Options Are Easy!
Stop Stressing And Learn What Options Can Do For You!

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If you’re new to options, or if you’d just like a quick refresher, this special options overview is for you.

What follows is not an extensive or elaborate options training program. This report covers the essential basics of option trading, which is all we really need to get started. **It’s simply not necessary to be a sophisticated institutional trader to make money with options.** While there is a minimum level of comprehension that’s required to implement successful strategies, fortunately, we can cover that material quickly and pain free.

[For more extensive options educational resources and tutorials, you can always visit www.cboe.com.]

The important takeaway here is that option trading is nowhere near as complicated as a lot of people think.

Sure, there are some pretty complex strategies and uses out there, but do you really need to be an institutional trader in order to benefit from options?

Of course not.

And the key word here is “benefit.”

Options have changed my own life – they’ve improved my own investing results and helped me to accelerate the wealth building process while also lowering my own overall long term risk.

And the strategies I employ? They simply aren’t that complicated. In fact, I can teach you everything you need to know to understand the basics of options once and for all and give you the foundation that I believe you can then begin building on in order to improve your own investing results.

The Essential Way to View Options

Before we dive into our quick overview of the nuts and bolts of options and option trading, you will be well served to take a step back and consider the fundamental purpose and function of options.
By taking a look at the structural purpose and function of option trading, we can cut through all the fog and mystery that seem to shroud options in the popular imagination. This approach to options will help you to maintain your perspective and prevent you from getting too overwhelmed by the minutiae of options.

Here then is the key concept to remember when dealing with options—**options are always about the trading (i.e. buying or selling) of risk**. Think of options as a risk-reward dial. The more you turn it one way, the more both your potential reward and risk level increases. And the more you turn it the other way, the safer your portfolio becomes but the more you limit your potential gains.

If you understand only one concept about options, understand this—options allow you to outsource risk to a third party in exchange for cash and/or some portion of your potential profits, and conversely, options also allow you to assume someone else’s risk in exchange for cash and/or a portion of their profits.

If you “get” this, options and option trading strategies will never be mysterious and confusing and intimidating.

Having said all that, here then is the basic overview of options and all you really need to know in order to use options (and specifically to your long term investing advantage if you trade the way I do) . . .

**Overview**

There are some basic facts related to stock options that are important to understand:

- Each option contract (either a call or a put) represents 100 shares of an underlying stock or security (with rare exceptions)
- Each option contract has an expiration month
- The actual expiration date each month is set for the 3rd Friday (technically the Saturday following the 3rd Friday of each month but because markets are closed on weekends, for all practical purposes, expiration is that Friday)
- In the United States markets, there are now also options on certain stocks that expire on a weekly basis, but for the sake of this report, we’ll focus on the regular monthly options
And the quickest and easiest way to understand stock options is to explore them in terms of four different contrasts:

1. **Calls vs. Puts**
2. **Long vs. Short (buying vs. selling/writing)**
3. **Buy or Sell to Open vs. Buy or Sell to Close**
4. **In the Money (ITM) vs. Out of the Money (OTM)**

#1. Calls vs. Puts

There are basically only two types of options—**calls and puts**:

- A **call option** gives the holder the right but not the obligation to buy 100 shares of a certain stock (underlying security) at a certain price (strike price) by a certain date (expiration date)
- A **put option** gives the holder the right but not the obligation to sell 100 shares of a certain stock (underlying security) at a certain price (strike price) by a certain date (expiration date)

So what does that actually mean? Let’s look at a couple of examples by way of illustration . . .

**Call Example**

If you had reason to believe that the XYZ Zipper Company was undervalued and would rise in price in the short term, you could purchase a call option. If the stock’s share price moves higher as you anticipate prior to the expiration date, you would be able to capitalize on the move at a much higher rate than if you’d simply bought the shares outright.

Let’s suppose that XYZ is trading at $25/share. You purchase a call option with a strike price of $30 and an expiration date one month out. You purchase the contract for $1.25 (and since each contract represents 100 shares, you multiply the $1.25 by 100 to arrive at an actual cost of $125, excluding commissions).

You now have the right, but not the obligation, to buy 100 shares of XYZ at any time between now and expiration for $30/share. When the stock is trading at $25/share, there’s no incentive
to purchase the stock (i.e. exercise the call option). But if the stock moves ahead to $35/share, it’s a different story.

You could exercise the option, and purchase those 100 shares at the $30 strike price for an additional $3000 (excluding commissions). Factoring in the $125 you already paid for the call, your total cost would be $3125, or $31.25 for each share. With the stock now trading at $35/share, that gives you a $375 net gain.

It’s unlikely that you would actually exercise the option. In the above example, the call option you originally purchased for $1.25 would increase in value as the stock price rose. Although there are different factors involved in the pricing of options, the very short version is that you could simply sell the call option back and more or less make the same $375 gain without having to go through all the trouble of owning and then selling the stock.

