

# tradeMONSTER's Option Education: From the Basics to Covered Calls to Selling Puts

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# OPTIONS BASICS

## Why Options...

Options offer investors the opportunity to profit from upward, downward or sideways moving markets. Options also may provide leverage to the investor; that is, the ability to control a certain number of shares of a stock without actually buying the stock. Unlike a stock, though, an option is a time limited security that exists only until a pre-specified expiration date.

Many investors don't realize that options may also be used to protect existing stock positions. For example, if an investor holds a certain stock that has an upcoming earnings announcement, the investor can use options to protect the stock position for a period of time in which the earnings announcement occurs. To get this protection, the investor will have to outlay a certain amount of cash for the options position.

Options can also be used to generate income. This is accomplished by selling options. This approach offers the investor the ability to collect the premiums. Of course, collecting these option premiums also requires the investor to absorb the related risks over the lifetime of the sold options.

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### What is an Option?

A stock option is a contract between a buyer and a seller. The buyer gains the right (but not the obligation) to buy or sell stock, usually 100 shares, at a given price called the strike price. The right lasts for a limited period of time and ends when the option reaches its expiration date. The buyer secures the right by paying the seller a premium. Once the option contract is purchased, the owner can exercise his rights, meaning that shares of the stock will be purchased or sold at the strike price. It is the obligation of the option seller to sell or buy the stock at the strike price. Note that while the option buyer has a right to buy or sell the stock but is not obligated to do so, the option seller has an obligation to deliver or accept delivery of the stock at the strike price.

There are two types of options: calls and puts. Calls give the buyer the right to buy a specific number of shares of a stock at a specific price until a specific date. Puts give the buyer the right to sell a specific number of shares of a stock at a specific price until a specific date. In the case of a call, the seller of the call is obligated to sell the stock at the strike price, while the seller of the put is obligated to buy the stock at the strike price.

Let's look at some examples. Let's say an investor is interested in the options on XYZ stock. XYZ will have a series of options to consider, with a variety of strike prices and expiration dates, of both calls and puts. Let's say the investor decides to purchase the XYZ call option with a strike price of 50 and an expiration month of December. Once purchased, this option then gives the investor the right, but not the obligation, to buy 100 shares of XYZ stock at a price of \$50 per share. The right will last until the expiration date in December. Typically for stock options, the expiration date is the third Saturday of the expiration month. Specialty options can have different expiration dates so it's always important to understand when your option expires and when it stops trading.

Call options are typically purchased when an investor expects a stock to rise. But what if the investor expects the stock to fall in price? Then a put option may be considered. Recall the put gives the investor the right to sell 100 shares of a stock at the strike price. Let's say XYZ is trading at 50 and an investor owns 100 shares of XYZ. The investor expects the price to fall because earnings are due to be announced and the company has issued some warnings that earnings may fall short of expectations. The investor may consider buying the 50 strike put option. By buying the 50 strike price put the investor will have the right to sell the stock at 50.. This strategy is known as a protective put, because the purchased put option gives the investor the right to sell the stock at \$50 a share regardless of where the stock is actually trading.

It is worth noting that a majority of option contracts are never exercised. This is because an option position can be closed at any time prior to expiration by executing an offsetting transaction. For example an investor that owns, or is long, an option could sell it before expiration. An investor who writes an option, sells it short, could buy it prior to expiration.

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### Options Terminology

Let's review some of the terms we have seen thus far and introduce some new terms.

#### Call Option or Call

The right, but not the obligation to buy a specific number of shares of the underlying stock (usually 100 shares) at the strike price until the expiration date.

#### Put Option or Put

The right, but not the obligation, to sell a specific number of shares of the underlying stock (usually 100 shares) at the strike price until the expiration date.

#### Strike Price

The price at which option owners can exercise their rights to buy (in the case of a call) or sell (in the case of a put) the stock.

#### Expiration

The date on which an option is no longer valid and ceases to exist.

