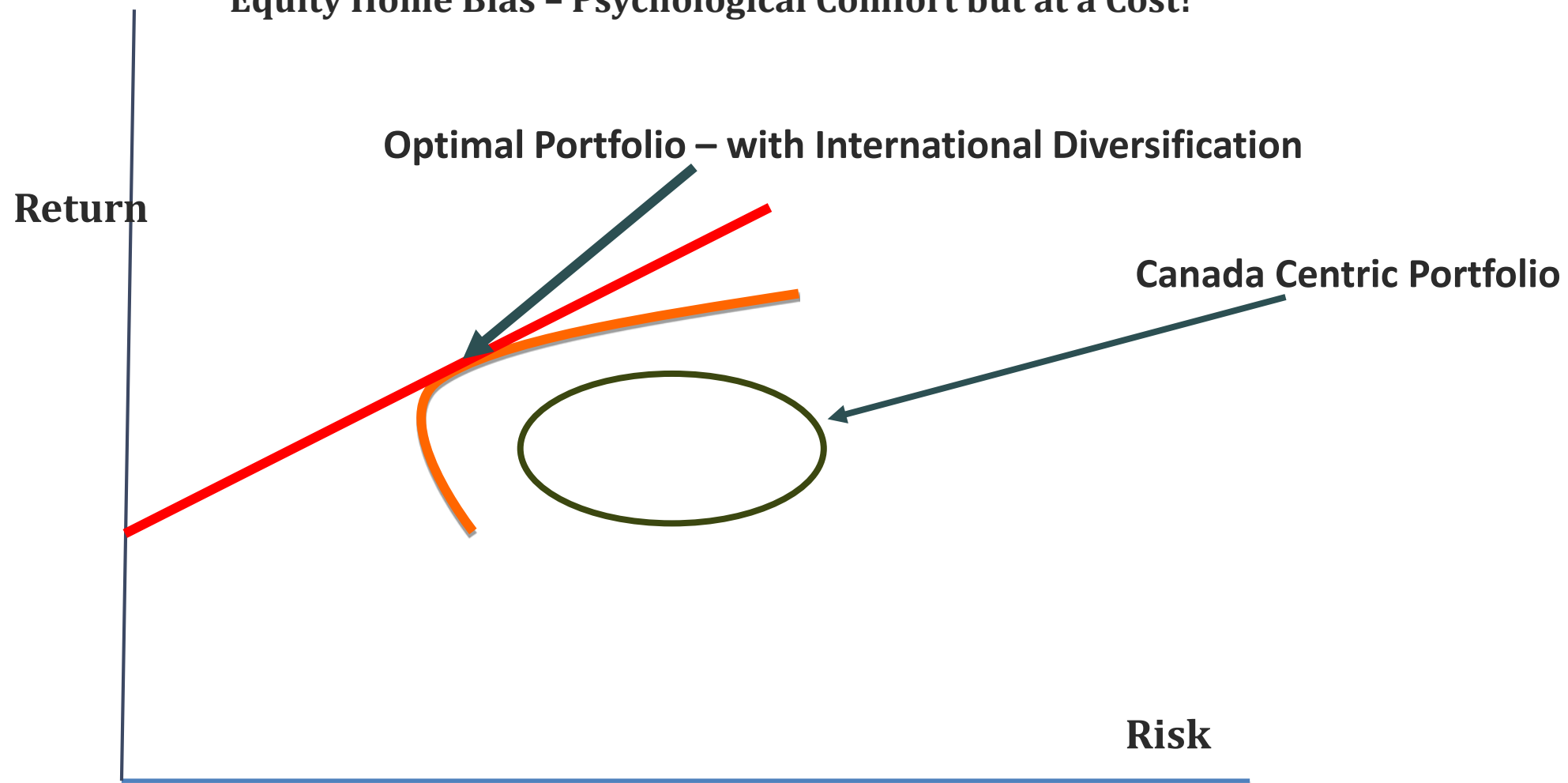
The Profile of the Canadian Investor

How Canadians Invest in Mutual Funds December, 2015

Source: www.ific.ca/en/stats



Equity Home Bias – Psychological Comfort but at a Cost!





