

Options ???



Let's Talk Stock
May 24, 2011

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BetterInvesting, Puget Sound Chapter — May 2011 ***

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Objectives — What You'll Learn Here

- What are options?
- Call and Put option basics.
- Option trading basics.
- Jargon for options.
- Profit/Loss diagrams.
- Where to go to learn more.



3

What are Options?



Options are Optional

“You can be highly successful as an investor without having the slightest ability to value an option. What students should be learning is how to value a business. That’s what investing is all about.”

-Warren Buffet

2010 Chairman's Letter to Berkshire
Hathaway Shareholders (top of page 22)

www.berkshirehathaway.com/letters/2010ltr.pdf

5

Options are Derivatives

- Derivatives are financial instruments that derive their value from an underlying asset.
- Options are just one of many kinds of derivatives.
- Equity Options are just one of many kinds of options.

6

Equity Options

- This presentation is about one specific kind of Equity Option:
 - Based on an underlying individual stock
 - American style (vs. European style)
 - Standardized Terms
 - Exchange-traded (“listed options”)
 - Physical Delivery (vs. Cash-Settled)
- We’ll just call these “Options”.

7

Options can be Speculative

- In what direction do you think the price of a specific stock is most likely to move?
 - Up?
 - Down?
 - By how much?
- When (by what date) do you think that will happen?

8

Options can be Insurance

- An option can be a kind of term insurance for a stock's price.
 - Option buyer pays a premium to transfer, for a limited time, some price risk to option seller.
- As with other areas of investing, you never get anything for free.

9

Call and Put Options



Call and Put Options

- Would you like to buy a stock at \$60 ... after it has gone up to \$65? You can, with a Call option.
- Would you like to sell a stock at \$60 ... after it has gone down to \$55? You can, with a Put option.
- What's the "catch"?
 - Buying an option costs money.
 - Price movement must happen by a specific date.
 - It will likely work out less than 20% of the time.

11

Call and Put Options

- There are only two kinds of options: Call and Put.
- Call option is the right to buy a stock.
 - Buyer benefits if stock price goes up enough.
 - Seller benefits if stock price doesn't go up enough.
- Put option is the right to sell a stock.
 - Buyer benefits if stock price goes down enough.
 - Seller benefits if stock price doesn't go down enough.

12

An Option Is ...

- a contract giving the option owner (buyer) ...
- the right (but not the obligation) ...
- Call: to buy from the option writer (seller)
Put: to sell to the option writer (seller) ...
- a specified number of shares (generally 100) of a specific stock ...
- at a fixed price (“strike” or “exercise” price) ...
- until a specified future expiration date.

13

Beyond Simply Call or Put

- All other option [Strategies](#) are just combinations of buying or selling Calls, Puts, or the underlying stock.
- For example:
 - Covered Call strategy is selling a Call while also holding the underlying stock.
 - Collar strategy is buying a Put, selling a Call (at a higher strike price), and also holding the underlying stock.
 - Straddle, Strangle, Butterfly, Iron Condor, etc. are other examples of named strategies.

14

Option Trading



Option Trading

- An option contract is created by selling it (called “writing” an option).
- An option ceases to exist on its expiration date.
 - Generally the 3rd Saturday of a month.
- Option positions can be closed before expiration.
 - Buyer’s open position (“buy to open”) is closed by selling the same option (“sell to close”).
 - Seller’s open position (“sell to open”) is closed by buying the same option (“buy to close”).

Option Trading

- An option's "premium" is the cost of buying the option. It's the price the buyer pays (and the seller receives) to purchase the option contract.
 - An option's premium amount changes due to market forces and other factors (just like the price of a stock).
- All option trades and exercises are settled by the Options Clearing Corporation (OCC).
 - Buyers and sellers do not deal with each other directly.

17

Option Chain

- List of all options available for a single security.
 - Expiration dates available for the underlying security.
 - Strike prices available for each expiration date.
 - Each combination is a separate option.
- Shows price (premium) for each available option.
 - IMPORTANT NOTE. Option prices are quoted per share but one option contract is generally for 100 shares. So, buying one option contract priced at \$4 (per share) would cost \$400 (plus commission).

