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THE FUNDAMENTALS OF STOCK OPTIONS

Facts You Need to Know

There are two basic types of stock *options*, calls and puts. A *call* is the option people buy when they think that the price of a stock is going to go up. A *put* is what they buy when they think that it will go down. An easy way to remember which is which is provided by the sentence, "I call up my broker and then I put down the phone." Since calls are the more popular, we will discuss them first.

ELEMENTS OF CALLS

A call is the right to buy 100 shares of a certain stock or stock index at a stated price within a given period of time. For example, a call might be the right to buy 100 shares of stock in Ford Motor Company for the price of \$60 per share at any time between now and the third Saturday in January. The price per share at which the call buyer has the right to purchase the stock or index is called the *strike price* or *exercise price*. Thus, if a call is the right to acquire a share for \$60, that call would have a strike price of \$60.

All options have very precise and definite time limits. They completely cease to exist once that time limit has passed. Since options literally expire upon the passage of that time limit, that time limit is called the *expiration date*. Expiration dates are referred to by the month in which they occur. No actual date is needed because the expiration date is always the Saturday following the third Friday of the named month. So when we talk about a May option, we mean an

option that expires on the Saturday following the third Friday in May. This usually turns out to be the third Saturday.

Options are available with a number of different expiration months. They are the two nearest-term months plus two additional months from quarterly cycles that start in either January, February, or March. For example, if it were now late September options would be trading that expire in October and November. Some stocks would also have options expiring in January and April, other stocks would have options expiring in February and May, and some would have options expiring in March and June. Thus, at any time, the shortest-duration option will vary from as little as a few minutes to one month and the longest-duration option will vary from just over six months (on expiration day) to nine months (when the new options have just been added). Even longer-term options are called LEAPS.

The acronym LEAPS stands for long-term equity anticipation securities. These options may extend for up to three years and three months from their original listing. They expire only in January on the regular expiration date. Except for their longer duration, they are just like regular options. In fact, once enough time has passed, they simply become regular options.

All options expire at 5:00 P.M. eastern time on the Saturday immediately following the third Friday of the named month, and this Saturday is the date you will see in the description of your option in the confirmation slip you receive from your brokerage firm and in its monthly statements. But this date is a technical one and of no importance to you. More important for you is the date by which your broker must receive your instructions to *exercise* your option. This will vary from firm to firm, but it cannot be later than 5:30 P.M. eastern time on the business day (normally Friday) preceding that technical expiration date. And even more important than the cutoff date for exercising an option is the last time it can be traded. Normally options on individual stocks trade until 4:02 P.M. eastern time, which is two minutes after the stock exchange closes, while options on stock indexes trade until 4:15. On the final day of an option, the expiring options on individual stocks stop trading at 4:00, and options on stock indexes stop trading at 4:10. Many brokerage firms require that orders for expiring options be entered at least 30 minutes before the final trading time due to the large influx of orders that often develops at the close.

Thus any call can be fully described by stating all of the following critical aspects, always given in the same order: first the name of the underlying common stock or stock index, then the expiration month, and finally the strike price. A call termed "Ford January 60" gives its

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owner the right to acquire 100 shares of Ford Motor Company common stock for the price of \$60 per share at any time between now and the Saturday following the third Friday in January.

READING THE OPTIONS QUOTATIONS

Now that you understand the elements that define each option, it is an easy matter to read the prices in newspaper reports or other quotation sources. The first item is the name of the stock with the strike price. In some formats this is followed by three columns listing the price for the option of that strike price for each of the next three expiration months. The number below the name of the stock is its closing price on the stock exchange. This may or may not be the same number you will see for the close of the stock on the stock market pages of a newspaper, since the price in the options listing is the consolidated close, and may have taken place at a stock exchange other than the New York Stock Exchange (NYSE).

The *open interest* figure is the cumulative total of all the options that have been sold (or “written”) to create new positions. When an option *writer* writes (sells) a new option, the open interest figure goes up by one and will continue to reflect that contract until the contract expires, the option is exercised, or the writer closes out the position by purchasing an identical option.