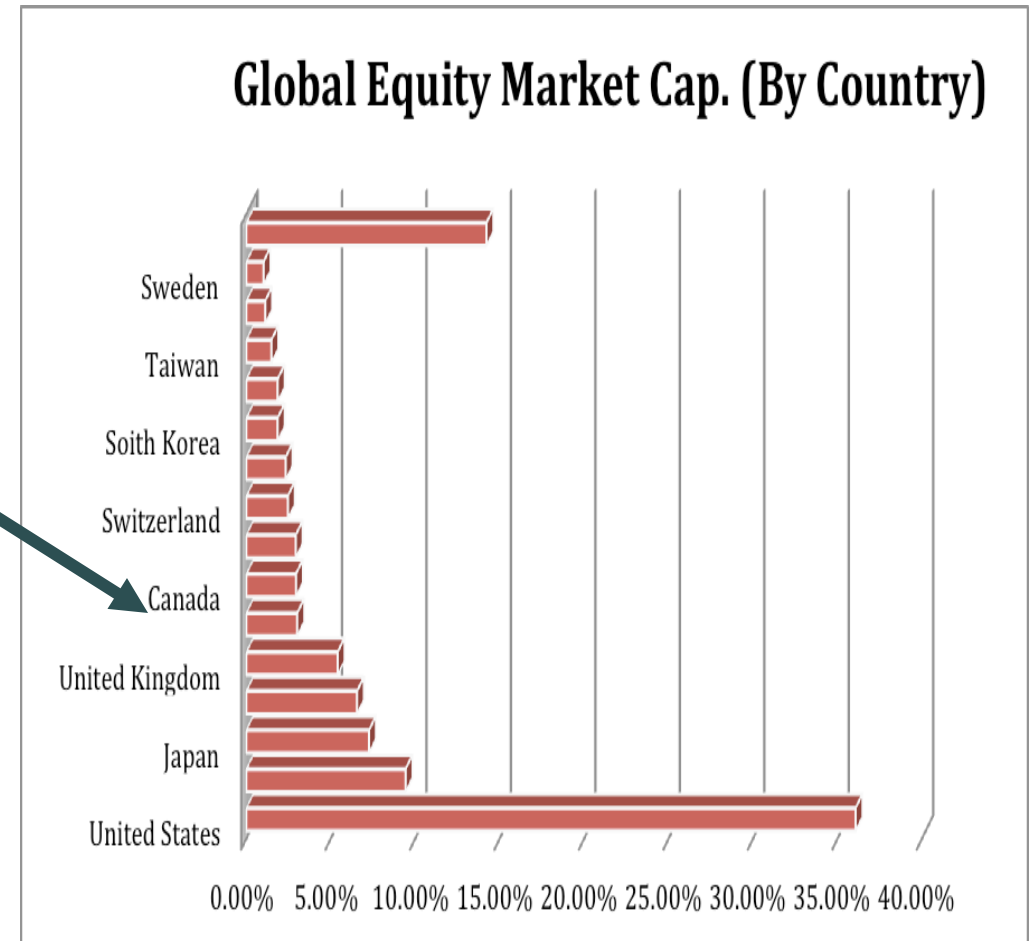
The Canadian Equity Home Bias

- Tendency for investors to hold less than optimally diversified portfolios that favor domestic equities.
- Contradicts 50 plus years of research and advisor based advice that international diversification reduces risk and potentially increases returns (French, K., and Poterba, J., 1991).

The Equity Home Bias – Canadian Version

Canada in the World

- Particularly critical to Canadian investors.
- CAD is relatively small proportion (2.94%) of total global equity markets
- Source: www.besspokepremium.com (April 5 2016)

