

Gold Call Overwriting strategy

Gold as an inflation hedge

Despite what many ancient alchemists may claim, you cannot create any more units of gold from lead. You have to resort to good old fashioned mining. Ultimately what this means is that gold is difficult to debase as a commodity. In contrast, simply turning up the dial on the quantitative easing press introduces a wave of inflationary pressures on bog standard paper money. Useful as a tool for controlling economic concerns, unhelpful for certain investors looking to generate decent real returns. It is therefore generally believed that gold is one way of hedging against rises in inflation.

Given this widely held view one would assume that accessing and investing in gold is a relatively straightforward exercise. Many of the gold ETFs certainly back this assumption up with the physically-backed SPDR Gold Shares ETF holding a staggering 937 tonnes somewhere in vaults beneath the streets of London. However, when it comes to investing in securities that reference the gold futures directly it is important to consider the costs associated with rolling the current contract.

Futures roll costs

A futures curve that is upwards sloping represents a scenario where longer-dated contracts are more expensive than nearer-dated contracts. There may be several reasons why this can be, and in the case of gold it is generally associated with the cost of carrying the physical position. As you can imagine warehousing gold in vaults doesn't come cheap, and the interest foregone on the cash tied up in purchasing the asset means that overall carry costs can add up.

In order to build a product that references gold futures we first need to purchase the nearest contract. This obviously has a maturity date and come the time of expiry we are required to sell the existing contract and buy the more expensive one further out along the curve.

This process, along with any commission charged each time we sell and then purchase, is what we call our futures roll costs.

Call overwriting

The call overwriting strategy is an efficient way of enhancing the overall long exposure to gold whilst dampening the effects of the roll costs. To create a call overwriting strategy we follow the below steps:

- 1) Enter into a long position on gold by purchasing the nearby futures contract. This is represented by the dashed red line in the below diagram.

Rationale: gaining long exposure in gold

- 2) As we enter into a long futures position we simultaneously sell a call option contract on gold, matching the above futures contract expiry. We can choose the strike of our call option to match our investment views. This is represented by the dashed blue line in the below diagram.

Rationale: generating value from the volatility premium and theta decay

Contact:

General: T 020 8050 2900 E enquiries@fortemcapital.com
 Sales: T 020 8050 2903 E sales@fortemcapital.com

Trading: T 020 8050 2901 E trading@fortemcapital.com
 Research: T 020 8050 2902 E research@fortemcapital.com

9th September 2016

Indicative Levels – 6yr	
FTSE/S&P 5% step 60% EKIP	8.00%
FTSE 4% step 65% EKIP	8.00%
FTSE/S&P 60% digital 60% EKIP	41.00%
MSCI World Supertracker 70% EKIP	168.0%
S&P USD Supertracker 60% EKIP	180.0%
Topix GBP Supertracker 65% EKIP	177.0%

Rates (bps)		
	Current	Week Chge
GBP 1yr	47.40	-0.10
GBP 3yr	46.50	0.80
GBP 5yr	54.50	1.60

Equity Indices (%)		
FTSE 100	6838.88	-0.81%
S&P 500	2163.05	-0.78%
Nikkei 225	16965.76	0.24%
Eurostoxx 50	3072.19	-0.78%

Currencies (%)		
GBPUSD	1.3307	0.10%

5yr Credit Spreads (bps)		
Citigroup	77.99	2.12
Credit Suisse	121.06	-2.66
Deutsche	196.49	-14.18
GS	93.88	0.33
HSBC	68.26	5.60
JPM	60.14	0.84
MS	90.38	0.55

Commodities (%)		
Gold	1336.23	0.83%
Oil	47.11	6.01%

3m Implied (vol pts)		
FTSE 100	13.54%	-0.34%
S&P 500	12.33%	-0.63%
Nikkei 225	21.09%	-0.12%
Eurostoxx 50	18.94%	-1.02%

5yr Implied (vol pts)		
FTSE 100	19.37%	-0.43%
S&P 500	21.16%	-1.53%
Nikkei 225	20.17%	0.09%
Eurostoxx 50	20.08%	0.28%

Source Bloomberg / Partner Banks
 Data as at 9th Sep, 3.00pm

Upcoming events	
13 th Sep	ECB's Draghi to speak in Italy
13 th Sep	UK CPI
16 th Sep	EU leaders to speak about Brexit