**Put Example**

Suppose, however, you already owned 100 shares of The XYZ Zipper Company and it was trading for $40/share. If you believed the stock was at risk of falling in the near term, you could purchase a put option to give yourself some protection.

Let’s suppose that you decided to purchase a put option expiring in one month with a $35 strike price for $1 (multiplied by 100 shares = $100). You now have the right, but not the obligation, to sell your stock for $35/share between now and the expiration date.

If the stock stays above $35/share, your put expires worthless and you keep your stock, and you’re out the $100. If, however, the stock does take a dive, your put guarantees you’ll still be able to get out at the strike price of $35/share no matter how low the stock itself trades.

The above is an example of a married put, a hedging strategy designed to protect your holdings from big declines. But most buyers of puts do not actually own the underlying stock, and, in fact, there is no requirement that you must do so. **Most buyers of puts are simply betting that a stock will fall in price** because, all else being equal, when a stock tumbles, the value of its corresponding puts will increase.

*See Table 1 on the next page:*

#2. Long vs. Short (Buying vs. Selling/Writing)

The next contrast to understand is Long vs. Short. In the Calls vs. Puts section above, we were long in both examples.

- Long an option simply means you purchased it.
- Short an option, on the other hand, is an option contract which you either sold or wrote. Either term is correct.

A long option position is fairly easy to grasp, but a short option position can be a little confusing at first. Unlike shorting stocks, it doesn’t actually represent a bet on your part that a stock is going to go down. You profit on a short put position, in fact, when the stock trades higher or, at the very least, stays flat.

Let’s look at a couple of quick examples to illustrate how a short option position works and why someone would want to set one up . . .

Example #1 – Short Call

The first example we’ll use is a covered call. Imagine that you’re the lucky owner of 100 shares of The XYZ Zipper Company which is trading at $35/share. You don’t necessarily want to sell the shares at the current price, and you don’t think the stock is going to be moving significantly
higher any time soon. But it would be nice if you could figure out a way to squeeze a little extra profit out of your position.

You decide to sell a call option that expires in 2 months at the $40 strike price for $1.50. As explained in previous examples, that equates to $150 excluding commissions. **By selling the call, or writing it, you have essentially given someone else the right to purchase your stock at any point over the next two months for $40/share. In exchange, you’ve received $150 in cash.**

If the stock is trading below $40/share at expiration, the call option you sold expires worthless, you net the $150 in profit, and you are free to write another covered call if you so choose.

And if the stock is trading significantly higher, say $50/share? Since you were obligated to sell at $40/share, you missed out on $10/share in capital gains. In this example, you do still get a $5/share gain (selling the $35 stock for $40/share) and the original $150 premium you collected is also yours to keep.

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**Example #2 – Short Put**

Here’s an example of a short put, or one that you sold or wrote instead of one you purchased.

Assume that The XYZ Zipper Company is trading at $40/share. You currently own no shares but would like to buy some if you could get them for $35/share.

You decide to sell, or write, a put option that expires in two months with a $35 strike price. In exchange, you receive a $1.50 premium ($1.50 x 100 shares = $150). If the stock fails to trade below the $35/share price, the put expires worthless and you miss out on the chance to own the shares, but the $150 cash you receive is a nice compensation.

If the stock is trading below $35/share at expiration, you will be obligated to buy 100 shares for $3500. That’s true whether the stock is trading at $34/share or $2/share. The $150 in premium you received when you wrote the put is yours to keep and functions as a limited buffer to the downside, in effect lowering your cost basis on the stock from $35/share to $33.50/share.
#3. Buy (Sell) To Open vs. Buy (Sell) To Close

A third area of contrast or distinction is simply between opening an options position and closing one out. As we’ve already seen, whether we’re talking about a call or a put, a long position is one you’ve purchased and a short position is one you’ve sold.

It’s pretty straightforward and makes sense then that when you initially purchase a long position, you do so via a process of BUY TO OPEN. Likewise, if you close out that long position prior to expiration, it’s called SELL TO CLOSE.

The rationale and process is the same for short option positions as well. When you initiate one (i.e. you sell or write a call or put), it’s called SELL TO OPEN, and if you close it prior to expiration, it’s called BUY TO CLOSE.

It’s essential to understand BUYING/SELLING TO OPEN vs. BUYING/SELLING TO CLOSE, especially when placing an order. Imagine if you held a long put option and you wanted to sell it. You must designate it as a SELL TO CLOSE order. If you accidentally submitted the order as a SELL TO OPEN, not only do you keep the long put, now you’ve got a second position, a short put. Correcting that mistake generates unnecessary and costly commissions.

#4. In The Money (ITM) vs. Out Of The Money (OTM)

The fourth and final fundamental contrast is the difference between what’s considered in the money and what’s considered out of the money. Those distinctions differ depending on whether you’re talking about calls or whether you’re talking about puts, although it doesn’t matter whether your positions are long or short:

- **A call option is in the money when the strike price is below the stock’s share price,** and it’s out of the money when the strike price is above the share price. In the money call positions are automatically exercised upon expiration.