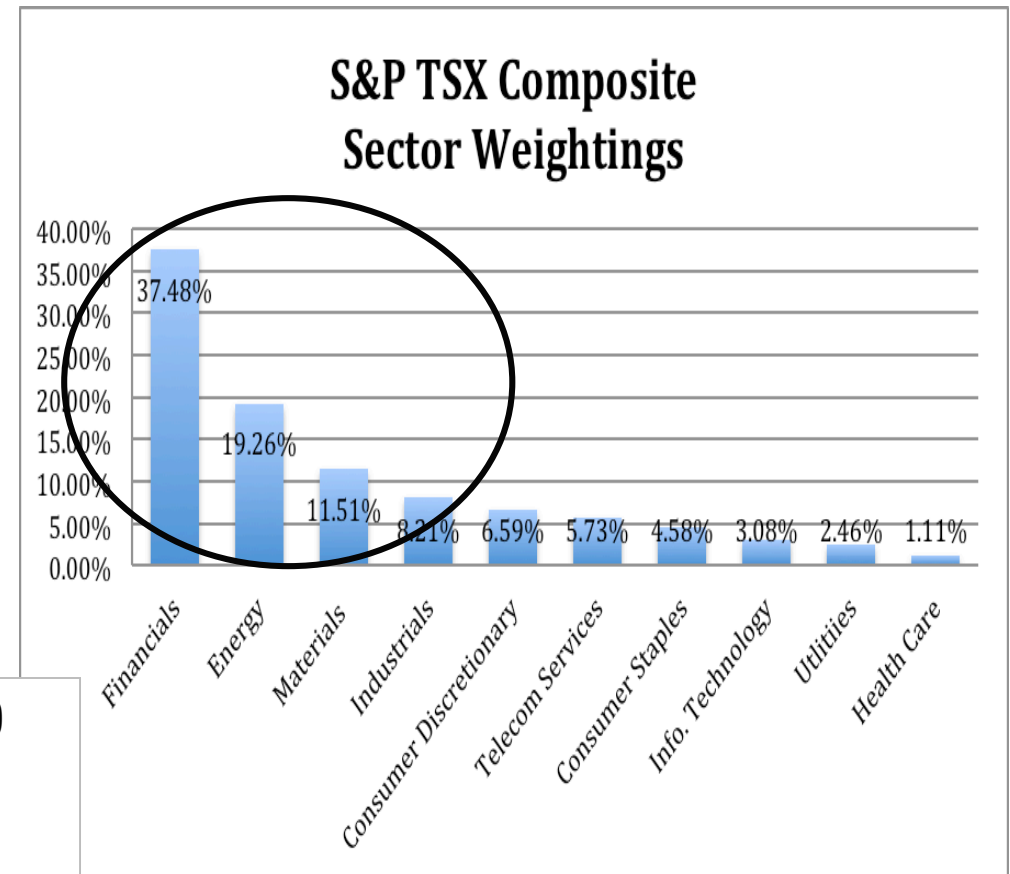


The Equity Home Bias – Magnification of Bias

Canada in the World

- Over 68% of the S&P TSX Composite is made up to three sectors.
- Financials 38%
- Energy 19%
- Materials 12%

Source: web.tsxmoney.com/indices (Date: April 9 16)



The Equity Home Bias – Magnification of Bias

Company	Global Weight
Royal Bank of Canada	.20%
Toronto Dominion Bank	.18%
Bank of Nova Scotia	.15%
Canadian National Railway	.10%
Suncor Energy Inc	.10%
Bank of Montreal	.09%
Enbridge Inc	.07%
Canadian Natural Resources Limited	.08%
CIBC	.08%
Bell Canada Enterprises	.06%

Source: Vanguard, Global Equities: Balancing Home Bias and Diversification: A Canadian Perspective (July, 14) and www.marketwatch.com (Date: Feb. 12 15)

CIBC and BCE weights calculated from data taken from www.cibc.com and www.bce.ca and www.marketwatch.com (Date: April 10, 16).

Changes in Correlations of CAD Assets to the World

Correlation Matrix: Canada and the World

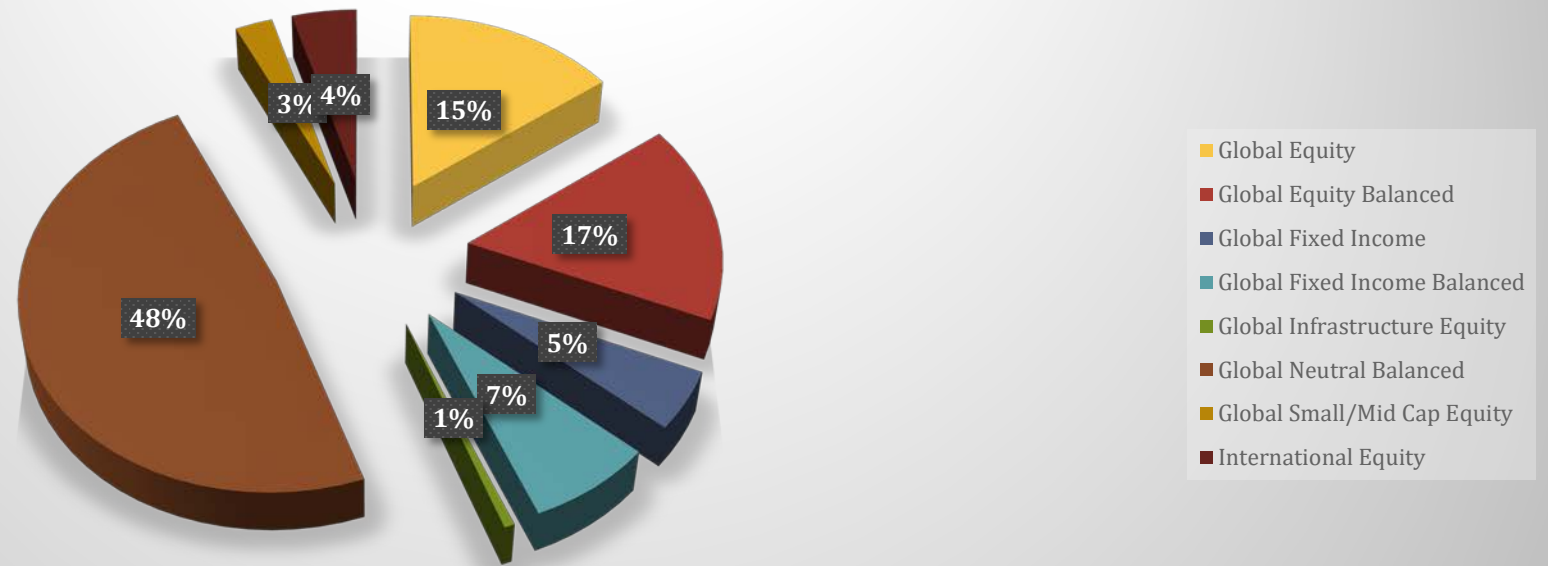
Geography	EWC	EEM	XWD	EFA	FM	EEML	IVW
EWC	1	.877	-.354	.488	.828	.704	-.125
EEM		1	-.525	.271	.562	.853	-.424
XWD			1	.479	-.005	-.869	.982
EFA				1	.752	-.111	.546
FM					1	.356	.118
EEML						1	-.803
IVW							1

Source: www.yahoo.com/finance (Date: April 13 16) and author's calculations.
Forex is not accounted for in these correlations.