18

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Example Option Chain

View By Expiration: **May 11** | Jun 11 | Jul 11 | Aug 11 | Sep 11 | Oct 11 | Jan 12 | Jan 13

Call Options							
Expire at close Thursday, May 26, 2011							
Strike	Symbol	Last	Chg	Bid	Ask	Vol	Open Int
20.00	MSFT110527C00020000	4.22	0.00	4.10	4.20	10	12
22.00	MSFT110527C00022000	2.15	↓ 0.08	2.14	2.18	43	100
23.00	MSFT110527C00023000	1.28	↑ 0.06	1.16	1.20	4,663	1,583
24.00	MSFT110527C00024000	0.32	↓ 0.01	0.29	0.30	1,669	3,054
25.00	MSFT110527C00025000	0.01	↓ 0.01	N/A	0.01	2,854	7,927
26.00	MSFT110527C00026000	0.02	0.00	N/A	0.01	224	230

Put Options							
Expire at close Thursday, May 26, 2011							
Strike	Symbol	Last	Chg	Bid	Ask	Vol	Open Int
22.00	MSFT110527P00022000	0.01	0.00	N/A	0.01	2	100
23.00	MSFT110527P00023000	0.02	0.00	0.01	0.02	1,239	902
24.00	MSFT110527P00024000	0.13	↓ 0.02	0.12	0.14	1,550	8,203
25.00	MSFT110527P00025000	0.80	↓ 0.05	0.83	0.86	592	1,252
26.00	MSFT110527P00026000	1.80	0.00	1.82	1.85	440	191
29.00	MSFT110527P00029000	4.55	0.00	4.80	4.90	0	1

Highlighted options are in-the-money. finance.yahoo.com/q/op?s=MSFT+Options

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- ## Option Owner Has Control
- An option owner can “exercise” their option anytime before its expiration date.
 - When an owner exercises, some seller gets “assigned” and must fulfill the contract obligation.
 - Assignments are arranged via OCC and brokers.
 - Owner is in control.
 - Seller has no control.

Owner Has Rights Seller Has Obligations

- Call Option
 - Owner (holder, buyer) has a right to buy (option to exercise) at a specified price.
 - Seller (writer) has an obligation to sell at that price, if assigned an exercised Call.
- Put Option
 - Owner (holder, buyer) has a right to sell (option to exercise) at a specified price.
 - Seller (writer) has an obligation to buy at that price, if assigned an exercised Put.

21

Option Buyer Risk

- Option Buyer has limited dollar risk.
 - An option buyer absolutely cannot lose more than the cost of the option (option premium + commissions).
 - Note this is the same as buying a stock, where the buyer cannot lose more than the cost of the stock.
- However, 100% loss is common (losing the entire option premium paid).
 - Note this is different than buying a stock, where 100% loss is uncommon.

22

Option Seller Risk

- Selling options “naked” means the seller doesn’t have a position in the underlying stock.
- Naked Call seller faces potentially unlimited risk.
 - Stock price can rise without limit.
- Naked Put seller faces substantial risk, but no more risk than holding a long position in the stock.
 - Stock price can’t fall below zero.

23

Equity Option Approval Levels

- Option trading permission must be granted by your broker. For example ...
- Level 1 — Sell (write) covered calls.
- Level 2 — Buy calls and puts, sell cash secured puts, buy straddles and combinations.
- Level 3 — Sell covered puts and spreads.
- Level 4 — Sell uncovered (naked) options, straddles and combinations.
- Level 5 — Sell uncovered index options, etc.

24

More Options Jargon



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In ... Out ... At? (The Money)

- In The Money (ITM) ...
 - Call option: when the strike price of the option is below the current market value of the stock.
 - Put option: when the strike price of the option is above the current market value of the stock.
- Out of The Money (OTM) ... not “In The Money”.
- At The Money (ATM) ...
 - Refers to the option with the strike price closest to the current market value of the stock.