Certain Sunday newspapers and *Barron's* publish more complete reports of the week's activities, including the high and low prices of each option for the week. But all the important information is contained in the daily reports, even though in order to save space some newspapers do not report the volume figures for the individual options.

One note of caution is in order. One cannot rely on the figures to be a guide as to what you may do on the following day, because all the figures are closing figures; that is, they describe the final transaction of the day. Since some options have very little volume, the final transaction might have occurred at 2:00 P.M., when the stock was at \$87, and by the time the stock market closed the stock might have sunk to \$85. But of course the figure you will read in the newspaper for the option is the price when the stock was \$87. Obviously, if the stock opens the next morning at \$85, the price of the call will be less to reflect the decline in the stock. If you ask your broker after the market close, he should be able to tell you when the final trade for any option took place. He can also tell you what the closing *bid* and *asked* prices were for the option, which are accurate price indications of the closing stock price.

THE VALUE OF OPTIONS

The right to acquire a stock for a given price between now and some future date is almost always worth a certain amount of money. This is true whether the stock is currently priced at more or less than the strike price. The reason is that, even if the current price of the stock is below the strike price, there is a possibility that by the time the expiration date comes around, the price of the stock will have risen above the strike price. The owner of the call will then be able to purchase the stock at a bargain price. This is called exercising the call. The call owner can sell the stock immediately after exercising the call and make a cash profit of the difference between the strike price and the then market value of the stock.

For example, if on the third Friday in January the Ford stock used in our initial example was selling at \$65 on the New York Stock Exchange, the owner of the call with a strike price of \$60 would be able to acquire the stock by paying \$60. He would then own stock worth \$65. His profit on exercising the call and selling the stock would be \$5, less what he originally paid for the call and his commissions. Thus, on its expiration date a call is worth the price of the stock minus the strike price with an adjustment for commissions. On the other hand, if the price of the Ford Motor Company stock was \$60 or less on the expiration date of the call, then the owner of the call would have nothing of value. This is because the right to purchase the stock for \$60 is worth nothing if anyone can do the same thing without owning a call. So he would not acquire the stock through his call; whatever he had paid for the call would be a complete loss.

The amount that a person pays to acquire an option is called the *premium*. In effect, this is the price of the option, but it is called a premium to distinguish it from the underlying common stock, which also has a price. Premiums can consist of two types. If the strike price of a call is above the current price of the stock or stock index, then the entire premium is said to be *future time value* because it will only be of any real value in the future (if the stock goes up over the strike price). If, however, the strike price is below the stock price, then a part of the premium is said to be *cash value*, because if you owned that call and exercised it today you would have something of value.

Here are examples. If a July 80 call has a premium of 4 and the underlying stock is now at \$75, the entire premium of 4 is said to be future time value. If you owned that call and were to exercise it today

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it would not have any value. That would be true until the stock went over \$80. On the other hand, if the stock is now \$85 and the premium is 7, the call would have a value right now of 5 if you were to exercise it. For this reason, we say that 5 *points* of the premium represents cash value; the other 2 points are future time value. These two concepts are of great importance in deciding which options to buy or to sell, as we will see later.

Premiums of calls are quoted for individual shares, but the actual price of a call is the quoted premium multiplied by 100 because one call gives you the right to purchase 100 shares. Thus, when one reads that a Ford Motor Company call is selling for $2\frac{1}{4}$, this means that the premium on one share of Ford stock is \$2.25, so the cost of purchasing one call is 100 times that: \$225.

The same rule applies to stock index options. If a call on the Standard & Poor's 100 index, known as the OEX for short, has a premium of 16, you multiply this by 100 to get the actual amount you would pay to buy this call, namely \$1,600. The value of the underlying security is 100 times the current price of the index. Thus if the OEX is at 700, one call on it represents a call on \$70,000 worth of stock.

The person who buys a call must always pay cash for the full premium. There is no *margin* possible on a call, with the exception of LEAPS, because there is such a high probability that the call will soon be worth nothing, so that a brokerage house putting up the margin could quickly have no collateral for its margin loan. LEAPS are an exception, and brokerage firms are allowed to loan up to 25% of the current market value of options that have more than nine months until expiration.