Similar research is found in a research note by Provisus Wealth Management (August, 2013). Interestingly Provisus found a low positive correlation to the S&P 500 (C\$) index ($r = .46$). Forex is accounted for in the Provisus data and research.
www.provisus.ca (Date: April 13 2016)

Growth in International and Global Investing

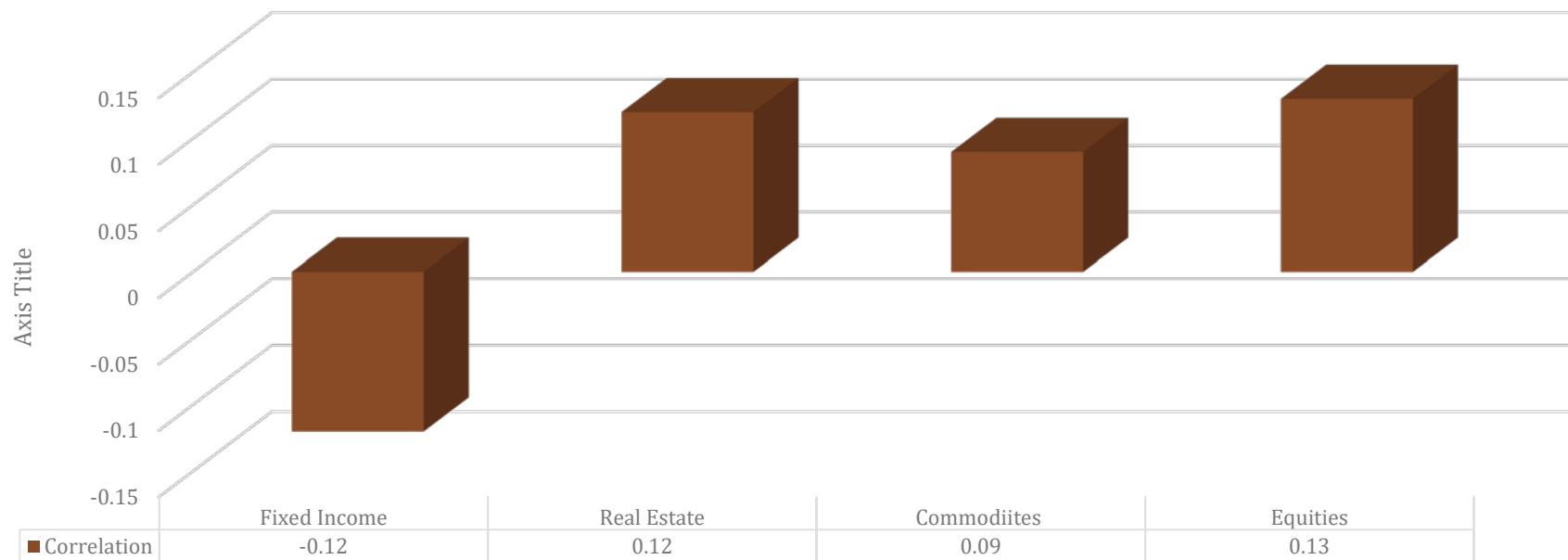
CAD Investment in International & Global Funds
www.ific.ca/stats



Currency as an Asset Class

Correlation of Currency Returns and Traditional Asset Classes

Source: Merk Investments, LLC (2013)



A vertical decorative bar on the left side of the slide, featuring a golden-yellow background with various currency symbols (dollar, euro, yen, pound, etc.) in a 3D, embossed style.

Why does Currency have Low Correlations?

Primary Roles of Currency:

- Function of Money
 - Store of Value.
 - Medium of Exchange.
 - Unit of Account.



Why does Currency have Low Correlations?

Primary Roles of Currency:

- Government Management of the Economy
 - Basis for international reserves.
 - A store of value and a unit of account that can be used in currency market intervention.
 - An anchor for pegging local currencies.

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Why does Currency have Low Correlations?

Primary Roles of Currency:

- Private Actors
 - Used for valuing invoices for international trade.
 - Unit of account for currency substitution.
 - Unit of account for trade and financial transactions.

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Why does Currency have Low Correlations?

