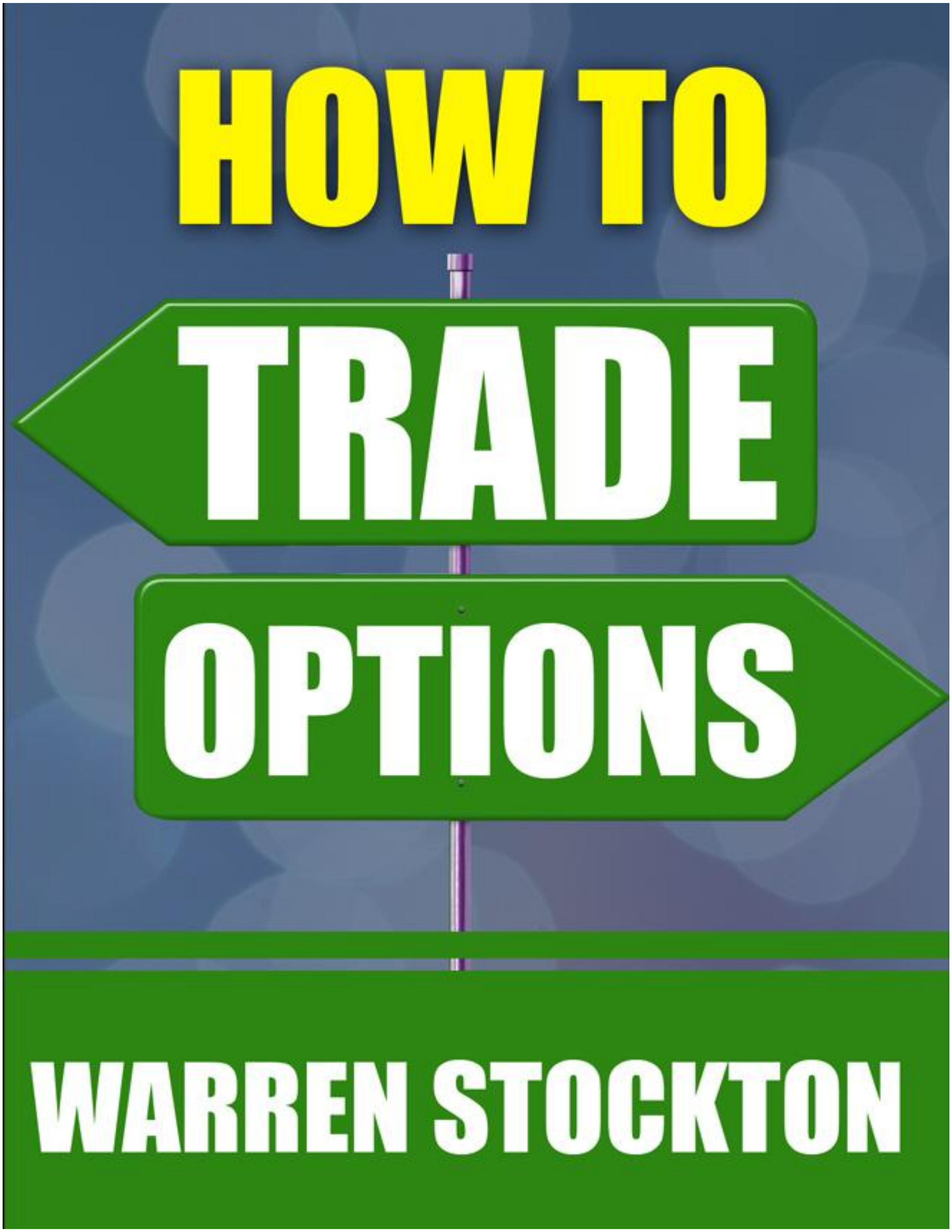
HOW TO
TRADE
OPTIONS
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Contents

OPTIONS BASICS AND RISK INTRODUCED

In the world of investing, risk assessment is everything. If you are looking into buying stock options, you must realize first that while trading options can be one of the most rewarding investment ventures, it is also one of the riskiest solutions.

This is not said to deter you from seeking out this wonderful opportunity, but instead to make sure you are educated and fully aware of all aspects of options trading.

So, the first order of business when learning how to trade options and determining if they fit your investment portfolio needs is to gain a good understanding of what stock options are in the investment world and the terminology behind them.

When you are trading options, you are entering into a contract for a specified amount of time that allows you to either buy or sell a specific security at the strike price. You can set the contract time yourself for a short period of time or even a long period of time, such as a couple of years. Now, instead of inundating you with options examples, and assuming that you understand the terminology, let's take a look at options first.

There are different types of stock options, but they fall into two main standard categories: call options and put options.