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Perhaps these definitions have left you slightly less than trembling with excitement. Your reaction might well be, so what? What's so exciting about the right to buy or sell a stock for a given price within a given amount of time?

The answer is that nothing else in the securities sphere offers as great an opportunity to make or lose a fortune in as short a period of time as stock options. You've heard the old adage that when the elephant sneezes, the mouse is knocked down by a hurricane. The option is the mouse and the underlying common stock is the elephant. When the common stock moves up by 5%, the call can move up by 100%. And that, in its simplest form, is what calls are all about.

Leverage

Options give a person the chance to make a large gain with a relatively small investment. They give the investor tremendous leverage. For a small investment, usually 10% of the price of the underlying common stock or less, the option purchaser gains the right to participate in the price increase or decrease of the underlying stock for a period of time, just as if he actually were an owner of the stock. The call owner differs from the stock owner in that he has to pay for the cost of the call, but he has his right for only a limited time, and he does not receive dividends. But, thanks to the liquidity of the options exchanges, a call buyer can always overcome the time limitation by buying another call when his first one expires.

Let us illustrate this leverage with an example, using our Ford call option with a strike price of \$60 expiring in January. Suppose the current price of Ford stock on the New York Stock Exchange is, more or less by coincidence, also \$60. If the expiration date in January is three months away from the date when the call is purchased, the premium (price) of the call might be 3, meaning you would pay \$300 for the call). Now let us assume that you are considering purchasing 100 shares of Ford stock for a total price of \$6,000.

You firmly believe, on the basis of everything you have read, that Ford is underpriced and that within the next three months it is pretty certain to go up to \$70 a share. You intend to purchase the stock as a short-term investment only, and will sell the shares at the end of January. How much money could be made by buying the stock as compared to the call? If you buy 100 shares of the stock for \$6,000, and the price of the stock does go up to \$70 a share by the end of January, it would be worth an additional \$10 a share and you would have a profit of \$1,000.

On the other hand, if you invest the same amount (\$6,000) in calls at a premium of 3 (i.e., at a cost of \$300 each), you will be able to purchase 20 calls on a total of 2,000 shares. Now if the price of the underlying common stock goes up to \$70 a share, the right to acquire the stock for only \$60 will be worth \$10 a share. In other words, your calls will have gone up in value from \$3 a share to \$10 a share. The calls that you bought for \$300 each are now worth \$1,000 each, and your original investment of \$6,000 is worth a full \$20,000. You have just made a 233% profit on a \$6,000 investment in only three months. Compare this with the 16.66% profit you would have made by buying the stock.

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If you want to figure out what this options profit would come to in annual terms, since three months are a quarter of a year, you multiply by four and find that you are making a profit at the rate of 932% a year! Pretty good. And this all from a stock that had a rise of only 10 points. By comparing the \$1,000 profit you would have made on buying and selling the stock with the profit of \$14,000 you would make by buying a call, you can understand what the excitement is all about.

And of course, had the stock gone up more, the difference in profit would have been even more sensational. If the stock had gone up 20 points to \$80 share, the profit on the common stock itself would have been \$20 a share for a total profit of \$2,000. The purchaser of the call would have made a profit of \$17 a share for a total profit of \$34,000. That would be his net profit on a \$6,000 investment in just three months.

But, you might wonder, aren't there any liabilities to be incurred in buying a call? What if you should be proven wrong and the price of the stock falls, or just stays where it is? Will you then have to come up with more money? This is a natural question for anyone who has tried to get a little more leverage from common stocks by buying them on margin, only to see the price of the stock fall and receive a call from his broker asking for more money immediately to protect his investment. With respect to a call, the answer to the liability question is a clear and emphatic "no." The buyer of an option can never be required to put up more money. The only liability he has is the cost of the option when he buys it. The only risk he faces is that it will expire when the price of the stock is at or below the strike price and the call becomes worthless. Then the call purchaser will have lost the entire premium paid for the call, but that is all he will have lost.