- The currency market is consider an “efficient market BUT.....
- It is used inefficiently by various market participants

FX Quotes: Currency Exchange Pairs

CAD/USD Quotation

\$1 CAD / \$.7273 USD

Base Currency (first currency)

Quote Currency (second currency)

Source: www.google.com/finance (May 2nd 2017)

FX Quotes: Currency Exchange Pairs

USD/CAD Quotation

\$1 USD / \$1.3749 CAD

Base Currency (first currency)

Quote Currency (second currency)

Source: www.google.com/finance (May 2nd 2017)

FX Quotes: European vs. American Terms

European versus American Terms

European Terms

\$1 CAD/.7273 USD

American Terms

\$1 USD/\$1.3749 CAD

How many USD purchases 1 forex unit How many forex units purchases \$1 USD

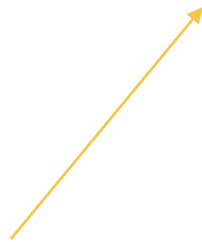
Source: www.google.com/finance (May 2nd 2017)

FX Quotes: European vs. American Terms

CAD/USD (American Terms)

February 7th 2017

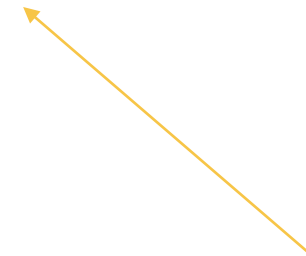
\$1 USD / \$1.3167 CAD



\$1 CAD / \$.7595 USD

March 7th 2017

\$1 USD / \$1.3417 CAD



\$1 CAD / \$.7453 USD

FX Quotes: European vs. American Terms

CAD/USD (American Terms)

February 7th 2017

\$1 USD / \$1.3167 CAD

March 7th 2017

\$1 USD / \$1.3417 CAD

- A rise in the quoted currency (second currency) results in a depreciation in the value of the second currency, in reference to the base currency (first currency).
- A decrease in the second currency (quoted currency) is an appreciation of the quoted currency, compared to the base (first) currency.

FX Quotes: European vs. American Terms

CAD/USD (American Terms)

February 7th 2017

\$1 USD / \$1.3167 CAD

March 7th 2017

\$1 USD / \$1.3417 CAD

Understanding the Effects of a Change in the Quoted Currency

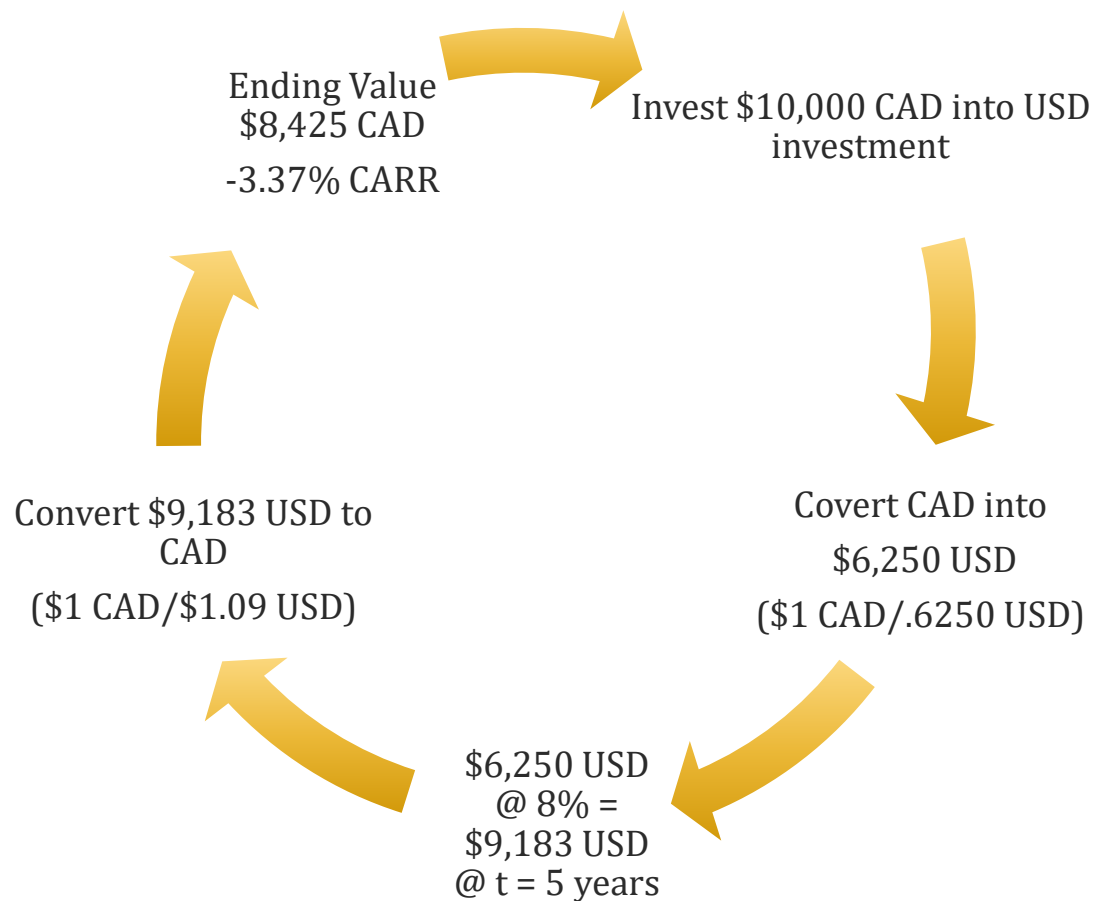
Rise in the Quoted Currency

- **Appreciation in the base currency**

Decreased in the Quoted Currency

- **Depreciation in the base currency**

An Appreciation in the CAD vs. the USD



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What Causes Currencies to Rise and Fall?

