Trading and Options Basics

Profits Run

DISCLAIMER: Stock, forex, futures, and options trading is not appropriate for everyone. There is a substantial risk of loss associated with trading these markets. Losses can and will occur. No system or methodology has ever been developed that can guarantee profits or ensure freedom from losses. No representation or implication is being made that using the information in this special report will generate profits or ensure freedom from losses. Risks also include, but are not limited to, the potential for changing political and/or economic conditions that may substantially affect the price and/or liquidity of a market. The impact of seasonal and geopolitical events is already factored into market prices. Under certain conditions you may find it impossible to liquidate a position. This can occur, for example, when a market becomes illiquid. The placement of contingent orders by you, such as "stop-loss" or "stop-limit" orders will not necessarily limit or prevent losses because market conditions may make it impossible to execute such orders. In no event should the content of this correspondence be construed as an express or implied promise or guarantee that you will profit or that losses can or will be limited in any manner whatsoever. Past results are no indication of future performance. Information contained in this correspondence is intended for informational purposes only and was obtained from sources believed to be reliable. Information is in no way guaranteed. No guarantee of any kind is implied or possible where projections of future conditions are attempted.

Copyright © by Profits Run, Inc.

All rights reserved. No part of this publication may be reproduced or transmitted in any form or by any means, electronic, or mechanical, including photocopying, recording, or by any information storage and retrieval system.

Published by:
Profits Run, Inc.
28339 Beck Rd Unit F1
Wixom, MI 48393
www.profitsrun.com

Objectives

- Understand the basics of options
- Options Overview
- Definitions
- Option Types
- Options versus Stocks
- Options Language
- How to handle assignment
- Review of a typical broker options chain quote and order page

Objectives, first to understand the basics of options, including an options overview, definitions, option types, options versus stocks, options language, and then how to handle the unlikely event of assignment. Now we are going to review a typical broker options chain quote page, and an order page. The overall objective here is to demystify options. Once you get into it you will find that they make perfect sense and are easy to understand.

Options Overview

- Options provide the trader or investor the opportunity to manage risk in the markets in ways not available when just buying a stock or ETF
- Options are risky?
  - No more risky than trading the underlying security
  - If done properly, options trading can actually be less risky than stock trading
  - Yes, if you abuse the leverage aspects of options and put position sizes on that are to large relative to your account size
- Options require far less margin than buying stocks or ETFs outright require to control the same number of shares
- Profit potential trading options can be far greater than trading stocks or ETFs
- Successful options trading does require good methods to evaluate the price movements of their underlying securities. And then given the assessment of the underlying security, the proper options strategy is applied.

Options provide the trader or investor the opportunity to manage risk in the markets in ways not available when just buying a stock or ETF; and as we get into this you will see how different strategies can accomplish just that. Options are risky, well they are no more risky than trading the underlying security. If done properly, options trading can actually be less risky than stock trading.

Yes, if you abuse the leverage aspects of options and put options sizes on that are too large relative to your account size, you are going to have a problem. And it is precisely the leverage aspect of options that, when abused, causes them to be highly risky. But like anything, if you know what you are doing, there is no need for that.

An example would be a driving analogy. If you put a kid in behind a steering wheel, driving, or attempting to drive a car down the highway, would that be risky? Boy you bet it would. But if you put an adult behind the wheel who has had proper drivers training,

properly licensed, the risk is dramatically diminished. Options is the same way, if you know what you are doing, they are no more risky than trading stocks; and indeed can be less risky.

Options require far less margin than buying stocks or ETFs outright. When you buy a stock or an ETF, you are going to have to put up the full amount of money; or if you have a margin account, approximately half or 40 percent of the money. But with options, it is significantly less than that. Oftentimes 10 percent, or 5 percent of the margin required to control the same number of shares. Again, if you abuse that and overtrade or put position sizes on that are far too large relative to your account size, that is when you get into trouble, and there is no need for that.