Protection from Stock Price Declines

And while we're on the subject of liabilities, this is a good time to look at the purchase of calls from another point of view, namely that of restricting your losses in case of a decline in the price of the stock. Suppose in our original Ford Motor Company example, you think that the stock is probably going to go up, but you know that if certain developments occur, the price is likely to go down. You could purchase the 100 shares for \$6,000 as we mentioned before and pray hard that the price will go up and that your fears of a decline will not materialize.

Or in the alternative: You could decide to invest in calls that would give you a profit potential similar to the 100 shares. More specifically, you could decide to buy a single call for \$300. If the strike price is \$60, you would make \$100 for every dollar the stock rises above \$60 (less the premium of \$300 that you paid). What this means is that you are obtaining leverage similar to a \$6,000 purchase with an outlay of cash of only \$300. In addition to conserving your capital, the big advantage comes if the price of the stock should go down.

Let us suppose that the price of the stock falls by \$10, to \$50 a share, during the period of the option. If you had purchased the stock for \$6,000 it would now be worth only \$5,000, for a loss in value of a full \$1,000. On the other hand, by purchasing a call for \$300 you limit your loss to just that \$300. Thus you'd be ahead of the stock purchaser by \$700. And remember, no matter how fast the stock falls in price and no matter how far it finally plummets, the \$300 you paid for the call is the most that you can possibly lose. So the further the stock falls, the better the call purchaser does in relation to a person who bought the stock.

THE CALL SELLER

Since buying a call seems like such a wonderful way to make quick money in an upswing and such a great way to cut losses in a downturn, you might wonder who is stupid enough to sell you a call. After all, if you are going to buy one, it means that someone has to sell you one. And if you are going to make a 100% profit on your purchase, doesn't that mean that the person who sells you the call is going to lose an equal amount? If buying a call is such a wonderful investment, why would anyone ever sell one? Well, we will explore just how wonderful an investment buying a call is in more detail in Chapter 2. But right now, we'll explain that the seller of a call doesn't necessarily lose any money at all when the underlying stock goes up above the strike price.

In all probability the seller of your call is also the owner of the underlying stock. Thus, when the stock goes up and you make money on your call, he is losing money on the call he has sold you, but at the same time he is making money on the rise in the price of the stock he owns. In fact, the two equal each other and the gain in one completely cancels out the loss in the other so that the stock owner is not losing anything on the rise in the price, but rather is making money to the extent that the call was sold originally for more than its actual

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cash value. For example, if a stock were \$42 a share, the option with a \$40 strike price would have a cash value of \$2, and if he sold it for \$4, he would have a profit of \$2.

He would, however, have made more money if he owned the underlying common stock and had not sold the call—thereby losing potential profits. But he doesn't mind this, because no matter what happens to the price of the stock, he gets to keep the entire premium as profit. The seller of a call figures that this compensates him for giving up some potential profit when the stock goes up. And remember, even when the stock goes up, he still has the profit of his premium, to the extent it exceeded its cash value.

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When the expiration date for the option arrives and the price of the stock is above the call's strike price, the owner of the call can exercise the call, meaning that he directs his broker to buy in the stock at the exercise price. This, however, involves paying a commission. He must pay a commission on the purchase of the stock, and if he sells the stock immediately to realize a profit, he must pay another commission on that sale. But, the call owner has an alternative for a *closing transaction*. Instead of exercising his option he can sell it. Even on the last trading date for that option, there will be a buyer for it who will be willing to pay the approximate difference between the stock price and the strike price.

You might wonder who in the world would want to pay \$7 for a call that is going to expire in one day. The answer is that for every person who owns an option—is *long* an option—there is a person who is *short* an option—who has sold an option that he didn't have in the first place. Unlike common stocks, which start out their existence by being issued by a corporation, an option is a creation of the options exchange itself. It is created simply by selling it short.

So, on the final few days of trading, if you own a call that is worth some money, that means someone sitting on the other side of the fence is short a call, which is going to cost either money or stock to redeem. When a call expires *in the money*—that is, when the stock is above the strike price—the seller of a call must either deliver the stock or close out the position by buying a call to offset the one that is short. If the call writer owns the shares, there is no problem. But a call writer who does not own shares may not wish to buy them just so they can be called away. He will therefore buy a call instead, to close out his position. This is why in the last few days of an option period

there is often a frantic amount of trading in those calls that are in the money.