- Comparative Economic Growth
- Rise/Decline on Commodity Prices

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What Causes Currencies to Rise and Fall?

- Comparative Levels of Interest Rates
- Comparative Levels of Inflation Rates

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What Causes Currencies to Rise and Fall?

- Current Account Balances
- Global Economic & Political Stability



Managing Forex Risk with Currency Options

“The opportunity or ability to choose something or to choose between two or more things; something that can be chosen; a choice or possibility.”

www.merriam-webster.com/dictionary/option (Date: May 1, 2017)



A Primer on Equity Options

Call Option

Put Option

Buyer - long the option

Has the right but NOT the obligation to buy (call away) a financial asset (referred to as the underlying) from the option writer - usually a common equity.

Seller (Writer) - short the option

A Primer on Equity Options

Call Option

Put Option

Buyer - long the option

Has the right but NOT the obligation to buy (call away) a financial asset (referred to as the underlying) from the option writer - usually a common equity.

Has the right but NOT the obligation to sell (put) a financial asset (referred to as the underlying) to the option seller - usually a common equity.

Seller (Writer) - short the option



A Primer on Equity Options

Call Option

Put Option

Buyer - long the option

Seller (Writer) – short the option

Must respond to the buyer's exercise of his/her right by selling a financial asset to the option buyer – usually a common equity.

A Primer on Equity Options

Call Option

Put Option

Buyer - long the option

Seller (Writer) – short the option

Must respond to the buyer's exercise of his/her right by selling a financial asset to the option buyer – usually a common equity.

Must respond to the buyer's exercise of his/her right by buying a financial asset from the option buyer – usually a common equity.

A Primer on Equity Options

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Put Option

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Has the right but NOT the obligation to buy (call away) a financial asset (referred to as the underlying) from the option writer - usually a common equity.

Has the right but NOT the obligation to sell (put) a financial asset (referred to as the underlying) to the option seller - usually a common equity.

Seller (Writer) - short the option

Must respond to the buyer's exercise of his/her right by selling a financial asset to the option buyer - usually a common equity.

Must respond to the buyer's exercise of his/her right by buying a financial asset from the option buyer - usually a common equity.

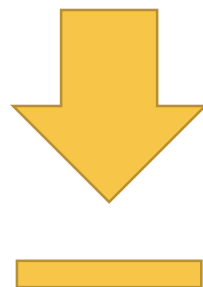
A Primer on Equity Options

Call Option

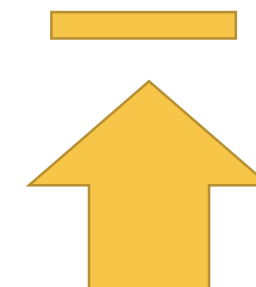
Buyer - long the option



Seller (Writer) - short the option



Put Option



Comparing Option Contract Quotes

Currency Option Contract Pairs Montreal Bourse and Philadelphia Exchange			
Philadelphia Exchange (NASDAQ PHLX)		Montreal Bourse (MX)	
Currency Pair	Contract Size	Currency Pair	Contract Size
CAD/USD	10,000	USD/CAD	10,000
AUD/USD	10,000	Note: currency options that are traded on the NASDAQ PHLX and MX are European style options.	
GBP/USD	10,000		
EUR/USD	10,000		
CHF/USD	10,000		
NZD/USD	10,000		
JPY/USD	1,000,000		
Source(s): http://business.nasdaq.com/trade/US-Options/PHLX-FX-Options.html (May 5 th , 2017) and https://www.m-x.ca/produits_options_devises_en.php (May 5 th , 2017)			

The Call Option: A Typical FOREX Risk Management Strategy

Currency Option Contract Pairs Montreal Bourse and Philadelphia Exchange			
Philadelphia Exchange (NASDAQ PHLX)		Montreal Bourse (MX)	
Currency Pair	Contract Size	Currency Pair	Contract Size
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An investor believes that over the next 6 months the USD will continue to rise, compared to the CAD. He wants to take advantage of this rise using a currency option contract – a typical call option strategy.