Call Options

When you purchase a share of stock, you are purchasing one share. When it comes to buying call options, each contract represents the right to purchase 100 shares. Now, while this gives you the right to purchase the 100 shares, you are under no obligation to make the purchase. As you put this terminology under your belt, think about call options as you are buying your right to call stock away from a person.

Put Options

When purchasing put options, it's about selling stock and not buying stock. Each put contract purchased allows you to sell 100 shares of a specified stock within a specified time frame. This is again a right and not an obligation. Just like with call options where you are calling stock away from a person, put options are easily remembered as the right to put stock to a person.

A Closer Look At Risk

Before delving further into the world of options terminology, let's take a closer look at risk. There are going to be commissions paid on each contract purchased just like when you are purchasing securities in the traditional manner. Since you are buying the right to purchase or sell securities at a later date under no obligation, the simplest loss could be the commissions you pay without exercising your options. Therefore, this should be your first lesson to understanding that your options calculations should be carefully considered and each trade should be respected just as if you were obligated.

When purchasing stock options, you are going to pay the base commission, plus you are going to pay a fee per contract. While the extra fee per contract is minimal, it represents an extra cost and should be understood and weighed.

Purchasing stock options on margin is another type of risk when it comes to options investing. Margin investing is available for traditional securities as well, and perhaps you have already tried this route. It is a great way to gain leverage with your investments, but it can also be extremely risky. In fact, some people let that leverage get to their head and end up losing their shirt.

When purchasing stock options on margin, you are first gaining leverage using money you don't have, and then you are further increasing your leverage with the options themselves. Obviously, the draw here is the potential, but while greater risk can mean greater reward, it can also lead you down a completely different path.

OPTIONS TERMINOLOGY AND SCENARIOS

Understanding Long And Short

Long and short are two terms regarding the types of positions you take when purchasing stock options. Do not confuse long and short with time; instead it refers to ownership. You are purchasing put or call options, which translates to you being long regarding a specific security.

When you are short regarding a specific security, it means you have sold a stock option without owning the stock. Now isn't that intriguing! You can sell a stock you don't own? Yes. Just don't get into trouble thinking its easy money. Remember, options should be treated with the same respect that buying securities traditionally demands.

In The Money

When dealing with call options, "in the money" is a phrase you are going to hear. You are in the money with a call option when it gives you the right to purchase the stock at a value lower than the current price of the security on the open market. For example, you have one call option to buy stock "X" at 18.25 per share, and the stock opens up on the market one day for 18.95 a share. This price difference represents your call option being in the money. Of course, this means that your option has worked out and that you should certainly exercise your right to buy the stock. In the money represents exactly what it sounds like.

Out Of The Money

Now, on the flip side of being in the money is where things can get troubling. If the prediction contained within your call option doesn't materialize to the point it allows you to purchase the security for less than its selling at market price, then you are not in the money. You lose money on the options contract and are back at square one.

With put options, in the money is all about selling the stock. Naturally, you're going to be in the money when you can sell the stock at the strike price chosen in your put option contract for more money than you would make selling the stock on the open market at current price.

While it is great to end up in the money, it is just as easy to end up out of the money. People get googly eyes when looking at the amount of money that can be made with options. After all, each contract represents 100 shares. There are many ways to minimize the investment capital needed while putting the risk potential through the roof. This can especially be detrimental to novice investors, who can quickly find themselves in over their head.

That being said, it's best when starting out purchasing options contracts to take things slowly. In other words, you might not want to leverage a put contract to the point you're trying to sell a stock you don't even own. Instead, the best thing to do is to dip your toes in the water by purchasing a single contract that is leveraged against securities you own and without a ton of risk. This helps you utilize your knowledge to get experience under your belt before you further immerse yourself in the world of options.

Time And Options Contracts

Time was previously mentioned in regards to options contracts. Time affords you certain luxuries with options contracts, but again its all about balance. The more time you choose in regards to your options contracts, the more you are going to have to pay for each contract. Any platform you choose when trading is going to let you look at different scenarios.

For example, you would be able to see how much you would have to pay for a call option contract for a specific security at a strike price for six months. After taking a look at the price and doing some math, perhaps you realize the company's annual meeting and first quarter reporting is nine months away.

You take a look at the nine month contract price, and you decide this is where your risk lies. Any scenario could play out, and this is only an example.

You should never purchase an options contract if you're not fully committed to pulling the trigger on a security in the open market at some point. This may sound basic enough, but newbie investors make this mistake quite often. Purchasing securities on the open market demands a certain respect and readiness; however, some people approach options like they approach the lottery. This is a big mistake.