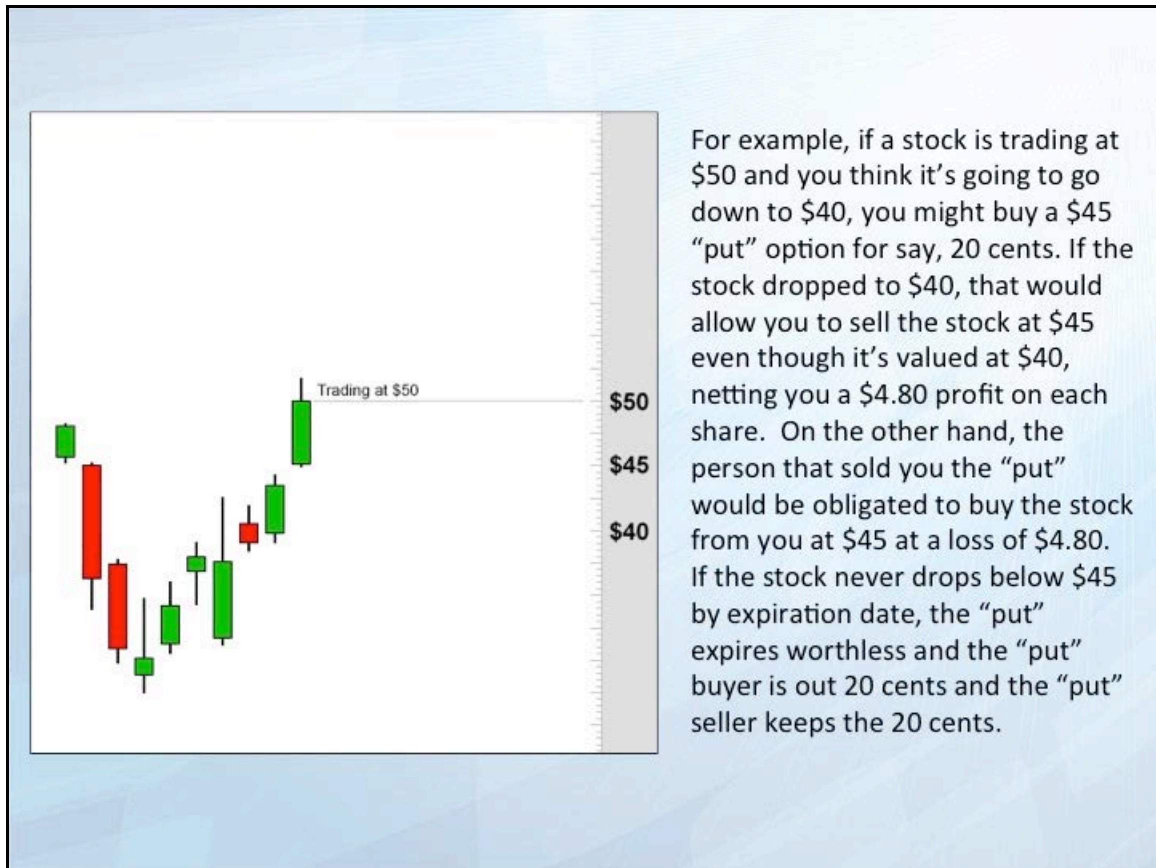
The profit potential trading options can be far greater than trading stocks or ETFs. Successful options trading does require good methods to evaluate the price movements of their underlying securities. And then, given the assessment of the underlying security, you can apply the proper options strategy. So there are two parts to this.

One is understanding options and the various options strategies, and the other is having a method, or methods, to evaluate the likely direction of the stock, ETF, or index for which you will be trading the options. So you need both of those. But if you are trading stocks, you need that anyway. I mean you are not just going to go in and put orders in blindly, you are going to go in and trade according to what your assessment is of the market or likely market direct.

Alright let us get right in to the basic definitions. First a put option definition and example, and then a call option definition and example.

First, **a "put" option** is a contract between two parties to exchange a stock at a "strike" price, by a predetermined date. One party, the buyer of the "put", has the right, but not an obligation, to sell the stock at the strike price by the future date, while the other party, the seller of the put, has the obligation to buy the stock from the buyer at the strike price if the buyer exercises the option.