26

Intrinsic Value vs. Time Value

- Intrinsic Value is the amount (if any) by which an option is "in the money".
- Time Value is the amount by which an option's premium exceeds its intrinsic value.
- An "out of the money" option has only time value (because it has no intrinsic value). An option that is substantially "in the money" normally has very little time value.

27

Wasting Asset

- An option is said to be a "wasting" asset because, if not sold or exercised prior to expiration, an option will become worthless.
- Because of this, the time value of an option usually (but not always) decreases as expiration approaches, and decreases more rapidly the closer the expiration date becomes.

28

Greeks

- Delta, Gamma, Vega, Rho, Theta (etc.).
- Theoretical estimates of option premium changes based on other factors.
- Delta is probably the most important. The rest are primarily of interest only to option “traders”.
- Most broker web sites provide greek values.
 - Also Morningstar.com

quote.morningstar.com/Option/Options.aspx?ticker=MSFT

29

Greeks — “Delta”

- Delta estimates how much an option premium should change due to a small change in the underlying stock price.
- Expressed in dollars (typical); estimated \$ change in premium due to a \$1 change in stock price.
 - Also, est. probability of expiring “in the money”.
- Expressed as a percent; estimated percent change in premium due to a 1% change in stock price. (Sometimes called “lambda”.)

quote.morningstar.com/Option/Options.aspx?ticker=MSFT

30

Long vs. Short

- “Long” = buy first (and sell later).
- “Short” = sell first (and buy later).
- Applies to both Stock and Options.
 - Long Stock (buy stock, sell later)
 - Short Stock (sell stock, buy later)
 - Long Call (buy call, later sell or exercise/expires)
 - Short Call (sell call, later buy or assigned/expires)
 - Long Put (buy put, later sell or exercise/expires)
 - Short Put (sell put, later buy or assigned/expires)

31

Profiting From Options



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Stock Profit vs. Option Profit

- You buy stock because you expect the stock price will be higher in the future. To profit from stock ownership you must be correct (only) about the direction of price movement.
- You buy (or sell) an option because you expect the underlying stock price to change as you predict before the option expires. To profit from owning an option you must be correct about both direction and timing of the underlying stock price.

34

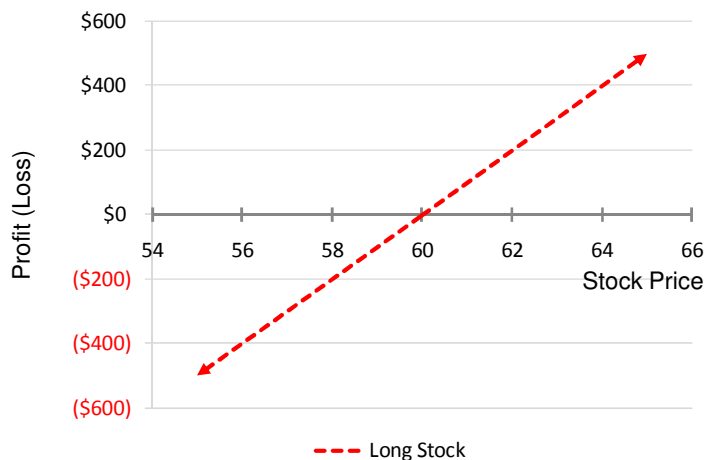
Long 100 XYZ Stock

- Buy 100 shares XYZ stock;
anticipate selling at a higher price in the future.
– BetterInvesting methodology.
- Profit if stock price goes up.
- Loss if stock price goes down.
- No time limit.
- Profit/Loss Diagram shows profit/loss potential.