Taking on the stock market as an investor is going to have its ups and downs. You are going to win some, and you are going to lose some. That being said, with sound financial decisions, you have the upside potential of a nice return that beats any other investment vehicle. At the same time you don't want to lose your shirt buying and selling options contracts, you also don't want to simply offset your returns. For example, you have a solid 8 percent return throughout the year on your standard portfolio, but little options slip-ups that never are in the money end up stripping that return down or even put you in the negative.

Using Options To Avoid Risk

Take a look at another stock options contract scenario. Say you own 1,000 shares of stock "X." You are a firm believer in that company's ability to outperform the market, but you are also aware that its never a sure deal. You decide to lower your risk by purchasing 10 put options contracts for this stock, allowing you to sell the stock at the strike price vs the market price if something doesn't go your way. This is what is known as writing a covered call. You can also take care of this all at once by purchasing or buying a stock and selling an option simultaneously.

As you can see, while certain stock options plays can come with extra risk, they can also be executed to help you avoid extra risk. Naturally, greater risk means greater reward, so you don't necessarily want to offset each stock purchase with backup call or put options.

If you are the owner of an option and find yourself in the money, you are going to be exercising your option. Therefore, an option seller of "writer" is going to be obligated to carry out the option, which translates to buying or selling the security at the strike price. With this scenario explained, you can see how you need to pay attention to any obligations!

Certainly, there are ways to play stock market options without obligations as explained previously. However, obligations do abound. For instance, you sell three options contracts concerning securities you already own. The strike price comes into play, and someone is able to take your securities right out from under you at a discount. They gain money and you lose money. The best thing for you to do when starting out with options is to not find yourself obligated to anything. Test out the stock options contracts available to you that provide you with an option but not an obligation.

Implied Volatility

When assessing your risk in order to purchase regular securities, you're going to do your homework. You're going to look at charts and data, and you're going to see what the analysts have to say. The same goes for buying stock options contracts, and another term you need to be familiar with is implied volatility.

Implied volatility is essentially a forecasting of a stock's volatility based on the options pricing model. While there is no guarantee that this forecasting is accurate, you should definitely use this piece of the puzzle when weighing your decisions regarding purchasing options.

THE CHALLENGE

By the end of this chapter, you are going to be challenged to begin trading options, albeit in a virtual setting. It is time to put your knowledge to the test and gain some experience!

Be Realistic

When looking at options contracts, do not allow yourself to get caught up in a move that looks too good to be true. You are asking to get burned. One way to gain an in-depth understanding of this is to look at the fluctuations in prices of options in regards to earnings announcements and other real time data or occurrences involving companies. You're going to realize different patterns that traders take regarding options plays, and you're going to get a better understanding of how their reactions drive the prices of options contracts up and down.

You have taken the time to read through this book to get a better understanding of trading options. Options are not intended to be tricky, but they are more complex than the regular buying and selling of securities. That being said, it is best if you start with a virtual trading account.

You can make a few different types of options plays with your virtual trading account, and you can see how they play out in real time. Win or lose, it's virtual money, and you have some experience under your belt. This book has provided you with enough information to get you started, but there is more terminology and scenarios that can play out.

You might hear people using terms that have not yet been discussed. For instance, when measuring expected performance of options, seasoned investors often utilize the Greek language. Continue to soak up new information, but focus primarily on the basics discussed in this book so that you're not overwhelmed.

One Greek letter that you need to know is "Delta." The delta of an option is going to be the expected volatility and is based on each dollar of the security. For example, if the delta of an option is 25 cents, this means that for each dollar increase in the price of the security, the option price will also raise 25 cents. Knowing delta can help you further figure out options plays and get your bearings on price volatility.

For your last lesson prior to getting started, you need to understand how delta can also help you assess risk. It's not a sure thing, but it does serve as a gauge. In the previous paragraph, the scenario was used giving a delta of an option at 25 cents. Roughly translate this number to probability, meaning you can estimate there is a 25 percent chance of you winding up in the money. A good rule of thumb is to remember that the delta for out of the money stock options is going to be below .50. Furthermore, when it comes to put options, delta is expressed in negative numbers.

That number should represent a truly humbling realization. It makes buying and selling options contracts seem more like day trading instead of a buy and hold strategy. However, buying and selling options presents many different scenarios that fall in between, and some of them have been explained to you.

The rest of the lingo can be learned later as you gain experience. Take it slow, and your challenge is to begin virtually trading on the options market so that you can move into buying and selling options contract on the open market. You are also going to need to begin assessing your portfolio specifically to see how you can use options for your benefit.

Are you going to write a few covered calls regarding stocks you already own? Do you plan to buy securities and want to purchase shares and sell an option contract on the side to minimize risk? Explore your moves virtually and prepare your plan.