Exercising Index Options

Stock index options are handled differently. If you were to exercise a call to acquire a stock index and you received 100 or 500 different stocks in different quantities, including fractions of shares, you would have quite a mess on your hands. Therefore, options on stock indexes are exercised on a cash basis. This means that the actual value of the index is calculated and then the strike price is subtracted from that, and the difference is credited to the brokerage account of the person who is exercising the option.

For example, let's say you were long an October 1,300 call on the Standard & Poor's 500 stock index (SPX), and the index closed on the Friday of the expiration Saturday at \$1,327.53. You decide to exercise the call. You would subtract the value of the strike price (\$1,300 times 100 equals \$130,000) from the value of the index itself (\$1,327.53 times 100 equals \$132,753). You would receive the difference, which is \$2,753. This is clearly cleaner than receiving 500 stocks and then having to sell them.

SHORT SELLING A CALL

How much must a person pay if he decides to sell a call short? After all, there has been no expense incurred by the options exchange in issuing the call, and the call buyer has paid the full amount of the premium. What is there for the seller to pay? Yet it stands to reason that selling cannot be free to everyone who wishes to do so, because if the underlying stock goes up, the person who sells short may be called upon to deliver a large amount of money.

The answer is that the seller of a call must put up money, which is held in escrow by the exchange as the guarantee that he will fulfill his obligations upon expiration. The amount of margin that the exchanges require is computed under formulas that are discussed in Chapter 7. Normally the required margin is much greater than the amount of the premium received for the call. In addition, the margin must usually be *marked to the market* every day, which means that if the stock underlying a call you are short goes up today, you must deliver an additional amount for each call you are short to your broker. Because of this requirement for daily compu-

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tations, most brokerage houses require that you maintain greater margin balances than are actually required. This also discourages rampant speculation and provides a degree of safety to the broker should the price of the call suddenly escalate. Instead of having your margin in cash, you can deposit the required number of shares of the stock.

So far, we have concentrated on calls. And yet calls are only half of the stock option picture. Puts make up the other half.

ELEMENTS OF PUTS

A put is the right to sell 100 shares of a particular stock or stock index at a certain price within a given time. It differs from a call only in that a call is the right to *purchase* a stock for a set price whereas a put is the right to *sell* a stock for a set price. For example, a put might be the right to sell 100 shares of Sears stock at \$35 each at any time between now and the January expiration date. This would be denominated a "Sears January 35" put. If the price of the stock on the day before expiration was \$30, the holder of the put would have the right to require the put writer to purchase 100 shares of Sears stock from the put holder for \$35 each. He would "put" the stock to the put writer. Since he could acquire the shares for only \$30 each just before exercising his put, the value of the put would be close to \$500.

The owner of a put is under no obligation to exercise the put, and if the price of the stock goes up (against the expectations of the put buyer) the only liability faced is the loss of the premium paid. Thus, puts are very much like calls in that the purchaser has no liabilities and no potential losses other than the premium paid for the option. Because most investors expect that stocks will go up, there is usually not as great a demand for puts on individual stocks as there is for calls, and accordingly the premiums are generally less than for comparable calls. Interestingly, the reverse typically is the case for puts and calls on stock indexes.

As with a call, the buyer of a put traded on an exchange would not need actually to purchase the shares of stock and deliver them to the put seller in order to make a profit. The put owner will probably prefer to simply close out his put transaction by selling a put during the final period of its existence. Since he is the owner of a put, when he sells it he is out of the market, and the difference between the cost of the put and the selling price is his profit. This profit will normally be just about what he would have realized by

actually purchasing the shares on the open market and delivering them to the put writer. Selling a put eliminates the need to have enough cash to finance the purchase of the stock and saves the commissions on the purchase and sale of the stock. Of course, a put owner who owns the underlying stock might prefer to deliver his shares for the strike price.

