Interactive Brokers

presents

Mechanics of an Overseas Trade

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Webinar begins @ 12:00 pm EST

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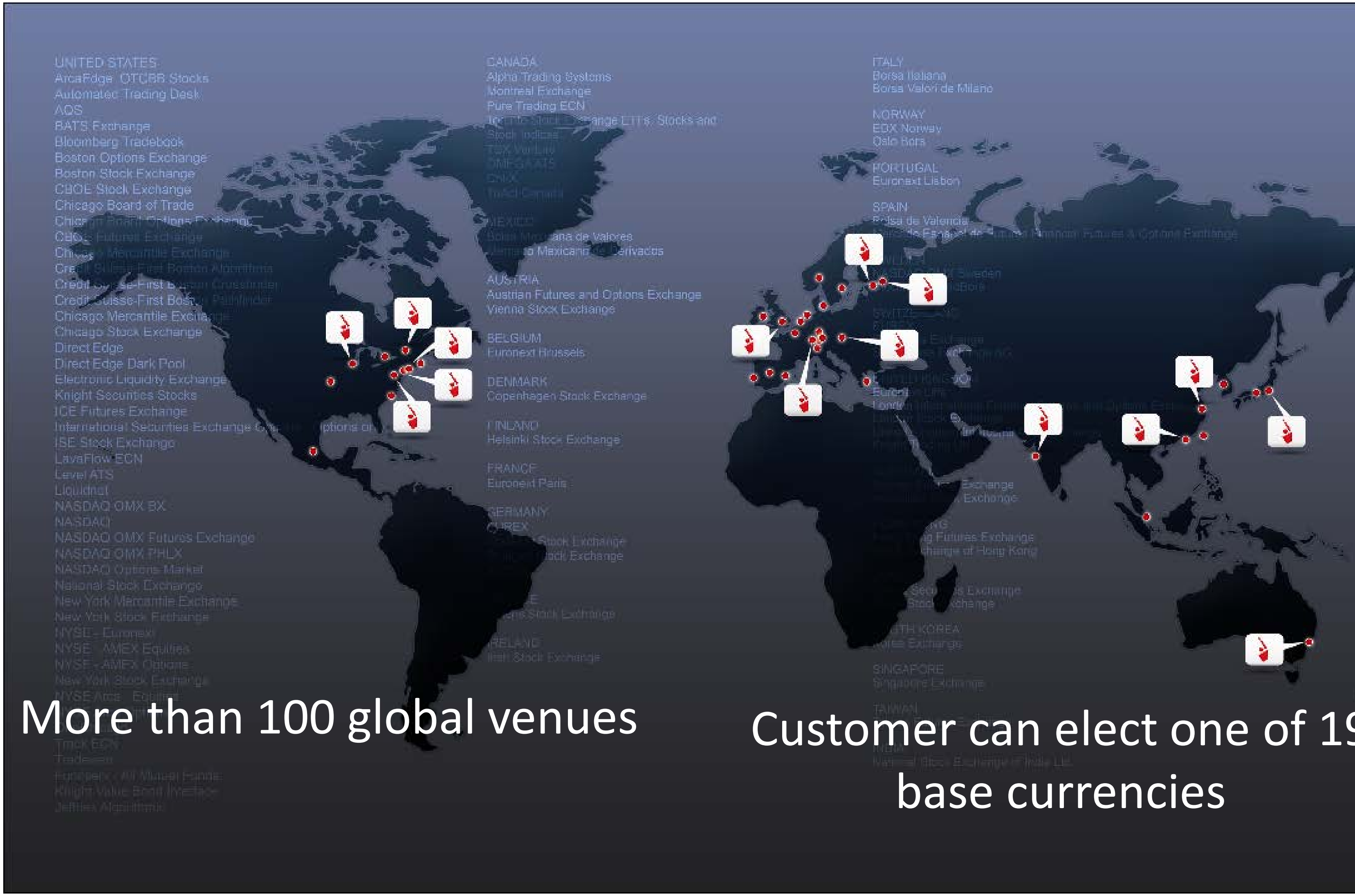

More than 100 global venues

Customer can elect one of 19 base currencies

Foreign Transactions - Factors

- Trading risk
- Exchange rate risk
- Settlement in non-base currency
- Need for local market data?

Credit Manager

- Client enters foreign stock transaction
- Credit manager checks currency account
- Is currency available?

Yes – Credit Manager debits currency account = Currency Conversion

No – Credit Manager creates Margin Loan using base currency as collateral

– OR –

- Customer can BUY currency
- Customer can attach an FX order

This is for Margin accounts only!