#### Exercise

The process where the buyer of an option takes or makes delivery of the underlying stock. In the case of a call, the option buyer takes delivery of the stock; in the case of a put, the option buyer delivers the stock to the assigned party.

#### Assignment

The process by which the seller of an option is notified that their option has been exercised by the holder. The seller must then fulfill the obligations of the option contract to sell (in the case of a call) or buy (in the case of a put) the stock.

Now let's introduce some new terms that are important to understanding option prices and how options are exercised:

#### In the Money or ITM

A call option whose strike price is below the price the stock is trading at, or a put option whose strike price is above the price the stock is trading at. For example, if XYZ stock is trading at 50, the 45 strike call option would be ITM, as would the 55 strike put option.

#### At the Money or ATM

An option whose strike price is roughly equal to the current stock price.

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## OPTIONS BASICS

### Out of the Money or OTM

A call option whose strike price is above the current stock price, or a put option whose strike price is below the current stock price.

### American

An option that can be exercised at any time before expiration (most options on individual stocks are American).

### European

An option that can be exercised only at expiration. This style of exercise is mainly found on a select number of index options. Note that European options can be sold at any time prior to expiration.

### Intrinsic Value

The amount by which an option is ITM. For example, if XYZ is trading at 58, the 55 strike call option is said to have \$3 of intrinsic value. The 50 strike call option would have \$8 of intrinsic value.

### Extrinsic (or Time) Value

The value of an option less the intrinsic value. For example, if XYZ is trading at 58 and the 55 strike call option is trading at a value of \$4.50, the option is said to have \$3 of intrinsic value and \$1.50 of extrinsic value.

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### Options Premiums

It is important for an investor interested in options to gain a firm understanding of how option prices fluctuate. There is a whole topic dedicated to this subject, but we will introduce some basic concepts here regarding the premium or price of an option.

The cost of an option is known as the premium. Option premiums have two components, the intrinsic value and the extrinsic or time value. Let's look at an example. Say XYZ shares are trading at 44. We notice the 40 strike call option on XYZ has a cost of \$6.30. This option has \$4 of intrinsic value (or is in the money by \$4) and \$2.30 of extrinsic value. Now let's say we see the 45 strike call option has a value of \$3.20. This option is out of the money, since the strike price of the call option is above the current stock price. Thus, there is no intrinsic value and \$3.20 of extrinsic value. For an out of the money option, the entire premium is extrinsic value.

When the stock price and the strike price are the same, or close, the option is known as at-the-money or ATM. ATM options are essentially all time value.

Here's how to determine intrinsic value and extrinsic value for calls and puts:

#### Calls

Intrinsic Value = Stock Price – Strike Price, when Stock Price > Strike Price

Intrinsic Value = 0, when Stock Price <= Strike Price

Extrinsic (Time) Value = Premium Paid – Intrinsic Value

#### Puts

Intrinsic Value = Strike Price – Stock Price, when Stock Price < Strike Price

Intrinsic Value = 0, when Stock Price >= Strike Price

Extrinsic (Time) Value = Premium – Intrinsic Value

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## Option Chains

When a stock has options trading on it, the stock is said to be optionable. For every optionable stock there are a number of different strike prices and expiration months. To view the array of options data for the various strike prices and expiration months we use a table called an option chain or simply a chain. The range of strikes and the expiration months offered for options will depend on the stock. Stocks that are very popular will tend to trade more expiration months than stocks that are less popular.

Below is a sample of an option chain.