ADJUSTED STRIKE PRICES

In addition to the regular strike prices of 20, 35, 60, and so on, you may have noticed that some stocks have odd strikes, such as $46\frac{5}{8}$, $37\frac{3}{8}$, and so forth. These odd *adjusted strike prices* are the results of stock dividends paid on the shares of stock, or of stock splits. One of the features of listed options is that there is no adjustment made in the exercise price when the common stock pays a regular or special cash dividend. In a way, it could be said that this is unfair to the purchaser of a call option because the payment of a dividend will normally reduce the price of the stock by the amount of the dividend. The reason a dividend causes a stock price reduction is simply that if a company is going to pay a 50 cents dividend, the day before the dividend it has cash of 50 cents per share in its treasury, and the value of the stock reflects the value of this cash. After the dividend is paid out to the shareholders, the company's treasury is reduced by 50 cents per share, and therefore the shares, which represent the value of owning a part of the company, are worth 50 cents less than they were before the dividend was paid out. So the stock price will generally fall by 50 cents.

This means that the value of any call options that are in the money will fall by a related amount. But, while this may be unfair theoretically, it was felt that administrative convenience and the need to standardize options made this inequity unavoidable. And, in practice, the inequity is reduced by the fact that options tend to have unusually low premiums just before a stock goes *ex-dividend*.

But what happens when a stock declares a stock dividend of, say, 20% of the value of the stock? Now we have a more drastic situation. Let's assume that a shareholder owned 100 shares of stock before the stock dividend, each with a value of \$100. Thus the value of his holdings was \$10,000. Once there is a 20% stock dividend, he will own 120 shares, but his total holdings will not have changed in value by one bit, assuming the stock price does not go up. He still owns the same percentage of the company, and the company has not become worth any more or any less by issuing

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some additional shares. His holdings are still worth \$10,000, but now consist of 120 shares; a little simple division will reveal that each share of stock is now worth only \$83.33. So, if the stock closed at \$100 before the ex-dividend date of the stock dividend and the price stays constant, it will open the next morning at \$83.33. That's fine for people trading in the stock, but what about the guy who owns the \$100 strike price option?

Obviously, unless something were done, his option would suddenly have lost almost all of its value when in fact there was no real decline in the price of the stock. So there had to be an adjustment of strike prices to reflect stock dividends, and that is what the odd strike prices are. When a stock goes ex-dividend after a stock dividend, the strike prices of all existing options are reduced proportionally, and in this example, a \$100 strike price option would become an $83\frac{3}{8}$ strike price option. But that is not all.

Remember, in addition to lowering the price of each share, more shares were created. To reflect this fact, the number of shares in each option is increased. Instead of one of these odd strike price options being the right to buy 100 shares of stock, it becomes the right to buy 120 shares (or some other number). So be careful when you buy or sell these options. If you are a buyer, and your broker quotes you a price of \$2, your cost of one option is going to be not \$200, but \$240 in this example, since the price per share is multiplied by the figure of 120 shares per option.

While this could be awkward, it is not as dangerous as the hazard faced by the option seller. Let's say you are a *covered call writer or seller*. After a stock split you buy 1,000 shares of the stock at $83\frac{3}{8}$. You proceed to sell 10 options with the $83\frac{3}{8}$ strike price for a \$2 premium and sit back to reap your hoped for profits of \$2 a share. You are happy to see the price of the stock go up smartly, and you wait to have the stock called away so you can go on to greener pastures.

The stock moves up to 100, and sure enough your stock is called away. All 1,000 shares. Plus 200 shares you don't own! To your horror you find that you were naked on 200 shares, which you must now buy in at the current price of \$100 and deliver at $83\frac{3}{8}$. The moral is simple: If you see an odd strike price, or any option with the symbol "o" after it in your quote source, be sure to ask how many shares are included in each option. This also is crucial in spreads where you may wish to combine some regular strike price options with some odd-priced ones. Be sure that you get the right ratio of options.

As soon as there is a stock dividend, the options exchange will

introduce new options with regular strike prices. Thus, in this case there would be that $\$83\frac{3}{8}$ strike price option, and right below it would be the new $\$80$ strike option. There often are some interesting spreads between the two, but please remember that you need 12 of the $\$80$ options to offset 10 of the $\$83\frac{3}{8}$ ones.