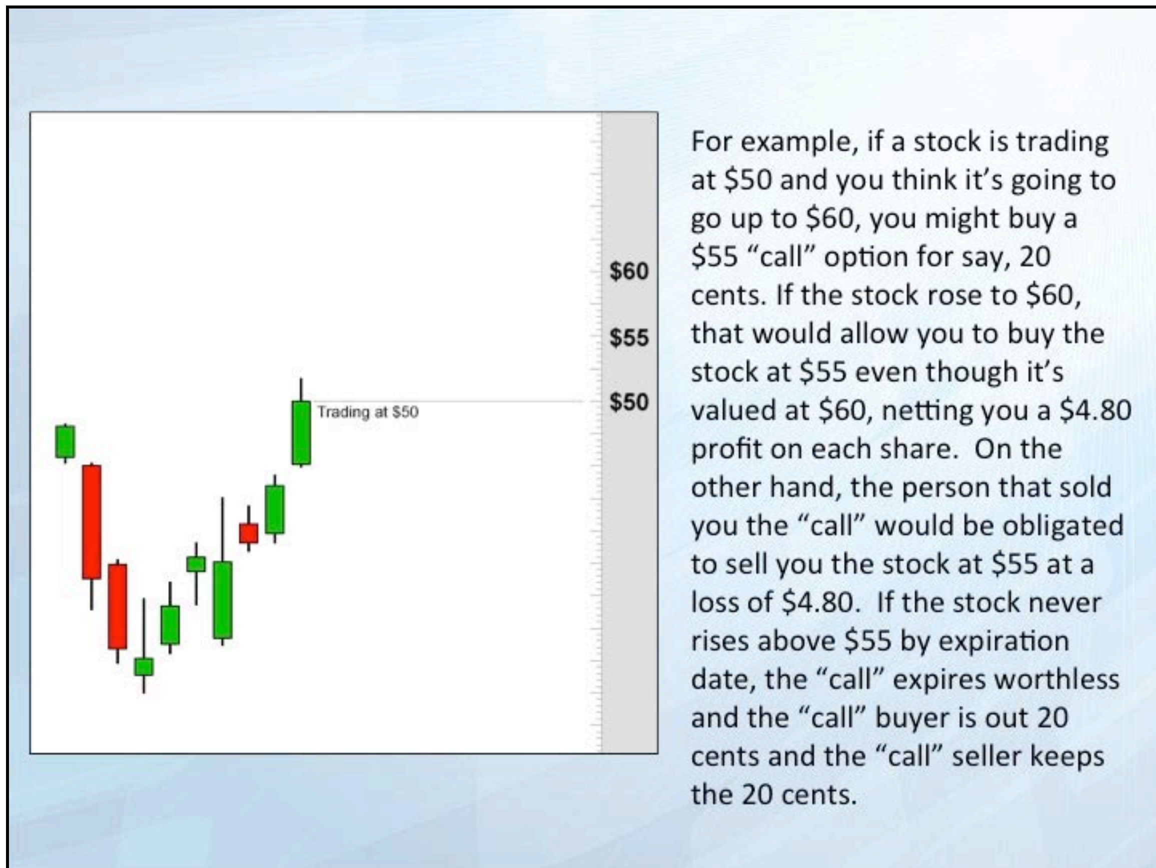
A put option is a contract between two parties to exchange a stock at a strike price by a predetermined date. One party, the buyer of the put, has the right, but not an obligation to sell the stock at the strike price by the future date. While the other party, the seller of the put, has the obligation to buy the stock from the buyer of the put at the strike price if the buyer exercises the option.



For example, if a stock is trading at $50 and you think it is going to go down to $40, you might buy a $45 put option for say $.20. If the stock did drop to $40, that would allow you to sell the stock at $45 even though it is valued at $40; netting you a $4.80 profit on each share. On the other hand, the person that sold you the put would be obligated to buy the stock from you at $45, at a loss of $4.80. If the stock never drops below $45 by the expiration date, the put expires worthless, and the put buyer is out $.20 and the put seller keeps the $.20.

