PART ONE

THE OPTION BASICS

CHAPTER 1

IT'S ALL ABOUT THE CALLS AND PUTS

Let's start at the beginning. There are only two types of options—calls and puts. It's really very simple, and it doesn't have to be any more complicated than that. Call and put options are a direct form of investment and should be seen as such. You can achieve everything you want on an investment basis with options, just as you would with any stock, bond, or mutual fund. That fact is very important to remember.

Every position that is built using options is composed of either all calls, all puts, or a combination of the two. One thing that smart option traders know is that you can sell options as easily as you buy them. That is going to be one of the main themes of this book as you will soon see that a majority of my trades entail the selling of options. Don't fret if you've heard that selling options is risky. The way that I do it has limited risk. One of the great aspects about the financial markets is that you can sell something first that you don't own yet. Instead of the usual "buy low, sell high," we can reverse it and "sell high, buy low." In this case, the sale transaction comes first.

What are call and put options? In short, options are another form of investment that can be bought and sold just like a stock, a bond, or

a commodity. They are referred to as "derivative" investments because an option's value is derived from other sources, which we will talk about later on in the book. If you've read some of the mainstream literature that is published about options, you will see the examples given from the buyer's view of the market. I want to let you know that I'm going to teach you to trade from the short side (selling) as well as the long side (buying) of an options contract. Why limit yourself to one strategy?

The main purpose of buying options is to gain leverage on your investment and to cut down on your initial capital outlay. This is a smart way to use your money. Options allow you to take a directional position in an underlying security using a small down payment. The reward is the potential for a big gain. It's just like buying a house with your 10 percent down payment. You only have to put up a fraction of the price, yet you get to control the whole house. In simple terms, you're using options as a substitute for the stock or commodity. But you have to know how to choose your options correctly to maximize your potential gains. And since I've found that most option buyers do not do this correctly, that's why I'm here to help.

OPTION BUYERS HAVE RIGHTS; OPTION SELLERS HAVE OBLIGATIONS

How do options work? In short, a buyer of a call option has the expectation that the underlying security is going to move up. And when I say "underlying security," I'm referring to the stock or commodity in which you are trading options on. A call buyer has the right to control a bullish directional position of long 100 shares of stock (in the case of stock options) for a specified period of time (until option expiration day) at a certain strike price level (the price at which you will buy the stock). The buyer pays a fee to the option seller for this right, which is called the "premium." In the case of commodity options, the call buyer has the right to control one long futures contract for a specified period of time at a certain strike price level. The buyer has no obligation to exercise the option contract and turn it into a bullish position in the underlying security if it is not profitable to do so.

The option buyer has a limited loss potential equal to the price paid for the option, but also has an unlimited upside gain potential.

The put option buyer has the expectation that the underlying security is going to move lower in price. A put buyer has the right to control a bearish directional position of short 100 shares of stock (in the case of stock options) for a specified period of time at a certain strike price level. In the case of commodity options, the put buyer has the right to control one short futures contract position for a specified period of time at a certain strike price level. The put buyer has no obligation to exercise the option contract and turn it into a bearish position in the underlying security if it is not profitable to do so. The put option buyer has a limited loss potential equal to the price paid for the option, but also has an unlimited upside gain potential.

Sometimes it's difficult to understand the put-buying side of options. Most people understand call option buying because we're all so used to going long the market. I think people get caught up in the terminology of buying something to sell it. It sounds confusing. When you buy a put option, you're giving yourself the opportunity to sell something at a certain price for a specified period of time, no matter where the price of the underlying security may be. As I have already mentioned, the financial markets allow you to sell something that you don't own first. That's a hard concept to grasp. If you own a stock and are willing to sell it, either you can just sell your shares or you can buy a put option contract, which allows you to pick the price level at which you may want to sell the stock and the expiration date of when to do it.