- **A put option is in the money when the strike price is above the stock’s share price,** and it’s out of the money when the strike price is below the share price. As with calls, in the money put positions are automatically exercised upon expiration.

And for those who prefer a table:
Table 2 – ITM vs. OTM

<table>
<thead>
<tr>
<th>TYPE</th>
<th>In the Money</th>
<th>Out of the Money</th>
</tr>
</thead>
<tbody>
<tr>
<td>CALL</td>
<td>Strike Price &lt; Share Price</td>
<td>Strike Price &gt; Share Price</td>
</tr>
<tr>
<td>PUT</td>
<td>Strike Price &gt; Share Price</td>
<td>Strike Price &lt; Share Price</td>
</tr>
</tbody>
</table>

And, I imagine you might be asking, so what? What’s the significance of this and how does this impact you?

To really simplify it and bring it home, just keep this in mind:

- If you’re on the **long side**, in the money is good (the trade’s going your way)
- If you’re on the **short side**, in the money is bad (the trade’s NOT going your way)

It’s one of those distinctions that’s primarily semantic when you’re processing it theoretically. But you’ll definitely “get it” in a real world trading situation, and usually very quickly.

## Volatility and Pricing

Finally, it’s important to understand the elements that make up the price of an individual option. At the most general level, an option is comprised of *intrinsic* and *extrinsic* value.

**Intrinsic Value** is the amount by which an option is in the money. If XYZ is trading at $25/share, and you’re holding a long call with a $20 strike price, the option has $5 of intrinsic value. Likewise, in the same scenario, if you hold a long put with a $30 strike price, it too has $5 of intrinsic value.

If an option is not in the money, then the option contains no intrinsic value whatsoever.

The *Extrinsic Value* of an option, logically enough, is everything else that goes into the pricing of an option. It can be also be seen as *time value* insomuch that once an option expires (i.e. runs out of time), that option’s remaining value—if it has any—will be limited to its intrinsic value.

Related to extrinsic value are the Option Greeks, or the mathematical formulas that measure specific risks to the value of the option.

Table 3 on the next page details those individual Greeks . . .
**TABLE 3 – Option Greeks Defined**

<table>
<thead>
<tr>
<th>GREEK</th>
<th>RISK MEASURED</th>
<th>DEFINITION</th>
</tr>
</thead>
<tbody>
<tr>
<td>Delta</td>
<td>Sensitivity to price change in the underlying security</td>
<td>The amount of the value an option will change for each $1 change in the underlying security</td>
</tr>
<tr>
<td>Gamma</td>
<td>Sensitivity of the delta to price change in the underlying security</td>
<td>The amount of change in the delta value of an option for each $1 change in the underlying security</td>
</tr>
<tr>
<td>Theta</td>
<td>Sensitivity to time</td>
<td>The amount of daily time decay in the price of the option assuming nothing else changes</td>
</tr>
<tr>
<td>Vega</td>
<td>Sensitivity to volatility changes</td>
<td>The amount of change to the option for each percentage unit change in the underlying security's volatility</td>
</tr>
<tr>
<td>Rho</td>
<td>Sensitivity to interest rates</td>
<td>The amount of change to the option for each percentage unit change in interest rates</td>
</tr>
</tbody>
</table>

Having a basic understanding of the Option Greeks is helpful in that you can get a pretty good idea how the value of the option will be impacted by changes to any number of factors.

*Historical volatility* measures how much the underlying stock’s price has fluctuated, on a percentage basis, over the previous year.

*Implied volatility (IV)*, in contrast, is just that—the expected annual rate of fluctuation in the underlying stock’s price, on a percentage basis, implied by the price of the option. For options expiring in less than one year, that figure can be divided or prorated accordingly to determine the expected price fluctuation over the life of the option.

Any options-friendly broker will calculate an option’s IV as part of an extended quote. There are also online calculators available.

And finally, along with historical volatility, any number of impending factors will be baked into the implied volatility and consequently the price of an option—an upcoming earnings report, an impending court ruling or FDA announcement, dividend distribution, and so on.
Conclusion

There you go – you now have sound fundamental understanding of options and how they work.

And, as promised, they really aren’t all that complex.

Are there easier concepts to grasp? Probably. But option trading is definitely not brain surgery.

And even if you still find yourself a little confused on certain aspects of options, don’t stress. There won’t be a test on the material, you can always review this material again at your convenience, and besides – no matter what it is we seek to learn, we never truly begin to learn something until we take action and begin implementing what we’ve learned.

Or said another way, intellectual knowledge is like unlocking a door. Actual first hand, direct experience is like opening the door and then walking through it.

Anyway, I really hope this has helped. I’ve enjoyed putting this material together in a concise and useful form.

If you have any feedback or additional questions, feel free to send me a message via my contact form at the Great Option Trading Strategies at:

http://www.great-option-trading-strategies.com/contact.html

Take care,

Brad Castro