Next, **a "call" option** is a contract between two parties to exchange a stock at a "strike" price, by a predetermined date. One party, the buyer of the "call", has the right, but not an obligation, to buy the stock at the strike price by the future date, while the other party, the seller of the call, has the obligation to sell the stock to the buyer at the strike price if the buyer exercises the option.

Now the call option is a contract between two parties to exchange a stock at a strike price by a predetermined date. One party, the buyer of the call, has the right, but not an obligation, to buy the stock at the strike price by the future date. While the other party, the seller of the call, has the obligation to sell the stock to the buyer at the strike price if the buyer exercises the option.



For example, if a stock is trading at $50 and you think that it is going to go up to $60, you might buy a $55 call option for say $.20. If the stock rose to $60, that would allow you to buy the stock at $55 even though it is valued at $60; netting you a $4.80 profit on each share. On the other hand the person that sold you the call would be obligated to sell you the stock at $55 at a loss of $4.80. Now if the stock never rises above $55 by expiration date, well then the call expires worthless and the call buyer is out $.20 and the call seller keeps the $.20.

Types of Options

- Options are available for stocks, ETFs and Indexes (also, futures, forex, etc)
- But not all stocks, ETFs and Indexes have options
- Monthly options are available for hundreds of stocks, ETFs and Indexes
  – Options with expiration dates for different months out into the future are simultaneously available for trading. These monthly options expire on Saturday following the third Friday of the month
  – Options with expiration dates 1 year or more into the future (from first trading day) are called LEAPS (all LEAPS expire on Saturday following the third Friday in January)

Okay let us talk about the types of options. You have options available for stocks, ETFs, and indexes; also futures, forex, and other underlying securities, but we will be focusing in on stocks, ETFs, and indexes. Now it is important to note that not all stocks, ETFs, and indexes have options; however, when it comes to monthly options, they are available for hundreds of stocks, ETFs, and indexes. So more than enough in order to trade options effectively.

Now these monthly options have expiration dates for different months out into the future, and they are simultaneously available for trading. So there may be, for example, a July call option, an August call option, a September call option, a December call option; all trading simultaneously. Now these monthly options expire on Saturday following the third Friday of the month. So the last trading day is that Friday, that third Friday.

Options with expiration dates of one year or more into the future are called LEAPS. LEAPS is an acronym that is not worth remembering, but it essentially means long term options. All LEAPS expire on Saturday following the third Friday in January. So the last trading day for a LEAP would be that third Friday in January.

Types of Options

- Weekly options are available for over one hundred stocks, ETFs, and Indexes
  - Options with expiration dates for different weeks out into the future are simultaneously available for trading.
  - Weekly options begin trading each Thursday when the equities markets open at 9:30 AM EST
  - Weekly options expire on Saturday following the Friday of expiration week when the equities markets close at 4:00 PM EST
  - Most weekly options have a life of up to four weeks

Now then there are weekly options, which are newer on the scene, and these are available for over 100 stocks, ETFs, and indexes. The mechanics work the same as monthly options, except that the life of these weekly options is much shorter. These are options with expiration dates for different weeks out into the future, and also are simultaneously available for trading. Weekly options begin trading each Thursday when the equity options open at 9:30am Eastern Standard Time. Then weekly options expire on Saturday

following the Friday of expiration week, when the equity's markets close at 4pm Eastern Standard Time. Most weekly options have a life of up to four weeks.

Options Versus Stocks

- Options will track the price movement of the underlying stock
- Options trade like stocks on the open market although some options are very thinly traded and should generally be avoided
- Prior to expiration, options can be bought and sold when the underlying stock market is open
- It is not necessary to hold an option position until expiration

Alright let us focus in now on options versus stocks. Options will track the price movement of the underlying stock. Options trade like stocks on the open market, although some options are very thinly traded and should generally be avoided. Prior to expiration, options can be bought and sold when the underlying stock market is open. So you can get into and out of an options position any time the market is open. It is not necessary to hold an option position until expiration.

