Introduction to Options

Part 2: Terms and Basic Options Strategies to Know for Options Traders

GREENE CHARTER

- **Underlying Security-** The underlying security that an options contract is tied to. Options are traded only to only security. It can be a stock, index, ETF, future, currency, commodity
- **Strike Price-** The value at which options can be exercised is called the strike price (also referred to as the striking price or exercise price)
- **In the Money (ITM)-** When the underlying asset's current value is higher than a call, the call is in the money (ITM)
- **Out of the Money (OTM)-** When the price is lower than the strike, the call option is referred to as being out of the money (OTM)
- **At the Money (ATM)-** When it is exactly equal to the strike

  Note: For puts, it's the inverse in regards to in the money (ITM) and (OTM).
- **Premium-** the cost of the option—is going to vary based three factors***:*** *time to expiration, volatility, and intrinsic value*
- **Expiration-** The date at which the option is scheduled to expire. The farther away the expiration date, the higher the option's value. Traders will place a trade with the time element in mind. The closer the strike to current market value of the underlying stock, the more the price of the option reacts to price changes in the underlying stock. The closer the expiration date, the more the option's premium value reacts to the stock's price movement
- **Volatility-** Main driver in the value of an options contract. Volatility is an expression of market risk. Assets with low beta, low volatility, are less risky, but they also offer less opportunity for profits in the asset or in options. Assets with wide trading ranges and rapid changes in price are high-risk but also presents an opportunity to trade the swings. The premium is directly affected by this price volatility. The level of unpredictability in a stock's current and future price level defines an option's premium value. The higher the volatility, the more risk a writer assumes so higher premiums are necessary

- **Intrinsic Value-** The part of the premium attributed to ITM status of the option
- When the option is ATM, strike is equal to stock price, there is no **intrinsic value**
- When the option is OTM, meaning call strike is higher than current stock price or put strike is lower than current stock price, there is also no **intrinsic value**
- **Ex:** A call option has a strike of $50 and the current stock price is 51. This option has two points of intrinsic value, worth $100 (100 shares * $1).
- Change in the stock's price will be matched by change in intrinsic value, down to the strike and upward. For puts, it's the inverse.

Options Strategies

- The various strategies can be interpreted as bullish, bearish, or neutral
- A bullish strategy is profitable if the value of the underlying assets increases
- A bearish strategy is profitable when the asset's value declines
- A neutral strategy is done in order to keep the value of a position relatively flat does best when the underlying asset's price can maintain within a narrow range
- **Single-option speculative strategies-** A trader uses options simply as an estimation of how the underlying stock price is going to move in the future and leverages that movement
- Meaning, the cost is lower than buying 100 shares outright, giving the benefit of having a portfolio consisting of speculative options more share control verses a portfolio requiring more capital to buy the share equivalent
- Long option positions increase in value when the price of the stock rises **(long calls)** or falls **(long puts)**
- Short speculative strategies, called **uncovered** or **naked writes**, assumes greater risk positions
- The holder of a long position will never lose more than the amount used to purchase, as suppose to a naked short selling includes potentially higher risks
- Why? A **naked call writer** has unlimited risk based on the potential that an asset's price could rise indefinitely.
- A **naked put write**r faces a downside risk; if the asset value falls, the put will be exercised at the fixed strike price, and the writer will be required to buy shares at a price above market value because they weren't hedged prior to writing the put
- Options can be used effectively as a way to swing trade a position, in which trades are timed to the top or bottom of short-term price swings

- Rather than using shares of stock for swing trading, going long options provides three key advantages
- There's less capital, so a swing trading strategy can be expanded
- The risk is limited to the cost of the long option, which is lower than buying or selling shares of stock
- Going long puts at the top of a short-term price range is easier and involves less risk than shorting stock
- Single options are also used to insure other primary positions
- **Ex:** A trader can hedge by can purchase one put to protect profits in 100 shares of stock that they are long or a trader can buy calls to mitigate the risk of a short position moving against them
- **Covered calls-** The most conservative options strategy. A trader owns 100 shares of the underlying stock and sells a call, the market risk is capped
- If the call is exercised, the writer is required to deliver 100 shares of stock at the strike
- Even though the market value will be higher, the **covered call writer** received a premium and earns dividends until the position is either exercised, closed, or expired
- **Spreads-** A spread involves buying/selling options at different strikes and/or expirations, on the same underlying stock.
- Variations include reverse spreads, butterfly, and ratio. These are the more popular of strategies because profits/losses can be controlled and capped
- **Straddles-** Involves buying or selling dissimilar options with the same strike and on the same underlying asset
- Risks might be greater, and creating profits is often more difficult than spreads, but there are various straddles that are appealing to traders

- One of the two sides can be closed in profit at any point, straddle risks mitigated over the period of the trade, especially for short positions or for the **strangle**, a variation of a straddle
- **Combinations-** Some strategies involve the combined positions in options with related positions, often favoring one side of the trade more
- Any position with both calls and puts that is not a straddle is considered a combination

Article Sources

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