On the flip side, sellers of calls and puts have different views and obligations. The seller of a call option has a neutral to bearish view of the underlying security and has an obligation to fulfill the terms of the contract if the option buyer decides to exercise the option contract. The seller of a put option has a neutral to bullish view of the underlying security and has an obligation to fulfill the terms of the contract if the option buyer decides to exercise the option contract. In short, the option seller is at the mercy of the option buyer with regard to exercising the option contract. The option seller has a limited gain potential equal to the price paid for the option by the buyer, but also has an unlimited downside loss potential.

PROBABILITY IS THE KEY

Why would anyone want to sell options if the loss potential is unlimited? That's a great question and one that's asked just about every time I discuss options trading. The reason that option selling is such a useful strategy if used correctly is because of the probabilities involved. Option trading is all based on probability and statistics. Many investors or option buyers tend to see options as a lottery type of trade where they know it will cost them only a few dollars to play. If the stock or commodity makes the big move, then they're headed for Easy Street. But how often does that happen? As often as you win the lottery—which is practically never.

Those are low-probability trades and most of them are the "close-to-expiration, far out-of-the-money (OTM)" options. But people are still drawn to the gambler mentality, which of course is fun from time to time; but if you continually lose, you won't last in the game very long. As smart option sellers, we want to be the ones who take the other side of those low-probability losers and turn them into high-probability winners for us. To reiterate, selling options can be profitable because of the high probability of success if used correctly. Three out of the four strategies I will show you in the book are of the selling type, and I will give many examples later on down the road.

Buying OTM options is the speculation game pure and simple (don't worry, I'll tell you more about what OTM means very soon). We all like to speculate because the payoff can be great, especially with options where leverage plays a big part. Where else can you plunk down $100 to control a few hundred shares of stock for a limited time? This is the options market. You get to control something very large for a small amount of money. Unfortunately, this is where I believe the option market advertising went off track. A majority of people only see options as a lottery type of investment and continue to focus on buying the low-probability trades.

You need to remember that options are not an investment unto themselves. An option's value is derived from other sources; hence, options are considered derivative investments. The most important of these other sources is the prediction of the direction you think the underlying security is going to move in the time allotted before option expiration. For one reason or another, many investors believe

they can predict where a stock or commodity is headed in a very short time frame. They are lured into playing that hunch by buying the cheap options that have little chance of success. So once again, we're going to focus on how we can take advantage of those probabilities and turn those opportunities into our gains.

Even though I like to focus on selling options to take advantage of the buyer's low probability of profit, I also know how to buy options correctly as a form of investment. There's a certain way to buy options correctly as a substitute for a stock or commodity, and when I'm interested in purchasing options, there's only one way I do it. That way is to buy **deep-in-the-money (DITM)** options, which I'll explain later.

AN OPTION EXAMPLE

Let's walk through an example of what to do when you have a stock idea and you want to give options a try. We're bullish on Intel stock (INTC) and we want to use options to leverage our money. That's a great idea. But we have to decide what strike price and expiration month to pick. INTC is trading for $21 and we opt to buy a five-month option with a $25 strike price (as of February 2006). This option trades for a premium of $.40 per option contract (see option chain in Figure 1.1). Option prices have a $100 multiplier so our fictional call costs $40 ($.40 × $100). Since each option contract is the equivalent of 100 shares of stock, this means that we get to control 100 shares of INTC for the next five months at a cost to us of only $40. In order to find our cost-basis or breakeven price, we add our cost (option premium) to the strike price: $.40 + $25 = $25.40. If the option is held to expiration, we won't make money on the position unless INTC rises above $25.40. If you plan to trade out of the position before expiration, then you may see a profit, depending on how fast and how far INTC moves higher during the course of the trade. But I want to focus on the trade as most investors would—keeping the option until expiration.