SPECULATIVE NATURE OF OPTIONS

There is one final point that belongs in this chapter on the basics of dealing in puts and calls: With the exception of selling calls when you own the underlying shares, this is a highly speculative business. That sounds like a pretty tame statement, especially for anyone who has read a number of prospectuses for newly issued shares. The Securities and Exchange Commission (SEC) makes stock issuers write “highly speculative” all over the prospectuses, sometimes even in red, in capital letters. Well, while new issues are considered speculative, dealing in calls is about five times more so. If you think that certain stocks are risky, let me tell you that they loom as solid as the Rock of Gibraltar in comparison to puts and calls.

When you buy a put or a call with the price of the stock near the strike price, there is a 50% chance that when the call expires it will be worth absolutely nothing—that’s right, not one single penny. Whether you paid $\$200$ for it or $\$1,000$, the money you paid will have simply disappeared into thin air. And unlike the stock market, where that happens only occasionally when a company goes into bankruptcy or receivership, this is the norm for options. Remember, most of them become worthless!

So unless you are completely willing to kiss your money good-bye the minute you buy an option, you had better not invest in puts and calls. Or do it the only conservative way, which, as described in Chapter 3, is to be on the selling side when you own the underlying stock. Of course, you won’t get rich overnight by this method, but as that chapter explains, you might be surprised at just how fast you will make money.

On the other hand, the person who sells puts or calls without owning the underlying stock—a *naked option writer or seller*—can face an almost unlimited risk. He not only must be prepared to lose the money that he puts up as margin when he sells his call, but he must also face the possibility that every day the price of that underlying stock may jump. If it jumps high enough, he will get an urgent call from his broker demanding more money to cover the margin requirements. If the money is not sent in, the position will be closed out by

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the brokerage firm at a large loss to the client. In Chapter 4, I explain how to reduce the risk as much as possible, but the risk is still there.

With the exception of covered call writing, this is not a game for the person who is trying to accumulate enough money to send three children to college in another five years. This is not the investment for the person who is concerned with building up a substantial nest egg to retire on in 10 or 15 years. This is not for the person who wants to get out of the job he is in and needs to accumulate some capital in order to start a business of his own. If you need to accumulate some money for a particular purpose that is important to you, then this is not the method for you. The one exception would be to sell calls on stock that you already own. And that method is one I do recommend in such a situation.

Selling and buying options (with the exception just noted) is for the person who has some extra money. It is for the investor who has made some money in the stock market and is now looking for a quicker, more exciting way to increase it; for the professional person who had a good year and now has more money in a savings account than he really needs; for the businessperson who has already made payments into a retirement plan, paid for disability insurance, made the mortgage payments, and put away something for a rainy day, and still has money left over; for the single person who works for a corporation that pays for retirement, Blue Cross, and disability insurance, and who figures that anything left over after paying current expenses is money that he can easily afford to lose. For these people, trading in options can be extremely rewarding, as this book will demonstrate.

But one cannot warn the reader often enough that trading in options is for only the speculative person who isn't going to miss the entire investment if it is lost. At this point it is worth reprinting the third paragraph of the Options Clearing Corporation (OCC) prospectus, which appears in boldface type on the first page:

Both the purchase and writing of options involve a high degree of risk and are not suitable for many investors. Such transactions should be entered into only by investors who have read and understand this prospectus and in particular, who understand the nature and extent of their rights and obligations and are aware of the risks involved. An investor should not purchase an option unless he is able to sustain a total loss of the premium and transaction costs of purchasing the option, and should not write an option unless he is able to sustain substantial financial losses, or in the case of a call, unless he owns the underlying security.

Anyone contemplating trading in options is urged to read the entire prospectus. Having said that much, let me point out that if you can afford to lose your investment, there is no method I know of that can be more rewarding in as short a period of time than trading in options. While it is risky, experience shows that trading in carefully selected puts and calls can produce an extremely high income on the amount of the investment.