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The Joy of Options

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Owning stock has only two, maybe three, possibilities. The stock goes up. Or the stock goes down. Or, as a third possibility, it does a little of both. If you buy a stock, all you want it to do is go up. If you sell a stock short or close a position (or consider buying it and then decide not to ;), all you want it to do is go down. I call this one-dimensional trading. You're long, you're short, or you're flat. Your gains and losses travel up and down the number line you may remember from elementary school in lock step with the movement of the stock. Not only that, but it takes a big move to make a big profit. And a big move against you can mean a big loss. Potentially all the way down to zero.

You need to add a second dimension to your trading. You need more choices than picking a direction and hoping you are right. You need to limit your losses, improve your returns, and increase your flexibility. You need options.

For many people, options are something to avoid, being dangerous, complex, and scary. I would like to introduce you to the joy of options. Any time you think you want to buy a stock, I'd like to get you in the habit of first looking at how you could do more with less using options.

The anatomy of an option
Any time you read anything about options, it is incumbent upon the author to provide a brief introduction. This article is no exception.

Let's suppose you are house shopping, but are waiting to hear whether or not the job you are hoping for is actually going to be offered. You find the perfect house, but you cannot afford it unless and until your dream job becomes your real job. What is sometimes done in real estate is that you buy an option on the house. You pay the seller of the house, say, $500 to hold the house and sell it only to you for $100,000 at your option any time within the next thirty days. (The three underlined numbers are the terms of the agreement and are negotiable.) If you do not get the job or find something better, you will not buy the house, but you also will not get your $500 back. You paid $500 for the right to buy the house at the agreed upon price any time before your option expires. The seller accepted your $500 and has the obligation to sell you the house at the agreed upon price any time before expiration, if you choose to exercise your option. You paid for the option, so you hold all the cards (except the $500). This is a legal contract.

In the stock and commodities markets, the type of option we just described would be known as a call. A call typically represents 100 shares of a stock. In the commodities markets, a single option contract represents a single futures contract. (For simplicity, from this point forward, I will talk about options on stock. Just remember that the same discussion applies to options on futures.) Owning a call gives the owner the right to buy 100 shares (usually) of the underlying stock at the agreed upon strike price at or before the expiration date. (I say "usually" 100 shares because, due to splits or acquisitions, there are times when an options contract may represent something other than 100 shares.) Selling a call gives the seller the obligation to sell, if asked, 100 shares of the underlying stock at the agreed upon strike price any time up until the expiration date.

The other kind of option is called a put, and it is exactly the same as a call with one simple difference. A put gives the owner the right to sell 100 shares (again, usually) of the underlying stock at the agreed upon strike price at or before the expiration date. You can think of a put as insurance. No matter how badly the stock price crashes, having a put means that you can sell your stock for the strike price. On the flip side, selling that put means you may be obliged to buy stock at far more than its current market price.

An important distinction to always keep in mind: Buying an option gives you rights. Selling an option gives you obligations. Buying an option cannot cost you more than what you pay for the option. Selling an option can cost you far more than what you receive for selling the option.

Let's examine the terminology of calls and puts. The underlying is the actual instrument such as a stock or commodity that is being represented by the options contract. In the real estate example, the house would be the underlying. Options are said to be derivatives because their value is directly tied to or derived from that of the underlying. An option has no meaning without an actual asset underlying it. It is the right to buy or sell that underlying asset that gives the option a reason for being and some value.

The strike price is the agreed upon price for which the underlying can be bought or sold under the terms of the option contract. In the real estate example, the strike price was $100,000. The expiration date, obviously, is the date when the option expires. The day after expiration, an option is worthless. This is the single most important fact about options that you must remember. This is why your friends think you are crazy for your interest in options. Unlike a stock, which you can hold forever, an option has a clearly defined shelf life.

One term remains, and that is the premium. The premium is what you pay for the option, when you are the buyer. Or what you receive for an option, when you are the seller. In our real estate example, the premium was $500. That's what it cost you to hold the right to buy the house any time in that thirty-day period. The last day of the thirty-day period would, again, be the expiration date.

Factors that affect an option's value

Let's look at some scenarios and discover how market forces alter the value of an option. Let's suppose you hold the option to buy the house above, and the next day, a toxic dump is discovered in the backyard of the house. Is the house still worth $100,000? No way. What's your option worth now? Very little. Would anyone be interested in buying from you your right to buy that house for $100,000? Unlikely. The owner of the house, however, gets to keep your $500. Yes, he's stuck with a house he can't live in or sell, but the premium is his to keep. Small consolation for him, and a small loss for you, but which position would you rather be in?