✓ Sep08				Oct08	Dec08	Jan09	Mar09	Jan10		
Bid	Ask	Mark	Volume	Strikes			Bid	Ask	Mark	Volume
Calls				Sep08 (14 days)			Puts			
+ 17.40	17.60	17.50	481	90.0	+ 0.43	0.46	0.445	5.44k		
+ 12.90	13.10	13.00	503	95.0	+ 0.93	0.97	0.95	6.04k		
+ 8.90	9.05	8.975	5.3k	100.0	+ 1.90	1.95	1.925	8.69k		
+ 5.60	5.75	5.675	13.4k	105.0	+ 3.55	3.65	3.60	10.7k		
+ 3.25	3.30	3.275	9.41k	110.0	+ 6.15	6.25	6.20	7.33k		
+ 1.70	1.75	1.725	7.17k	115.0	+ 9.60	9.75	9.675	3.28k		

Note that across the top we have the expiration months. We can simply click an expiration month to view the options for that month. On the left side of the chain the Calls are listed, and on the right side the Puts are listed. In the center is each strike price. At the top of the strike prices the expiration month is noted as well as the number of days until the expiration date. Also note that more strikes may be available. Click the "Strikes" drop down menu to find out.

The option chain columns contain key data about the individual option contracts. First we see the Bid price and Ask price for the contract. Next is the Mark, which is the midpoint of the Bid and Ask prices. The Mark Change tells us how much the Mark is up or down on the day and the Volume tells us how many contracts have traded during the trading day. The final column is the unique Symbol for the option contract. Option symbols are constructed using standard sets of letters so as not to duplicate other option or stock symbols.

## Wrap-up

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## OPTIONS BASICS

Options enable an investor to profit in bullish, bearish or neutral markets if the appropriate strategy is used

Options offer the quality of leverage, where an investor can control an equivalent to a stock position for a limited period of time without actually owning the stock

There are two types of options traded on exchanges, calls and puts

Options buyers pay a premium for the right, but not the obligation to act

Options sellers (writers) have an obligation (if assigned)

Option buyers have the right to exercise, forcing sellers to deliver or accept stock at the strike price.

Options sellers are obligated, if assigned

Option premiums are made up of intrinsic value and extrinsic (or time) value

Option chains are used to see price quotes for multiple options on the same stock simultaneously

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# COVERED CALLS

## Why Covered Calls...

A covered call is a strategy that combines a stock position and an option position. To make the call covered, the investor buys (or already owns) 100 shares of stock and then sells 1 call option. Many traders use covered calls to generate income in their accounts. The income comes from the premium received when the call is sold. Keep in mind that until the call expires, their profit potential is limited.

Covered calls get their name because of the long stock position. The trader is “covered” from the perspective if the short call gets assigned and the investor has to deliver the stock, they can do so because they already own the stock.

In addition to income generation, covered calls can also be used as a means to exit stock positions. By selling a call that is likely to be exercised, a trader can get the strike price for the stock plus keep any additional premium collected by selling the call. Of course, the trader must absorb the risk the stock will lose value after selling the call and might not be exercised.

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## COVERED CALLS

### What is a Covered Call?

Implementing the strategy involves buying or owning 100 shares of a stock and then selling a call. Pairing the call and the stock position is said to “cover” the risk of the call with the stock. The sale is a credit and adds cash to your account. Selling the call brings in income to the account, but creates the obligation to sell the stock if the call is assigned. After the call is sold, the trader must hold the stock until the call is exercised, repurchased (to close the position) or until the call expires.

Covered calls profit up to, but not beyond the strike price sold. The maximum gain is realized if the stock price is right at the strike price of the call sold. At that point the full value of the sold call is retained and the stock achieves its maximum gain. For example: You sell a 50 strike call for \$1 with the stock at 48. The stock rallies to 50.00 at expiration. The call is assigned and the stock is sold for 50. There is \$2 of gain in the stock price and the \$1 profit from the option. The position will be profitable if the stock price drops by less than the amount of the sold call. In the example above, if the stock is at 47.20, there is still \$20 of profit (\$0.20 per contract X 100 shares per contract).