The Call Option: A Typical FOREX Risk Management Strategy

Currency Option Contract Pairs Montreal Bourse and Philadelphia Exchange			
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CHF/USD	10,000		
NZD/USD	10,000		
JPY/USD	1,000,000		
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USD/CAD Call Option Contract Symbol: USX				
Expiry Date	Strike Price	Bid	Ask	Highest
Dec. 15, 2017	147.50	.46	.79	.90
Source: https://www.m-x.ca/produits_options_devises_en.php (May 5 th , 2017)				

The Call Option: A Typical FOREX Risk Management Strategy

MX Call Option Cash Settlement Calculation

$$O_{\text{stlmnt}} = [((P_{\text{spot}} - O_{\text{strike}}) \times \$10,000) / 100] \times N$$

$$O_{\text{stlmnt}} = [((\$150 - \$147.50) \times \$10,000) / 100] \times 1 = \$250 \text{ CAD}$$

Where,

O_{stlmnt} = option settlement

P_{spot} = Forex spot price (Noon date of expiry as per Bank of Canada)

O_{strike} = Strike price on options contract

N = Number of options contracts

Source: https://www.m-x.ca/produits_options_devises_en.php
(May 5th, 2017)

USD/CAD Call Option Contract Symbol: USX				
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A Currency Put Option Strategy

Currency Option Contract Pairs Montreal Bourse and Philadelphia Exchange			
Philadelphia Exchange (NASDAQ PHLX)		Montreal Bourse (MX)	
Currency Pair	Contract Size	Currency Pair	Contract Size
CAD/USD	10,000	USD/CAD	10,000
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USD/CAD Put Option Contract Symbol: USX				
Expiry Date	Strike Price	Bid	Ask	Highest
June 16, 2017	134.50	.41	.61	.61
Source: https://www.m-x.ca/produits_options_devises_en.php (May 6 th , 2017)				

A Currency Put Option Strategy

Currency Option Contract Pairs Montreal Bourse and Philadelphia Exchange			
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Currency Put Option Premium

$$P_{\text{option}} = [((P \times \$10,000 \text{ USD})) / 100] \times N$$

$$P_{\text{option}} = [((.61\text{¢ CAD} \times \$10,000 \text{ USD})) / 100] \times 2$$

$$P_{\text{option}} = \$122 \text{ CAD}$$

Where,

P_{option} = option premium (cents per CAD)

N = Number of options contracts

Note: \$10,000 USD is the standard MX options contract on USD

Source: https://www.m-x.ca/produits_options_devises_en.php (May 5th, 2017)

A Currency Put Option Strategy

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MX Put Option Cash Settlement Calculation

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$$O_{\text{stmnt}} = [((\$134.50 - \$132.50) \times \$10,000 \text{ USD}) / 100] \times 2$$

$$O_{\text{stmnt}} = [(\$2.00 \times \$10,000 \text{ USD}) / 100] \times 2$$

$$O_{\text{stmnt}} = \$200 \times 2 = \$200$$

Where,

O_{stmnt} = option settlement

P_{spot} = Forex spot price (Noon date of expiry as per Bank of Canada)

O_{strike} = Strike price on options contract

N = Number of options contract

Source: https://www.m-x.ca/produits_options_devises_en.php (May 5th, 2017)

Overview of Options Strategies

Expectation Regarding the Base Currency in the Currency Exchange Pair	
Base (First) Currency is Expected to Rise	Base (First) Currency is Expected to Decline
<p>Buy Call Options – pay option premium.</p> <p>Risks – call expires out-of-the-money resulting in 100% loss of option premium.</p>	<p>Buy Put Options – pay option premium.</p> <p>Risks – put option expires out-of-the-money resulting in 100% loss of option premium.</p>
<p>Sell Put Options – collect option premium</p> <p>Risks – option is in-the-money at expiry resulting in assignment of cash settlement (you must pay cash settlement)</p>	<p>Sell Call Options – collect option premium.</p> <p>Risks – option is in-the-money at expiry resulting in assignment of cash settlement (you must pay cash settlement)</p>

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Which is the base currency?

Comparing Option Contract Quotes

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Philadelphia Exchange (NASDAQ PHLX)		Montreal Bourse (MX)	
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GBP/USD	10,000		
EUR/USD	10,000		
CHF/USD	10,000		
NZD/USD	10,000		
JPY/USD	1,000,000		
Source(s): http://business.nasdaq.com/trade/US-Options/PHLX-FX-Options.html (May 5 th , 2017) and https://www.m-x.ca/produits_options_devises_en.php (May 5 th , 2017)			

CAD is the base currency!

Comparing Option Contract Quotes

Currency Option Contract Pairs Montreal Bourse and Philadelphia Exchange			
Philadelphia Exchange (NASDAQ PHLX)		Montreal Bourse (MX)	
Currency Pair	Contract Size	Currency Pair	Contract Size
USD	10,000	USD/CAD	10,000
AUD/USD	10,000	Note: currency options that are traded on the NASDAQ PHLX and MX are European style options.	
GBP/USD	10,000		
EUR/USD	10,000		
CHF/USD	10,000		
NZD/USD	10,000		
JPY/USD	1,000,000		
Source(s): http://business.nasdaq.com/trade/US-Options/PHLX-FX-Options.html (May 5 th , 2017) and https://www.m-x.ca/produits_options_devises_en.php (May 5 th , 2017)			

USD is the terms or quoted currency!