Options Versus Stocks

- There is no set number of contracts available to trade for a particular option. Generally, the options market makers will make a market for whatever number of options contracts the market wants to buy and sell
- Options have a fixed life
- Options price is based on the movement of the underlying stock price
- Options can control the same number of stock shares for far less margin

There is no set number of contracts available to trade for a particular option. Generally the options market makers will make a market for whatever number of options contracts the market wants to buy and sell. Whereas with stocks, you have a fixed number of shares available to trade. Options have a fixed life, they have an expiration date; of course stocks do not. Options price is based on the movement of the underlying stock price, but not entirely.

As you will see, there are two major components that determine the price of an option, called intrinsic value and extrinsic value, and we will get into that a little later. Options can control the same number of stock shares for far less margin.

Options Language

- Options have their own language that must be understood
- An option is defined by:
  - The type of option (put or call)
  - The underlying security
  - The strike price
  - The expiration date
  - The option price or premium

Now of course options has its own language, and if you do not know the language then they seem difficult to understand; but if you do know the language, then everything suddenly becomes clear. Fortunately it is not too difficult to learn this language.

An option is defined by the type of option, either a put or a call, the underlying security, the strike price, the expiration date, and the option price, or premium.

Options Transactions

- Buy a call for a debit to your account
- Buy a put for a debit to your account
- Sell a call for a credit to your account
- Sell a put for a credit to your account

Typical options transactions include, buy a call for a debit to your account, buy a put for a debit to your account, sell a call for a credit to your account, or sell a put for a credit to your account.

Option Contracts

- When you buy a call to open a new position, you are entering into a contract to buy the call from the call seller
- When you buy a put to open a new position, you are entering into a contract to buy the put from the put seller
- When you sell a call to open a new position, you are entering into a contract to sell the call to the call buyer
- When you sell a put to open a new position, you are entering into a contract to sell the put to the put buyer
- One option contract controls 100 shares of the underlying security

Now options are traded as contracts. When you buy a call to open a new position, you are entering into a contract to buy the call from the call seller. When you buy a put to open a new put position, you are entering into a contract to buy the put from the put seller. Now when you sell a call to open a new position, you are entering into a contract to sell the call to the call buyer. And when you sell a put to open a new position, you are entering into a contract to sell the put to the put buyer. One option contract controls 100 shares of the underlying security.

Option Contracts

- Once you have opened an option position you must do one of the following prior to expiration day:
  - Sell the long call or put position to close the contract
  - Buy back the short call or put position to close the contract
  - Exercise the long call or put option at the strike price
  - Allow the option to expire worthless
  - Be prepared to accept possible assignment if short a call or put

Once you have opened an option position, you must do one of the following prior to expiration date. Sell the long call or put position to close the contract, buy back the short call or put position to close the contract, or exercise the long call or put position at the strike price, or you can allow the option to expire worthless if they are out of the money on expiration date.

And then, however unlikely, you should be prepared to accept possible assignment if short a call or a put. Now this is an area that concerns many novice option traders, but that is unnecessary. First of all, assignment does not occur very often, and when it does, it is easily handled; as we will talk about in a few minutes.

Option Price or Premium

- The price (premium) paid or received for purchasing or selling options
- There are two components to the premium:
  - Intrinsic Value
  - Extrinsic Value (time value)
- Intrinsic Value is based on the difference between the strike price and the current market price of the underlying security if favorable to option buyer
- Extrinsic Value is based on the time until expiration. As the time until expiration drops, the "time" value shrinks

Okay let us talk about the option price, or what is called the premium. The price, or the premium paid or received for purchasing or selling options is what we are talking about here. There are two components to the premium, as I said, intrinsic value and extrinsic value, which is a fancy word for time value. Intrinsic value is based on the difference between the strike price and the current market price of the underlying security if favorable to the option buyer. The extrinsic value is based on the time until expiration. As the time until expiration drops, the time value shrinks. For example, let us say you had a call option with a 40 strike and the stock was trading at $45. The intrinsic value of that option would be $5, the difference between $45 and the strike price of $40. Let us say that option had 90 days until expiration. So in addition to the $5 intrinsic value, it would also have extrinsic or time value. And with 90 days until expiration, such an option would probably have $2 of extrinsic value, depending on the implied volatility in the

option. So that the total value of that option at that point in time might be $7; $5 of intrinsic value, and $2 of extrinsic or time value.