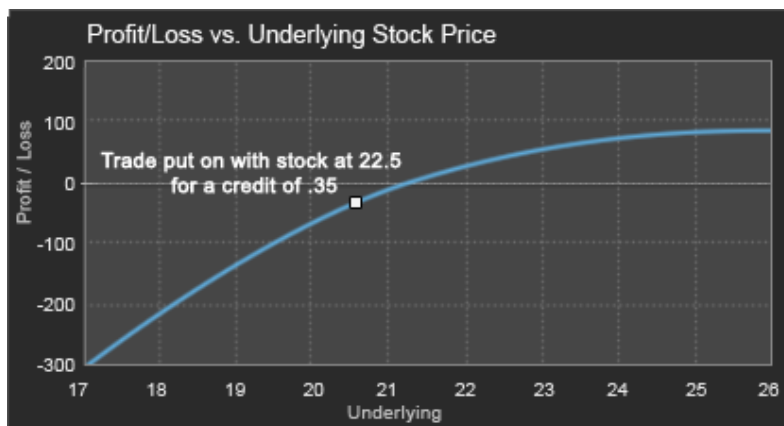
This strategy loses if the stock price drops significantly. You have the same risk as owning the stock, but you get the credit from selling the call. To exit a position, you will need to first buy back the call, and then sell the stock. If the stock takes off and moves beyond the strike price sold, the position will not partake in those gains.

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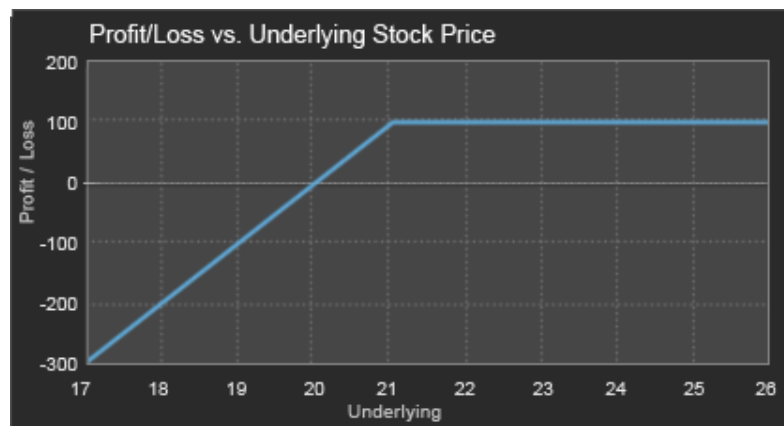
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**Example**

Let's look at a real world example. XYZ is trading at 20.98 (very close to at-the-money with the 21 strike). With 31 days until the April expiration, the 21 call is selling for \$1.36 and going out-of-the-money one strike, the 22 call is selling for \$.89. The risk profile when a 21 strike call is first sold and the stock is owned is shown below, with the stock at \$21. This is a neutral to bullish position.



Below is shown what the risk profile looks like at expiration. Clearly the position profits at any price above \$20, but assignment will happen above the sold strike of 21. The upside is capped.



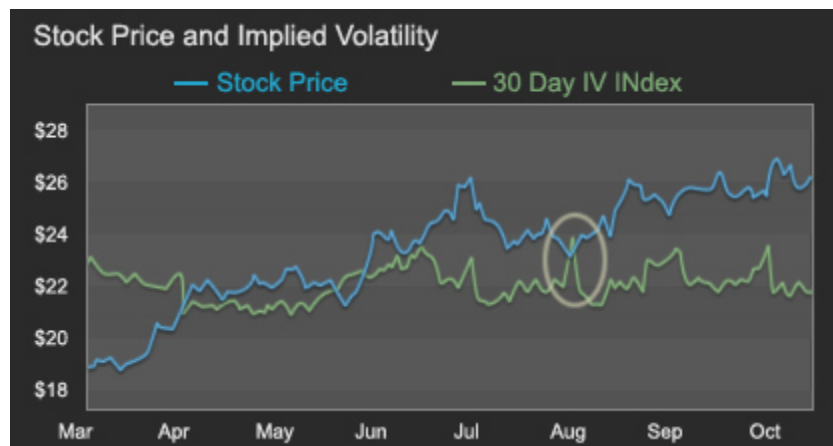
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## How They Win and Lose

Let's take a look at an example of a winning position.