FRIDAY NIGHT 'LIGHTS

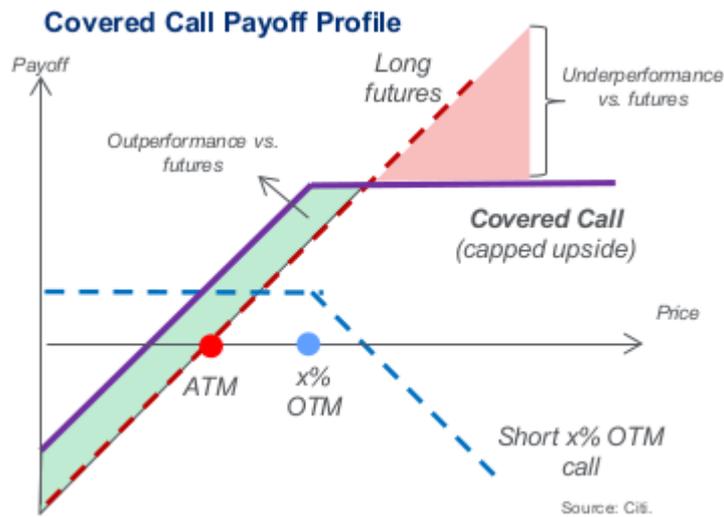
As time passes we periodically roll both the futures contract and call options so that the maturities match.

By selling the call options we generate premiums for our strategy (we are being paid for taking the upside risk). It is these premiums that allow us to benefit from an outperformance versus the underlying long futures position as shown by the shaded blue area in the diagram below.

Being short the call means we have to compensate the buyer if the underlying gold price finishes above the OTM strike level. The long gold futures position allows us to fulfil this obligation. This combination of elements effectively serves to cap us on the upside.

We can however choose where we cap our upside by selecting the appropriate OTM strike level on the call we sell. For example, for a particularly bullish view we would choose to push the strike level further OTM. The premium on this OTM call option would of course be lower but that is the trade-off for having a cap on the upside much higher.

Conversely, a slightly more bearish approach would have us writing OTM options with lower strikes, generating higher premiums and capping us at a lower gold price. Hence, you can see how versatile this strategy is in accommodating different investor views.



Conclusion

If you are looking for a straightforward long exposure to gold then one of the existing gold ETF securities is probably the best way forward, however if you believe that gold will appreciate but not "shoot the lights out", a superior risk adjusted return could be in the format of the call overwriting strategy. The beauty of this strategy is that you can tailor the strikes on the calls to fit with your investment view.

Contact:

General: T 020 8050 2900 E enquiries@fortemcapital.com
 Sales: T 020 8050 2903 E sales@fortemcapital.com

Trading: T 020 8050 2901 E trading@fortemcapital.com
 Research: T 020 8050 2902 E research@fortemcapital.com



FRIDAY NIGHT 'LIGHTS

Disclaimer

This factsheet has been issued as a financial promotion by Fortem Capital Limited having been approved for issue by Blackheath Capital Management LLP for the purpose of section 21 of the Financial Services and Markets Acts 2000. Fortem Capital Limited is an appointed representative of Blackheath Capital Management Limited which is authorised and regulated by the Financial Conduct Authority. This factsheet is intended for Professional Investors and Institutional Clients and advisors and should not be communicated to any other person. The information has been prepared solely for information purposes only and is not an offer or solicitation of an offer to buy or sell the product. All information, including prices, analytical data and opinions contained within this factsheet are believed to be correct, accurate and derived from reliable sources as at the date of the factsheet. However, no representation or warranty, expressed or implied is made as to the correctness, accuracy or validity of such information. Fortem Capital Limited assumes no responsibility or liability for any errors, omissions or inaccuracies with respect to the information contained within this factsheet. All price and analytical data included in this factsheet is intended for indicative purposes only and is as at the date of the factsheet. The value of investments and the income from them can go down as well as up and the investor may not get back the amount originally invested. Past performance is not necessarily a guide for the future. The information within this document does not take into account the specific investment objective or financial situation of any person. Investors should refer to the final documentation and any prospectus to ascertain all of the risks and terms associated with these securities and seek independent advice, where necessary, before making any decision to buy or sell. The product may not be offered, sold, transferred or delivered directly or indirectly in the United States to, or for the account or benefit of, any U.S. Person.

Contact:

General: T 020 8050 2900 E enquiries@fortemcapital.com
Sales: T 020 8050 2903 E sales@fortemcapital.com

Trading: T 020 8050 2901 E trading@fortemcapital.com
Research: T 020 8050 2902 E research@fortemcapital.com