Figure 1.1 is a screenshot of a typical option chain from one of my options brokers, optionsXpress (www.optionsXpress.com). The strike prices are listed down the "Strike" column and the bid/ask market

Calls									
Symbol	Last	Chg	Bid	Ask	Vol	OpInt		Strike	Symbol
Jul 06 Calls			(162 days to expiration)						INTC @ 21.00
NQGC	6.40	+0.40	6.20	6.30	54	983	trade	15.00	NQSC
NQGW	4.10	+0.30	4.00	4.10	517	7,496	trade	17.50	NQSW
NQGD	2.25	+0.30	2.10	2.15	2,254	26,828	trade	20.00	NQSD
NQGX	0.90	+0.09	0.90	0.95	2,733	21,875	trade	22.50	NQSX
INQGE	0.35	+0.05	0.35	0.40	313	31,605	trade	25.00	INQSE
INQGY	0.15	0	0.10	0.15	360	25,552	trade	27.50	INQSY
INQGF	0.05	-0.05	0.05	0.10	16	13,728	trade	30.00	INQSF
INQGZ	0.05	0	0	0.05	0	2,826	trade	32.50	INQSZ
INQGG	0.05	0	0	0.05	0	299	trade	35.00	INQSG

Figure 1.1 INTC Option Chain, July 2006 Expiration
Source: optionsXpress.

for the call options is in the middle of the graphic. Our five-month option would take us to the July 2006 options, where the $25 call can be bought for $.40.

The advantage of buying options instead of the stock is the leverage you get. You only have to spend a little money up front to control the 100 shares. Instead of paying $2,100 to buy 100 shares of INTC outright, we only have to pay $40 today by using options. That's the key.

Eventually, if INTC gets above our breakeven price of $25.40, we will be faced with a decision: We can either sell the option back to the marketplace and pocket our gain, or "exercise" the option and turn it into actual stock shares.

If we decide to exercise, then we must pay the full stock purchase price. It's like making a balloon payment at the end of a loan. In this case, we'd have to come up with the extra $2,500 to pay for the 100 shares of stock we just exercised. I will go into this in more detail when I discuss buying deep-in-the-money (DITM) options.

You have to understand, though, that you're buying something that has no "real" value right off the bat. You're entering into a contract

to buy INTC at $25 per share. Why would you want to buy INTC at $25 per share when you could buy it today for $21 per share? Good question. The answer, I believe, comes down to "hope and cheapness." Many people don't want to plunk down the $2,100 today to buy INTC but they feel okay spending only $40 for the chance that INTC will get above the breakeven price of $25.40 within five months. Some people would rather spend a little money today hoping that the stock will go up and become profitable, rather than buying the stock at current market prices.

THE PROFIT/LOSS SCENARIO

Regardless of which strike price you choose, let's see what the profit/loss (P/L) scenario looks like graphically for a typical "long call" strategy. It helps to visualize your position with the use of P/L charts as seen in Figure 1.2.

Our P/L chart plots our position with the stock price on the bottom and our potential dollar gain/loss on the left side. The vertical line