In the circled area, XYZ price bounces off resistance at the same time that volatility spikes.



Time decay is the greatest in the front month, and for strikes near the money, so in this case, with the stock at 23.50 and rising in mid-August, we will sell one month out, September 25 calls for \$1.00.

If the underlying price falls, and/or volatility drops (as is the case), it may be advantageous to buy back the short call.

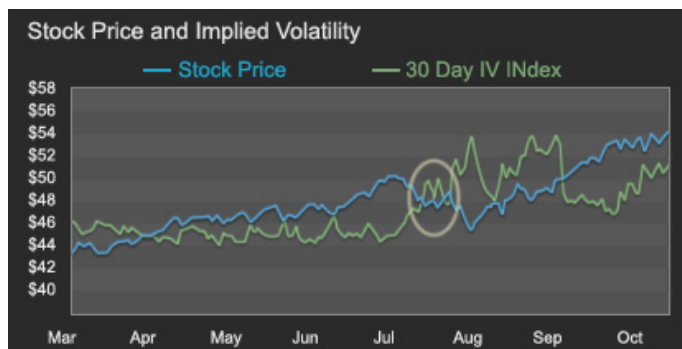
In this case, volatility fell quickly, but the stock price rose above \$25. In this situation it is usually best to wait for expiration and assignment. If we waited, we had the \$1 profit from the option and \$1.50 from the rise in the stock price, a gain of more than 10% for the month.

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Let's take a look at an example of a losing position.

Below is a chart of the stock price and volatility for XYZ.



We sell the August 49 call for \$1.20.

After a quick move in our direction, the price dives down to below 46 as the implied volatility increases almost 50%. Now we have two options. We can decide that we want to get out of the entire position, otherwise we can wait until expiration if we think that XYZ will be back up above 46.80 (our break-even point) by expiration.

We hold the position and the stock is down around \$46 at expiration, so we have a loss, but it is reduced by the amount of the credit of the sold call.

### Impact of Stock Direction

The covered call will profit from the stock moving up, staying flat or falling no more than the credit from the sold call. The position will lose as the stock price moves down more than the amount of the credit received.

### Impact of Volatility

Because volatility is a significant part of the premium paid for an option, if volatility goes down, the covered call will profit and if volatility goes up, it loses some value. This is only the case before expiration, because at expiration the extrinsic or time portion of the value of the option is zero.

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## COVERED CALLS

### Impact of Time Decay

Time is on your side with a covered call. You have a position with positive theta and so every day a portion of the sold call's value erodes from time decay.

### **Wrap-up**

The covered call strategy involves owning or buying stock and selling calls against it

It is a slightly bullish to neutral strategy

It can generate extra income in your account

It can be an alternate way to sell stock

The maximum gain is limited; the risk is the same as owning the stock less the credit received

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# SELLING PUTS

## Why Sell Puts...

Many traders use short puts to generate income in their accounts. Short puts can also be a way to acquire stock at a desired price. By selling the put, you are obligating yourself to buy the stock at the strike price should you be assigned. The premium you receive for selling the put serves in a sense as a discount to the strike price of the stock you are obligated to buy should the stock price drop below your strike.

The strategy is theoretically equivalent to a covered call. Short put = long stock + short call.

If you set aside the cash necessary to buy the stock on assignment, a short put is also known as a cash-secured put.

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## SELLING PUTS

### What is Put Selling?

Implementing the strategy requires choosing the strike and expiration date that you wish to sell. The sale is done for a credit and adds cash into your account when the order is filled. Cash will be held as collateral for the position. If the short put is “cash-secured” it means that your broker will require you to have enough cash in your account to purchase the stock at the strike price used. For instance if you sold a 30 strike put, you must have \$3000 cash in your account (\$30 x 100 shares per contract). You may not be required to have the same cash set aside in a margin account.