Option Premium

- As a buyer of a call or put to open a new position, your risk is limited to the purchase price, no matter what happens to the underlying security. Your profit potential is theoretically unlimited.
- As a seller of a call to open a new position, your risk is theoretically unlimited for a short call position. Your profit potential is limited to the credit received.
- As a seller of a put to open a new position, your risk is the difference between the strike price and zero (less the credit received) for a short put position. Your profit potential is limited to the credit received.

Now as a buyer of a call or a put to open a new position your risk is limited to the purchase price; no matter what happens to the underlying security. Your profit potential is theoretically unlimited. As the seller of a call to open a new position, your risk is theoretically unlimited for a short call position, because why? Theoretically the stock or underlying security could go to the moon, exposing you to unlimited risk. Your profit potential is limited to the credit received. Now as a seller of a put to open a new position, your risk is the difference between the strike price and zero, less the credit received for a short position. So if you were short a $40 strike put option, and you received a credit of $1 for shorting that put option, and the stock went to zero, you would lose $40 minus the

$1, or $39. Also your profit potential is limited to the credit received. So I think you can readily see that the way you apply various options strategies is very, very important. And again if you do not apply them properly, you have got a risky situation on your hands. But if you do, then options can, as I said, minimize risk, in fact be less risky than trading the underlying stock or ETF.

Assignment

- Assignment (happens rarely, and even more rarely with weekly options), but if it does, it is nothing to be concerned about
- If the market is in-the-money relative to your short option position, you could be assigned (meaning the holder of the put or call may exercise their option)
- If this occurs, you will be notified by your broker and in the absence of some other strategy that you may have, you simply instruct your broker (or go to the broker's online trading platform) to immediately buy back the stock shares (in the case of a call assignment) or sell the stock shares (in the case of a put assignment) and you will be completely out of the trade

Alright let us talk about assignment. Assignment happens rarely, and even more rarely with weekly options, but if it does, it is nothing to be concerned about. Do not let anyone cause you to be fearful of assignment. If the market is in the money relative to your short option, you could be assigned; meaning the holder of the put or call may exercise their option. Now the broker will do this automatically, and will advise you that you are being assigned. So in the absence of some other strategy that you may have, you simply instruct

the broker, or you can go to the broker's online trading platform to immediately buy back the stock shares in the case of a call assignment, or sell the stock shares in the case of a put assignment, and you will be completely out of the trade, and that is it. It is that simple.

Okay, let us take a look now at a typical broker options chains page and trading platform. Alright let us now take a look at the options express virtual trading account. It is a virtual account for you to practice with, but it looks almost identical to the live trading account;

and most good brokers will have such an account for you to practice on. So let us just take a look here at what we have got, we are looking at Apple – AAPL, but of course you can load any symbol you want in there that has an option; and the range that we are looking at in this table, this is a quote table of all the options, is called near the money.

That means Apple is trading right now at $394, this table is showing us options with strike prices around $394 above and below. If we wanted to see more options, we would click on more and we would see even a wider range of strike prices. Then I selected calls and puts. You can see here we have got calls listed and puts listed. Then expiration, you can pick whatever you want.
Right now it is showing those options expiring in July; however, if you open this window up, you can see that we have weekly options that expire in weekly increments. Then we have further out the monthly options, August, September, October, January, April, January, then we have the LEAPS that are at least one year out. So we select the expiration we are interested in, and then we click on view chain and that brings up the window we are looking at. So first is listed the underlying security Apple, the last trading price, the bid they ask, the high and the low of the day, and the current volume.

Then we have got each of the expiration dates in order, showing first the June week four calls expiring 6/28/13. Then we have the July week one calls expiring July 5th; and the week twos July 12th, and so on. If we scroll down, you can see the third week of July

coincides with the monthly July call expiring the third Friday of the month. Then we have the July week four calls, and on it goes. The August one week calls. And if we wanted to take a look at, let us say, the December options, there are none for Apple, let us say October.