Let's look at another scenario, one that will make you feel a little better for the poor homeowner. Instead of a toxic jump, they discover a diamond mine in his rose garden. Aren't you happy for him now? Well, don't be. He would share your excitement. You can now buy his house, INCLUDING the diamond mine, for the previously agreed to $100,000. Again, though, he gets to keep the $500 option premium. At least this time he gets to sell his house for the price he had intended. All he has "lost" is the unexpected profits from the diamond mine.

Are you starting to see how tricky it can be an option seller? As the option buyer, you spent exactly $500. Your loss is limited to that $500. No matter what. The seller of an option, on the other hand, has unlimited risk.

Was the real estate option in our example a call or a put? You bought the right to buy the house for $100,000, so, as we mentioned earlier, that's a call.

Buying options on XYZ

Now, let's consider stock and stock options for a moment. Consider the ubiquitous XYZ Corp., currently trading at $95 per share on 2/1/03. If you pay $4 per share for a March call on 100 shares of XYZ at the $100 strike price, you have acquired the right to buy 100 shares of XYZ for $100 per share, any time before the third Friday in March. This cost you $400, plus commissions. If XYZ is investigated for "irregular accounting practices" (the equivalent of discovering a toxic waste spill in the backyard), the share price may drop to $50. The call you paid $400 for is probably worth about $20. You've lost nearly 100% of your investment, and I wouldn't count on getting it back. But you've only lost $400.

Imagine if you had owned 100 shares of XYZ stock. What was worth $9500 yesterday is now worth $5000. That's a loss of $4500! Sure, you can wait for the stock to recover -- there's no time limit with stock. The call, on the other hand, will expire worthless (or you'll sell it for next to nothing) in a few weeks, but would you rather lose $400 or $4500? Would you prefer to hang on for years, waiting for XYZ to double in price so you can break even, or would you rather accept your $400 loss and move on to the next opportunity?

On the other hand, suppose XYZ announces that they're coming out with the world's first odorless, tasteless, wireless, weightless, invisible widget (the diamond mine in the rose garden). The stock jumps to $150. Now your call is worth about $6500. Not bad for a $400 risk.

Imagine if you had owned 100 shares of XYZ stock. What was worth $9500 yesterday is now worth $15,000. Awesome. But look at the percentages. The stock increased 58%. Incredible. A gain of $5500. But the call increased a whopping 1525%. A gain of $6100.

Of course, these numbers are fictitious, unrealistic, and tailored to make a point. Stocks don't usually move like that. People rarely discover toxic dumps or diamond mines. But the point is that options move with the underlying, while costing you less and having a fixed, limited risk. Time is the one factor that is against you with options. It is the one gotcha you have to watch out for when buying options.

Selling options on XYZ

Now, let's look at the same events from the seller's viewpoint. First, let's suppose that the seller of the XYZ call also owns 100 shares of XYZ stock. This is known as a covered call. It is considered a conservative options position. Many IRA accounts that will not even let you buy a call or put will still let you sell a covered call against stock you own.

So, our call seller owns 100 shares of XYZ and sells a call against it. The irregular accounting practices investigation is announced and the stock plummets. The seller is stuck holding a stock that just lost nearly half its value. The one consolation is that the call premium, the $400 received for selling the call, is his to keep. Very little consolation, actually. Holding stock has inherent risks, as the last few years has made abundantly clear. Selling the call put cash in his pocket, independent of the risk of holding the stock. In fact, had he held the stock, and not sold the covered call, he would have been $400 worse off.

Given the same 100 shares of stock and one short (meaning he sold) call, let's examine the diamond mine scenario. Here the stock shoots up over 50%. This is the part that makes call sellers very sad indeed. Instead of having a 50% increase in his stock, he has the $400 premium. The call buyer is surely going to exercise his option to call the stock away from him at the strike price. That is, the call seller will have to sell his stock for $100, since that's what the strike price of the call is, even though the stock is now worth $150. He sold, for $400, his right to enjoy that big move. But that is an emotional loss, not a financial one. He still sold his stock at the anticipated price, and pocketed the $400 option premium, as well. The fact that the stock climbed above his strike price is disappointing, but not a loss of money.

Sometimes the stock goes up just a little, or hovers near the strike price. If the stock goes up to $102, the call seller sells a $102 stock at the $100 strike price, but has still pocketed $4 per share on the call, and still ends up ahead. If the stock is at or below $100 on expiration day, the short call expires worthless, and the call writer has both the stock AND the $400 option premium. He can then write another call against the stock.