37

Long Stock (Buy/Hold Stock)

- 100 shares @ \$60



38

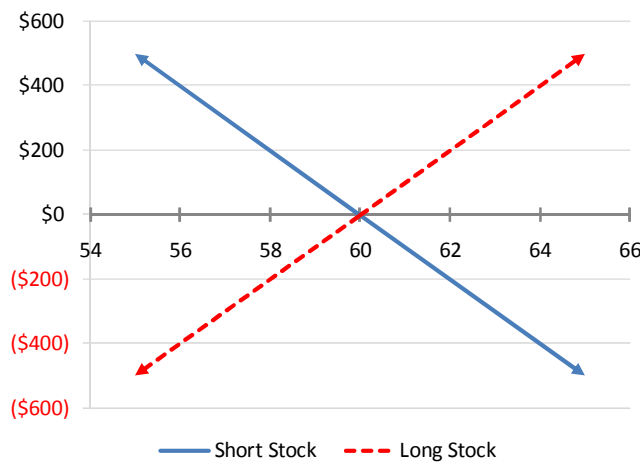
Short 100 XYZ Stock

- Sell 100 shares XYZ stock (that you borrow); anticipate buying at a lower price in the future.
 - You don't own the stock you sell — you borrow it!
- Profit if stock price goes down.
- Loss if stock price goes up.
- No time limit.

39

Short Stock (Sell Borrowed Stock)

- 100 shares @ \$60



40

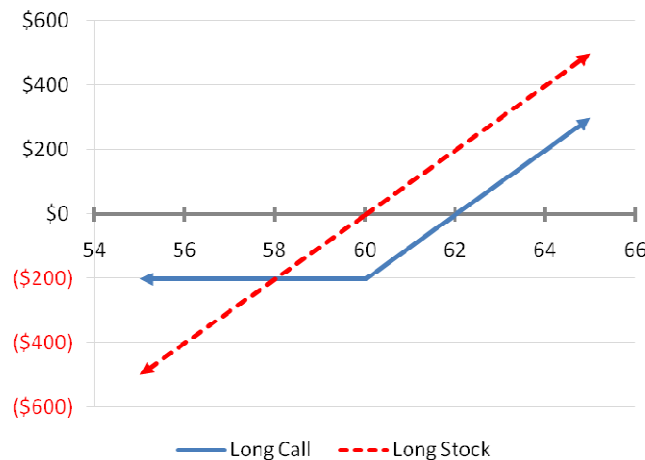
Long 1 XYZ Nov 60 Call @ \$2.00

- Buy (“long”) the option to buy (“call”) ...
- 100 shares of XYZ stock (“1 XYZ”) ...
- at \$60 per share (“60”) ...
- before the 3rd Saturday in November (“Nov”).
- To purchase this option you’d pay \$200 (plus commissions). That is your maximum loss.
- You’d profit if the stock price rises above \$62 by the 3rd Friday in Nov.

41

Buy (Long) Call

- 1 Call (100 shares), \$60 strike, \$2 premium



42

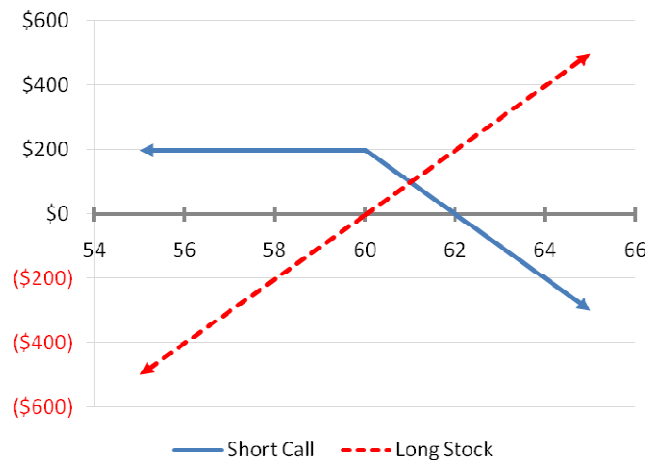
Short 1 XYZ Nov 60 **Call** @ \$2.00

- Sell (“short”) the option to buy (“call”) ...
 - (i.e., you agree to sell) ...
- 100 shares of XYZ stock (“1 XYZ”) ...
- at \$60 per share (“60”) ...
- before the 3rd Saturday in November (“Nov”).
- By selling this option you’d receive \$200 (less commissions). Maximum loss is “unlimited”.
- You’d profit if the stock price remains below \$62 until after the 3rd Friday in Nov.