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Scenario One

You are bullish on the USD appreciating against the CAD. If you use the Montreal Exchange for your options trades, what option position would you take?

Option Contract Quotes

Currency Option Contract Pairs Montreal Bourse and Philadelphia Exchange			
Philadelphia Exchange (NASDAQ PHLX)		Montreal Bourse (MX)	
Currency Pair	Contract Size	Currency Pair	Contract Size
CAD/USD	10,000	USD/CAD	10,000
AUD/USD	10,000	Note: currency options that are traded on the NASDAQ PHLX and MX are European style options.	
GBP/USD	10,000		
EUR/USD	10,000		
CHF/USD	10,000		
NZD/USD	10,000		
JPY/USD	1,000,000		
Source(s): http://business.nasdaq.com/trade/US-Options/PHLX-FX-Options.html (May 5 th , 2017) and https://www.m-x.ca/produits_options_devises_en.php (May 5 th , 2017)			

A vertical decorative bar on the left side of the slide, featuring a golden-yellow background with various currency symbols (USD, EUR, GBP, etc.) in a 3D, embossed style.

Scenario One

You are bullish on the USD appreciating against the CAD. If you use the Montreal Exchange for your options trades, what option position would you take?

1. Buys calls on the USD
2. Sells puts on the USD

A vertical decorative bar on the left side of the slide, featuring a golden-yellow background with various currency symbols (USD, GBP, JPY, EUR) and numbers (1, 2, 3, 4, 5) in a 3D, embossed style.

Scenario Two

You are bearish on the USD against the GBP. If you use the PHLX for your options trades, what option position would you take?

Comparing Option Contract Quotes

Currency Option Contract Pairs Montreal Bourse and Philadelphia Exchange			
Philadelphia Exchange (NASDAQ PHLX)		Montreal Bourse (MX)	
Currency Pair	Contract Size	Currency Pair	Contract Size
CAD/USD	10,000	USD/CAD	10,000
AUD/USD	10,000	Note: currency options that are traded on the NASDAQ PHLX and MX are European style options.	
GBP/USD	10,000		
EUR/USD	10,000		
CHF/USD	10,000		
NZD/USD	10,000		
JPY/USD	1,000,000		
<p>Source(s): http://business.nasdaq.com/trade/US-Options/PHLX-FX-Options.html (May 5th, 2017) and https://www.m-x.ca/produits_options_devises_en.php (May 5th, 2017)</p>			

Scenario Two

You are bearish on the USD against the GBP. If you use the PHLX for your options trades, what option position would you take?

PHLX quotes in European terms so the USD is the quoted currency!

1. Buys calls on the GBP
2. Sell puts on the GBP

A vertical decorative bar on the left side of the slide, featuring a golden-yellow background with various 3D-rendered currency symbols including the dollar sign (\$), pound sign (£), yen sign (¥), and euro sign (€).

Scenario Three

You are bullish on the USD against the CHF. If you use the PHLX for your options trades, what option position would you take?

PHLX quotes in European terms so the USD is the quoted currency!

Comparing Option Contract Quotes

Currency Option Contract Pairs Montreal Bourse and Philadelphia Exchange			
Philadelphia Exchange (NASDAQ PHLX)		Montreal Bourse (MX)	
Currency Pair	Contract Size	Currency Pair	Contract Size
CAD/USD	10,000	USD/CAD	10,000
AUD/USD	10,000	Note: currency options that are traded on the NASDAQ PHLX and MX are European style options.	
GBP/USD	10,000		
EUR/USD	10,000		
CHF/USD	10,000		
NZD/USD	10,000		
JPY/USD	1,000,000		
Source(s): http://business.nasdaq.com/trade/US-Options/PHLX-FX-Options.html (May 5 th , 2017) and https://www.m-x.ca/produits_options_devises_en.php (May 5 th , 2017)			

Scenario Three

You are bullish on the USD against the CHF. If you use the PHLX for your options trades, what option position would you take?

PHLX quotes in European terms so the USD is the quoted currency!

1. Buys puts on the CHF
2. Sell calls on the CHF

Overview of Options Strategies

Expectation Regarding the Base Currency in the Currency Exchange Pair	
Base (First) Currency is Expected to Rise	Base (First) Currency is Expected to Decline
<p>Buy Call Options – pay option premium.</p> <p>Risks – call expires out-of-the-money resulting in 100% loss of option premium.</p>	<p>Buy Put Options – pay option premium.</p> <p>Risks – put option expires out-of-the-money resulting in 100% loss of option premium.</p>
<p>Sell Put Options – collect option premium</p> <p>Risks – option is in-the-money at expiry resulting in assignment of cash settlement (you must pay cash settlement)</p>	<p>Sell Call Options – collect option premium.</p> <p>Risks – option is in-the-money at expiry resulting in assignment of cash settlement (you must pay cash settlement)</p>



Wrap Up and Question & Answer