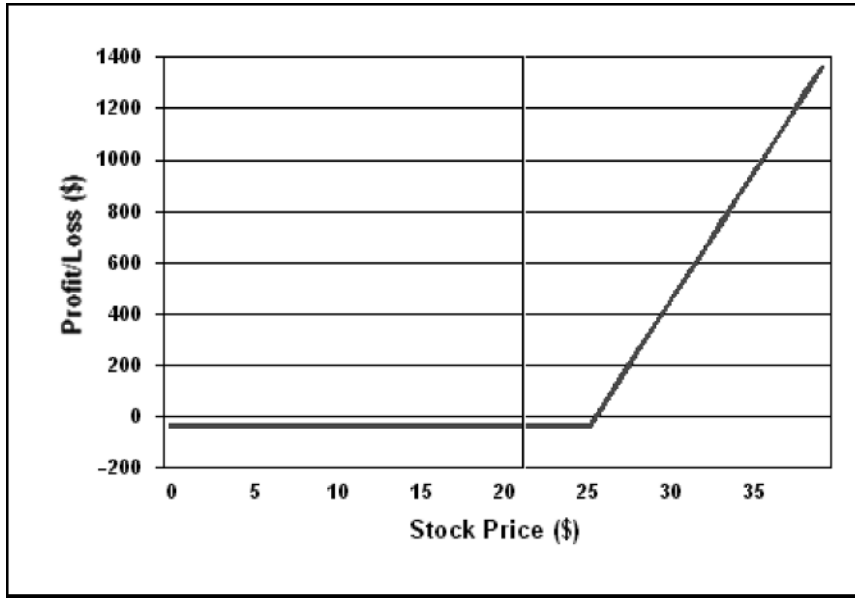

Figure 1.2 Call Option Profit/Loss Chart

represents the price of the stock today ($21) and the thick line represents our long call position. Since the call cost us $40, that is the maximum we can ever lose as indicated by the thick horizontal line that stretches from $0 to $25. As mentioned earlier, when you buy options you have limited risk, $40 in this case, and unlimited profit potential. The thick line starts to bend upward at our strike price of $25 and crosses the $0 P/L line at $25.40—which is our breakeven price. Once INTC gets above $25.40, we're making money for as long as INTC heads higher. As the price of the stock increases, our profit goes up indefinitely.

The question is, will INTC get above $25.40 in the next five months? Nobody knows, but that's what you're hoping. Remember that word "hope." Are you in an investment based on hope? When you buy the INTC $25 call option, you're really holding something that has no value right off the bat. It becomes valuable only when INTC goes above the breakeven price of $25.40 (if held until expiration). That's over $4 higher than where INTC is trading in the marketplace today. So, do you want to pay $2,100 to own 100 shares outright of INTC stock, or do you want to shell out a measly $40 and hope INTC goes up another $4 in the next five months? Only you can make that decision. Sure, it costs you only $40, but what's the probability of INTC getting to your breakeven price? Luckily for us, we have tools that can help figure out that probability. Using my probability calculator shown in Figure 1.3, our fictional INTC $25 call has a 21.9 percent chance of hitting breakeven by option expiration. Is that a high enough probability for you to take this trade?

When looking at the probability calculator in Figure 1.3, you want to focus on the box that reads, "Finishing above highest target." This is the box that tells us our chances of INTC being above our breakeven price of $25.40 at the time of option expiration based on the price of INTC, days to expiration, and the level of volatility that exists at the time of the trade. (As we get into Chapter 5, I will tell you why it's important to focus on the box that says, "Ever touching highest target.")

When you see it graphically in front of you that your investment has a 21.9 percent chance of being profitable, you might think twice about it. I know it's only $40, but it could be larger than that in some cases depending on how many option contracts you buy. Do this

Figure 1.3 Probability Calculator

Source: © Copyright Optionvue Systems International, Inc.

enough times with those small chances and you'll end up walking away in disgust from the options market.

The problem here is that many investors tend to pick strike prices too far away from the current price of the stock and/or an expiration period that's too close in time. These investors think that they can predict the very short-term moves with pinpoint accuracy in the short time allotted. Nobody is that good. Later on when I discuss DITM options you'll see how we use them in lieu of buying the stock and how you will get all the same movement of the stock, plus the leverage and at least a 50 percent risk reduction to boot.

Let's see what a P/L chart looks like for a "long put" strategy. (See Figure 1.4.) When you buy a put option, you're betting on the price of the stock or commodity to go down. As with the long call strategy, your risk is limited to what you pay for the option and your