43

Sell (Short) Call — Sell Naked Call

- 1 Call, \$60 strike, \$2 premium



44

Long 1 XYZ Nov 60 **Put** @ \$1.00

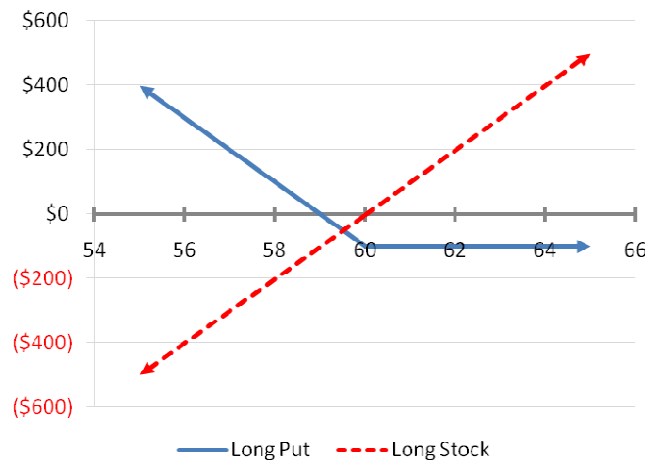
- Buy (“long”) the option to sell (“put”) ...
- 100 shares of XYZ stock (“1 XYZ”) ...
- at \$60 per share (“60”) ...
- before the 3rd Saturday in November (“Nov”).

- To purchase this option you’d pay \$100 (plus commissions). That is the maximum loss.
- You’d profit if the stock price falls below \$59 by the 3rd Friday in Nov.

45

Buy (Long) Put

- 1 Put, \$60 strike, \$1 premium



46

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Short 1 XYZ Nov 60 Put @ \$1.00

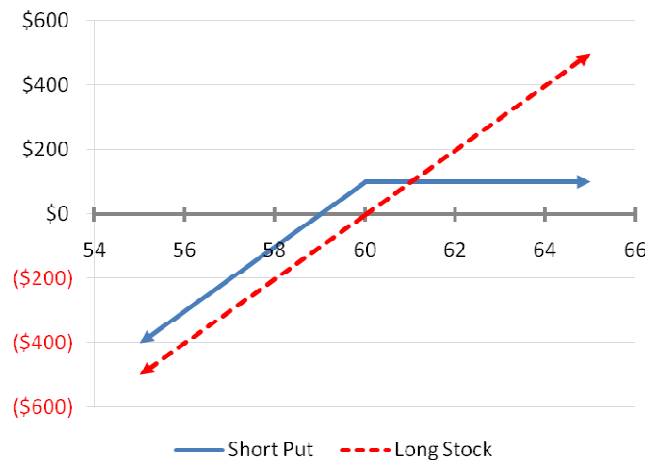
- Sell (“short”) the option to sell (“put”) ...
 - (i.e., you agree to buy) ...
- 100 shares of XYZ stock (“1 XYZ”) ...
- at \$60 per share (“60”) ...
- before the 3rd Saturday in November (“Nov”).
- By selling this option you will receive \$100 (less commissions). Maximum loss is very large.
- You’d profit if the stock price remains above \$59 until after the 3rd Friday in Nov.