Loans are not permitted in Cash accounts

Currency Conversion

Sell dollars – buy pounds

Assets	Liabilities
US$15,000	
GBP£1=$1.50	
$15,000/$1.50 =	
GBP£10,000	

- Investor converts dollar deposit at a $1.50 rate leaving account with £10,000
- Can now buy 10,000 shares @ £1.00 each

Currency Conversion –

CASE 1 - Shares sold – dollar strengthens

Assets	Liabilities
GBP £10,000	
*$1.40 = $14,000	
(loss = $1,000)	

- After some weeks the investor decides to sell his position at the same share price, leaving him with £10,000
- Now the investor must sell his pounds in order to get back to his base U.S. dollar currency. However, the pound’s exchange rate to the dollar has *weakened* to $1.40 – resulting in a $1,000 loss compared to the initial $15,000 conversion

Currency Conversion –

CASE 2 - Shares sold – dollar weakens

Assets	Liabilities
GBP£10,000 *$1.60 = $16,000 (Gain = $1,000)	

- After some weeks the investor decides to sell his position at the same share price, leaving him with £10,000
- Now the investor must sell his pounds in order to get back to his base U.S. dollar currency. The pound's exchange rate to the dollar has *strengthened* to $1.60 – resulting in a $1,000 *gain* compared to the initial $15,000 conversion

Currency Conversion –

CASE 3 - Share price rises – dollar moves

Assets	Liabilities
10,000 shares UK ABC Corp. @ £1.10 = GBP£11,000 (Gain £1,000) GBP£11,000 *$1.40 = $15,400 or $ 400 gain *$1.50 = $16,500 or $1,500 gain *$1.60 = $17,600 or $2,600 gain	

- The investor takes advantage of a 10% rise in the value of shares at UK ABC Corp. and sells his stake at GBP£1.10 each.
- Account now shows £11,000 credit balance
- When the share price gains in British pound terms, the dollar results depend on what happens to the rate of exchange – here the gain is eroded by a rise in the dollar and magnified by a fall in the dollar's value

Currency Conversion –

CASE 4 - Share price falls – dollar moves

Assets	Liabilities
10,000 shares UK ABC Corp. @ £0.90 = GBP£9,000 (Loss = £1,000) GBP£9,000 *$1.40 = $12,600 or $2,400 loss *$1.50 = $13,500 or $1,500 loss *$1.60 = $14,400 or $ 600 loss	

- The cautious investor sells to close his stake after 10% slide in the value of shares at UK ABC Corp. and sells his stake at £0.90 each.
- Account now shows GBP£9,000 credit balance
- When the share price falls in British pound terms, the translation back to U.S. dollars depends on what happens to the rate of exchange – here the loss is increased by a rising dollar and is eroded by a decline in the value of the dollar

Margin Loan -

Uses loan to buy British stock

Assets	Liabilities
US$15,000	Buys 10,000 shares in UK ABC Corp. @ £1.00 per share Loan created to enable settlement GBP£10,000

- An investor with an account value of $15,000 buys British shares with a value of £10,000
- With the exchange rate at $1.50 the investor creates a margin loan for £10,000 and now has an equal and offsetting liability to match the dollar-based asset

Margin Loan –

CASE 1 - Sell shares after they rise

Assets	Liabilities
US$15,000	Sells 10,000 shares in UK ABC Corp. @ £1.10 per share = GBP£11,000 GBP£10,000 loan GBP£11,000 balance GBP£ 1,000 gain after sale

Investor sells UK ABC shares after they rise to £1.10 each leaving the investor with a £1,000 gain after the loan is repaid

Margin Loan –

CASE 1 - Sell shares after they rise

Assets	Liabilities	
US$15,000	GBP£10,000	loan
	GBP£11,000	balance
	GBP£ 1,000	gain after sale
	*$1.40 = $1,400	or $ 400 gain
	*$1.50 = $1,500	or $1,500 gain
	*$1.60 = $1,600	or $2,600 gain

- The investor now has £1,000 in excess of the loan balance that needs translating back to dollars. Its dollar value depends on the performance of the dollar. If the dollar rises, the translation is less. If the pound rises (dollar declines) the residual value rises.

Margin Loan –

CASE 2 - Sell shares after they fall

Assets	Liabilities
US $15,000	Sells 10,000 shares in UK ABC Corp. @ £0.90 per share = GBP£9,000 GBP £10,000 loan GBP £ 9,000 balance GBP £ 1,000 LOSS after sale

- Investor loses faith and sells UK ABC shares after they decline to £0.90 each leaving the investor with a £1,000 LOSS after the loan is repaid

Margin Loan –

CASE 2 - Sell shares after they fall

Assets	Liabilities	
US$15,000	GBP£10,000	loan
	GBP£9,000	balance
	GBP£ 1,000	deficit after sale
	£1,000*$1.40 =	$1,400 loss
	£1,000*$1.50 =	$1,500 loss
	£1,000*$1.60 =	$1,600 loss

The investor now has £1,000 shortfall in order to pay off the loan balance, which now requires an amount of dollars to be sold to fund the overseas deficit. How much depends on the exchange rate. As the pound strengthens the dollar value needed to repay the loan rises. The investor benefits when the dollar strengthens since the shortfall is reduced.

Summary so far

Both transactions are available to equity traders wanting to buy company shares in overseas markets

Currency Conversion –

- Leaves the investor facing currency risk on principal sum
- Daily P&L also subject to currency risk
- Investor does not face finance charges

Margin Loan –

- Currency risk is removed from the principal sum
- Capital losses on equity could leave investor with debt of greater value than the cost of the loan
- Daily P&L subject to currency risk
- Investor may face finance charges depending on the “spread” between two yields
  - The base currency deposit used as collateral accrues prevailing interest payable
  - The margin loan incurs prevailing interest charge

Conclude

Let's look inside TWS and hopefully demonstrate a couple of real trades under:

- Margin loan
- Currency Conversion

Any questions?