Hit view chain, and that brings up the October calls and puts that expire the third Friday in October, 112 days until expiration. So for these October options, you see the strike price listed here for each option, and the pricing for the calls on the left, and the pricing for the puts on the right. So the $375 call option, October call, right now it is trading at $33.05 bid, $33.30 ask, and we will get into the details of bid ask and these other terms a little bit later.

But for right now I just want you to get a feel for what these quote tables look like. So the last trade was at $31.60, but if you were to enter a trade now, it would be somewhere in this range here, $33.05 to $33.30. Then the volume and the open interest. The open interest is the number of contracts that are currently open for this option. Then if you wanted to trade that option, you simply click on trade. That would bring up the order window, we will do that in a moment.

If you want more detail on the option, you just mouse over detail and that brings up what are called the Greeks that we will be talking about later on. So everything you need to know about this particular option is available to you on this option chains page. Now likewise, for puts the same information is available. And you can see, for example, right now the open interest for the puts is a lot higher than for the calls. That could mean that there is a great deal more concern about protecting the down side, than there is the upside potential of the Apple stock.

Now if I just wanted to look at the calls, I could go up here and click on calls, and that would bring up the call table only, not excluding the puts. And it would show you the

high and the low for the day. Now if I wanted to look at spreads, which we will be talking about, let us say I wanted to look at call spreads. I click on call spreads and that brings up the Apple call spreads, here for example is the 400, 405 call spread, where you are buying one option and selling the other. If you click on the plus sign, that opens it up and it shows you what the 400 call is selling at, and what the 405 call is selling at.

Furthermore, if you intend to put on a debit spread, you would click the radio button here for debit spread; if you intended to put on a credit spread, you would click that button. Again, we will be talking about spreads in far more detail. For now, just get used to the look and feel of this page. Alright, let us go back to calls and puts.

Click on view chain. Let us say we are bullish on Apple, and we think Apple is going to go up in price between now and October. Apple is currently trading at $393.85, so we could buy the Apple stock outright, buying 100 shares at $39,385; or we could by the $395 call, which controls 100 shares for $22.30 times 100, or $2,230. Far less money than it would take to buy the shares outright.

Let us say we wanted to go ahead and place that trade. Let us go buy one contract of the Apple $395 call for October expiration, and all we do here is click trade, and that brings up the order window. You can see it is preloaded for you, buy it open, October, $395 strike, one contract, and let us buy it at a limit price to make sure we get the price we want. Let us go in at $22.40, the ask was $22.30, but let us put in $22.40 to make sure we get filled. Preview, check the order to make sure you have got it right. It is going to cost us $2,200 after commission, place the order.

Okay, let us go look at the order status to see if we got filled. Alright, you can see, now this is very important, you can see that here is the trade right here. To buy one at $22.40, but the current price now has jumped to $22.45, $22.70. So if we want to get this filled for sure, what we can do is go in and click modify, and change this to a market order. Click preview, and place the order. Now we are paying a little bit more than we would

have liked. And it depends on your strategy, and your outlook will determine whether or not you want to do that.

Now we click on order status and we see that our first order was cancelled, but our second order was filled at $22.60, remember we were trying to get it at $22.40, so we paid a little bit more for it. But that way we were sure to get it filled. Now when it is time to close that option, close that position. You click on trade, and it brings up the order window.

We do not want to buy to open, we want to sell to close. So we want to sell our option, and we would not turn right around and sell it after buying it. But let us say it is now a month or two later and we feel like we should sell our option, maybe we have got a nice profit on it already, we do not have to wait until the expiration, and we are going to sell it at the market, check our order, we are going to collect $2,250, and we are done.

Check the order status and you can see that we sold the option at $22.50, and we are out. So we lost $.10 on this transaction, because we did it within a few minutes of each other, and that is to be expected with options, but I just wanted to show you how easy it is to buy an option and once you do, how easy it is to sell it.

This concludes basic options fundamentals.