47

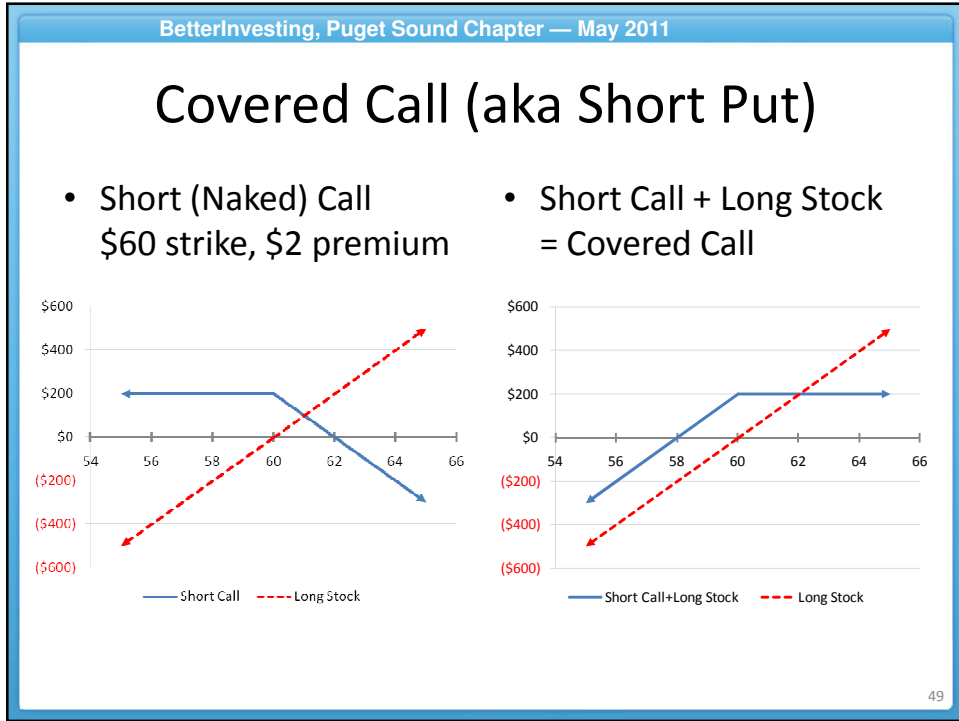
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Sell (Short) Put — Sell Naked Put

- 1 Put, \$60 strike, \$1 premium



48



Taxes

A collage of four photographs: an older couple looking at a laptop, a young woman smiling, a young couple embracing, and a young man smiling.

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Option Taxation Can Be Complex

- Trading options in an IRA avoids tax issues.
- <http://888options.com/resources/brochures.jsp>
 - *Taxes and Investing*
- www.irs.gov/publications
 - Publication 550
 - Look for “Options” in
Chapter 4 – Sales and Trades of Investment Property

51

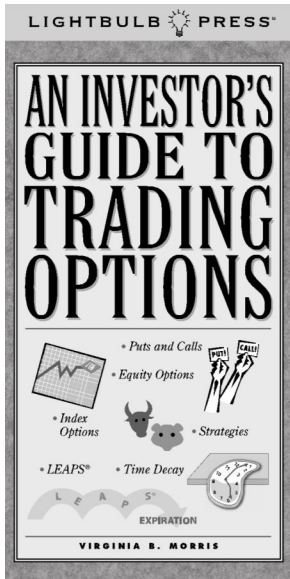
Places To Learn More



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www.888options.com/resources/book/ereader.jsp

- Free PDF download (B&W)



53

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OptionsEducation.org
(aka 888options.com)

OIC The Options Industry Council

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Get started with your options basics foundation.

- What is an Option?
- Options Basics your way: Online Class, Webcast, Podcast
- Benefits and Risks of Options
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Basics

- Getting Started
- What is an Option?
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54

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education.OptionsEducation.org

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March 2011
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6 7 8 9 10 11 12
13 14 15 16 17 18 19
20 21 22 23 24 25 26
27 28 29 30 31

Upcoming Events
OIC Intermediate Seminar - Boca Raton, FL
Tues, Mar. 29, 06:00 PM - 09:00 PM
OIC Volatility Seminar - Boca Raton, FL
Wed, Mar. 30, 06:00 PM - 09:00 PM

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55

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Further Reading

- *Understanding Equity Options*
- *Equity Options Strategy Guide*
- *Options Strategies Quick Guide*
- *Characteristics and Risks of Standardized Options*
– All at 888options.com/resources/brochures.jsp
- Also OIC Options Central (quarterly newsletter)
– 888options.com/resources/literature/options_central.jsp
– For example “Options Myths” (Summer 2007)



56