Short puts typically profit by the amount of the credit if the stock is above the strike at expiration. This is the maximum profit. For example, if you sold the 30 strike put for \$1, then the investor keeps the \$100 credit if, at expiration, the stock is anywhere above 30. The strategy actually breaks even at a stock price of \$29, since the investor did collect the credit. If the stock is at 29.50 at expiration, you will have made \$0.50, but you will also be assigned and forced to purchase the stock. Many traders close out the position prior to expiration if they can buy back the option for a much lower price than they sold it, for instance selling the put for \$1.00 and buying it back for \$0.15. They do this to reduce the risk of the stock moving violently around expiration.

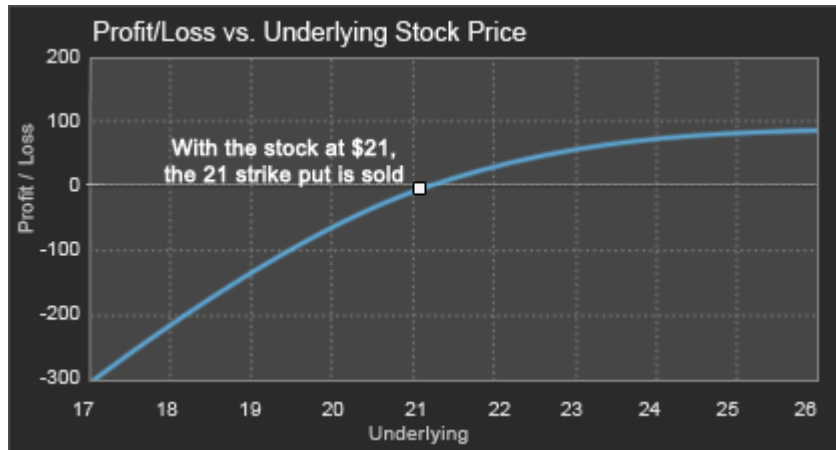
This strategy loses if the stock price drops significantly. Below the strike price that you sold, you have the same risk as owning the stock, because essentially, you do. If you attempt to use a short put to enter an equity position, and the stock takes off and you don't get exercised, then you missed out on the stock move. But because of the credit, you still make some profit.

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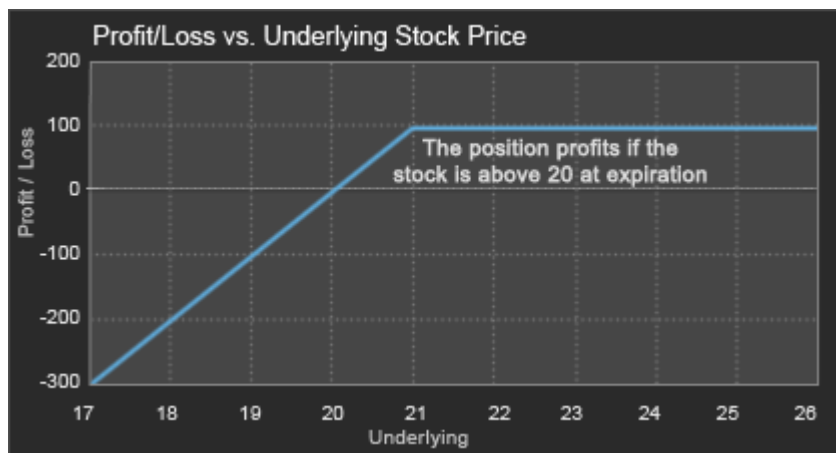
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**Example**

The chart below shows the risk profile when a 21 strike put is first sold with the stock at \$21. This is clearly a bullish position.



The chart below shows what the risk profile looks at expiration. Clearly the position profits at any price above \$20, but assignment will happen below the sold strike of 21. The upside is capped.