Naked options (not as appealing as it sounds)

Now let's look briefly at the result of selling naked calls. In this scenario, the call writer simply sells the call and does not own any of the underlying stock to cover the short call. If the stock plummets, the call writer is very happy and relieved. The premium of $400 is his to keep, and no one will be knocking on his door asking to buy the stock for $100 per share, since it is available on the open market for $50. It's his ideal scenario. Actually, any stock price at or below the strike price will be in his favor.

However, here's a very bad scenario. The call writer sells short a naked call. And the stock leaps 50%. He's got big problems. Somebody's going to want to buy XYZ from him for $100 per share, just as the option contract states. But he doesn't own any shares of XYZ. So he now has to go to the open market and buy 100 shares at the current market price, which is $150 per share. He took in $400 of premium and now has to cover is with a $15,000 stock purchase, for which he will only receive $10,000. He loses $4600 ($10,000 - $15,000 + $400). Not a happy ending. Do NOT even consider selling naked calls. Your broker probably would not allow you to anyway. However, until you really know what you are doing, don't sell naked puts either. When the bottom drops out of a market, naked put holders get very, very badly hurt. They are forced to pay high prices for low priced stock. You do NOT want to be in this position!

An option gives you something called leverage. Leverage is when you are able to control a large amount of money with a small investment. Each option contract lets you control 100 shares of stock for far less than the cost of buying those shares. But leverage is not the best reason to trade with options. True, with the leverage that options afford you, you stand to risk less and make more, assuming things move in your favor AND in your time frame. Remember the expiration date! You have traded leverage for limited shelf life. If things don't move your way soon enough, you lose. So, what is the main reason to trade options? Spreads!

What's a spread?

Very simply, a spread is a position in which options are bought and other options are sold. Having said that, there are dozens of ways to combine options to create simple or exotic trading positions. Remember that I said options let you move out of the one-dimensional trading world. When you combine the four types of options (long calls, short calls, long puts, and short puts) in various combinations and ratios, you can create a variety of bullish, bearish, or neutral trades that allow you to profit in any type of market condition.

Why would I want to put on a spread?

There are many advantages to option spreads.

Your risk is clearly defined, as when you buy an option. You cannot lose more than a predefined amount. You can get out of the spread and cut your losses, i.e. you do not HAVE to lose the entire predefined amount.

Your returns are typically in the 75% to 150% range. You stand to make significantly better returns with spreads than you do by buying stock.

You can choose your own breakeven price for the stock. You can "engineer" a spread for prices much more favorable than the current stock price, although you will have to settle for a smaller return. You can make a trade-off between return on investment versus probability of profit. Options allow you to trade in a way that suits your style and outlook.

There are a few disadvantages to option spreads:

The biggest disadvantage to an option spread is the time factor. Options, and therefore option spreads, expire. If the stock doesn't do what you hope it does by expiration date, your position expires. With a stock, you can always hold on and hope things pan out next week. With an option, that is not, er, an option.

Commissions are higher for options. Your average stock trade, buy and sell, with an online broker, will be about $40. Option commissions are usually higher, say $30 per trade, and you are doing twice as many trades, since you are buying one and selling another. So your commissions will be in the $120 area.

Multiple bid/ask spreads. The Bid/Ask spread is a factor when buying options, as well as stocks. Sometimes its worse for options. And you have to battle the spread twice, since you are buying one and selling one. It is possible, however, to mitigate this when you place the order by placing spread trades, as opposed to "legging in" by doing your buy and your sell as separate trades.

Surface scratching

We have barely scratched the surface. I say that not to intimidate you, but to make you realize that you only have enough knowledge to be dangerous to yourself. Please do not think that you are ready to go out and buy calls or place spread trades. You are not. You don't know how an option moves relative to moves in the price of the underlying. You don't know what time does to the value of an option. You don't know what volatility is or how it plays into option prices. You don't know the types of spreads or what they are used for.

Please, please get yourself better educated before you start putting money into option trades. Resist the temptation to buy some cheap options, just to try it out. This is expensive education. There are plenty of advantages to trading options, but it's still a ruthless market, happy to take your money, your wallet, and your hand if you give it an opportunity. Learn the rules of the game before you put money on the line.

Trading options can be satisfying, rewarding, stimulating, and fun. I invite you to add another dimension to your trading by including options to your repertoire.

To contact Lee visit his website at http://www.optioninsight.com

Good Trading

Best Regards
Mark McRae