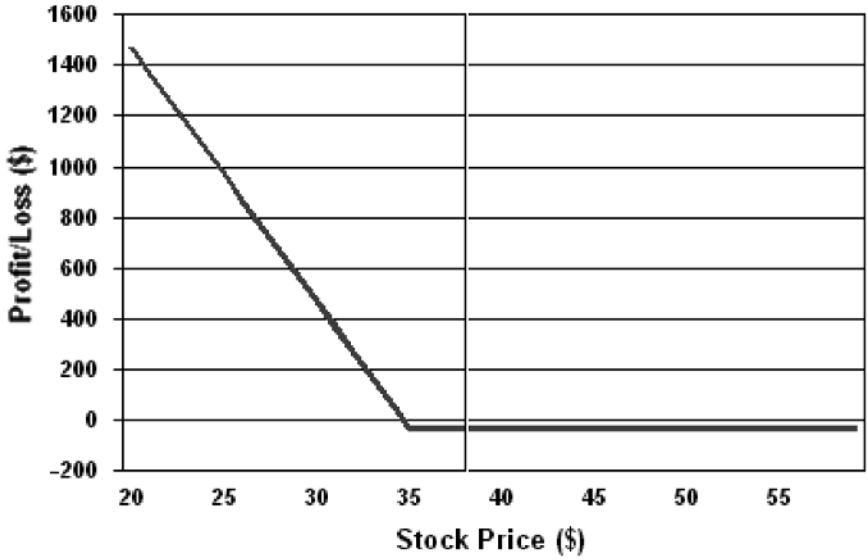

Figure 1.4 Put Option Profit/Loss Chart

reward is unlimited up to the point of the stock or commodity falling to zero. But like the long call, investors tend to concentrate on buying the low-probability, OTM, close-to-expiration options.

In this case, the chart looks reversed. This is because your profit goes up when the stock goes down. In this example of a put option purchase, the stock was at $38 and we bought a $35 put option for $.35 ($35 in actual dollars). The horizontal part of the thick line represents the maximum we can ever lose, which is $35. No matter how high this stock may trade, we can never lose more than $35. On the upside, our profit is unlimited as you can see in the thick line extending upward to the left. We can make as much money as possible to the point of the stock falling to $0 per share.

STOCK PRICE AND STRIKE PRICE RELATIONSHIP

The next thing we need to understand about the basic principles of options trading is the relationship between the strike price you choose and the current price of the underlying security. There are three terms

you need to know. They are: in-the-money (ITM), at-the-money (ATM), and out-of-the-money (OTM). Unfortunately, the options game does come with its own language so you need to know some of these terms to get a grasp of how to effectively navigate the battlefield. I've touched on some of these terms already, but I want to give the textbook definitions of each. We're just going to scratch the surface here with these terms and later on we'll dig deeper to see how they can affect your trading profitability.

For call options, if the strike price is higher than the current price of the stock or commodity, it is called OTM. For example, if INTC is at $20 then all strikes above $20 are OTM. Any strike that is priced near the current price of the stock is called ATM. The INTC $20 strike would be considered ATM. Lastly, all call strike prices that are below the current price of the security are ITM. If INTC is at $20, all strikes below that would be ITM.

Put options are the opposite. Any option whose strike price is lower than the current price of the stock or commodity is considered OTM. For example, if INTC is at $20, then all strikes below $20 are OTM. Any strike that is priced near the current price of the stock is considered ATM. The INTC $20 strike would be considered ATM. Lastly, any put option strike price that is above the current price of the security is considered an ITM put option. If INTC is at $20, all strikes above that would be ITM.

It's important to know these terms because each one will act differently due to the degree of the option being in-, at-, or out-of-the-money. We will talk extensively about how each of these types of options can affect the profitability of your position. It also helps to know the terms because you might be working with a full-service broker who can help you tailor your investment ideas to the types of options available.

SUMMARY

We learned the basics of options in this chapter—specifically what call options and put options are. They can be used as a substitute for taking a position in an outright stock or commodity trade.

The relationship between the price of the stock and the strike price is the key to determining whether the option is out of the money (OTM), at the money (ATM), or in the money (ITM). Picking the option's correct strike price will ultimately help decide the probability of profit for your trade—something we dive in to more deeply in subsequent chapters.