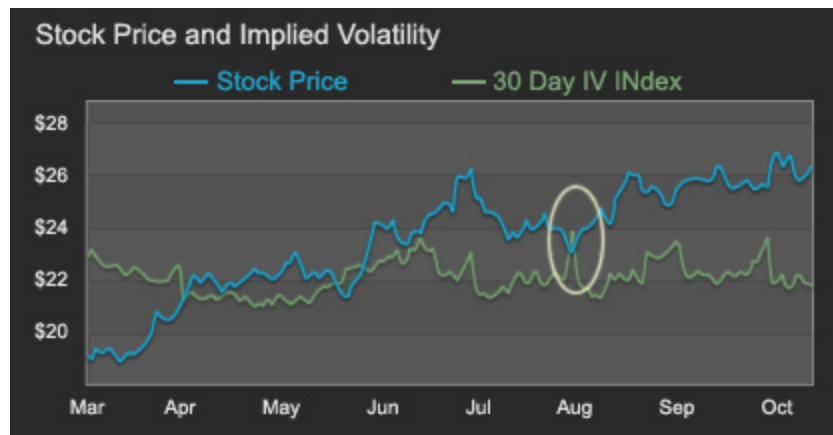
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## How They Win and Lose

Let's look at an example of how a short put wins.

In the circled area, XYZ price bounces off resistance at the same time that volatility spikes. We have an outlook that the stock will rise and implied volatility will fall. Both these factors would help a short put profit, plus time decay is on our side too.



Time decay is the greatest in the last month of an option's life before expiration, and for strikes near the money. So in this case, with the stock at 23.50 and rising in mid-August, we will sell one month out, the September 22.50 puts for \$1.25.

If the underlying price rises, and volatility drops (as is the case), it is best to buy back the put at some pre-determined value (say \$0.20). If the stock is staying above 22.5, but the put is not dropping quickly in value, we can let time-decay work for us and just wait for expiration.

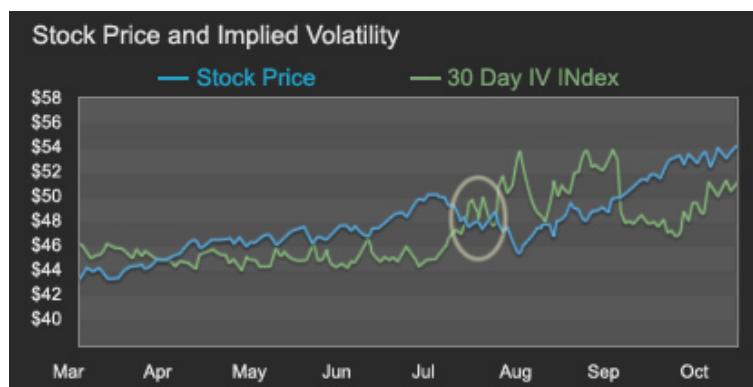
In this case, we were able to buy back the put for \$0.20 before expiration. This takes our profit off of the table and eliminates the risk of holding near expiration.

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Let's look at an example of how a short put loses

The price of XYZ seems to be bottoming out in late July with a spike in volatility. The price breaks back above 48 as the implied volatility starts to fall, so we sell the August 47 put for \$1.20.



After a quick move in our direction, the price dives down to below 46 as the volatility increases almost 50%. Now we have two options. We can buy back the put for a loss. Or we can wait until expiration if we are still bullish on XYZ and don't mind owning the stock at \$47 per share.

#### Impact of Stock Direction

The short put will profit from the stock moving up, as the put loses value. The position will lose as the stock price moves down.

#### Impact of Volatility

Because volatility is a significant part of the premium paid for an option, if volatility goes down, the short put will profit and if volatility goes up, it will lose.

#### Impact of Time Decay

Time is on your side with a short put. You have a position with positive theta and so every day you are profiting from time decay (as long as the stock price doesn't drop significantly).

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## SELLING PUTS

### Wrap-up

Short puts are a bullish to neutral strategy

They can generate extra income in your account

They can be an alternate way to acquire stock

They are theoretically equivalent to covered calls. The maximum gain is capped, the risk is virtually the same as owning the stock (slightly less because of the premium received)

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