

Trading Options

Trading stock options can be complex and theoretically risky for the uninitiated. In this article, we delve into trading options so whether you are a novice or trading options for a living, you will understand basic option trading strategies.

Options Trading Basics

What is options' trading?

A stock option is a contract between two parties that grants one party (the option buyer) the right to either buy (call option) or sell (put option) a stock at a fixed price (strike price) from another party (the option seller) on or before a pre-determined date. Stock options are typically issued with a contract size of 100 shares.

Options can be traded to speculate on the movement of a particular stock, or in conjunction with stocks that you own to “hedge.” Hedging is a strategy to protect against a downturn in value.

Basic Options Strategies Allow You to Express Your Outlook

Whether you are bearish (negative viewpoint) or bullish (positive viewpoint), different strategies allow you to express that viewpoint whether buying or selling. Here are some basic plays.

Buying Calls – The investor expresses a bullish outlook by buying a call option. To profit the investor must be right about the positive movement of the stock, the timeframe and the amount of positive movement.

Selling Calls – The investor expresses a bearish outlook by selling a call option. They are obligated to sell the stock at a pre-negotiated price. This is a risky strategy for inexperienced investors with upside limited to the premium received and the downside virtually unlimited.

Buying Puts- The investor expresses a bearish outlook by buying a put option. To profit, they must be right about the negative direction, the amount of movement and the timeframe.

Selling Puts – The investor expresses a bullish outlook by selling a put option. Profit is limited to the premium received, while the downside can increase until a stock is worthless.

An options trading example:

Nike's announced a major clothing and shoe line campaign centered on a popular football player. It has invested heavily on the player's reputation and the line is being released with a big marketing spend next quarter. Prior to the release, the athlete hits the news cycle after being arrested on serious felony charges. You believe this will hurt Nike's sales over the next quarter and have a negative impact on the stock price. Your bearish opinion leads you to buy a put option (an option to sell).

Nike is currently trading at \$60 and you believe that with heavy investment in the project it will have a \$10 impact on the stock price over the next 60 days. To capitalize you buy a 2 month put option to sell Nike stock at \$58 per share for \$1.50 per share. The option will cost you \$150 (\$1.50 times 100 shares).

As expected, the news drains the price of Nike stock and it falls to \$50 per share, which puts your option contract "in the money." You can exercise the contract and realize a net profit of \$650 (\$8 profit per share less your initial investment of \$150), or sell the contract for a similar profit.

Benefits of Using Options vs. Equities

As you can see by the previous option trading example, there are several benefits when you trade options vs. directly buying equities. Two key benefits are cost efficiency and enhanced trading strategies.

Cost Efficiency

If you really like a stock that is trading at \$80, taking a 500 share position in the stock will cost \$40,000. The same 500 share position using options allows the investor to replicate the position, usually for a fraction of the price. An option trade can mimic a position, yet free up capital to diversify elsewhere.

Enhanced Trading Strategies

As illustrated above the ability to capitalize on a negative outlook can make a difference. In the Nike example, our investor was able to capitalize on his bearish outlook. Recent government regulations have put restrictions on short sales particularly to curb a precipitous fall in a company in one day. There is no restriction against buying puts to play the downside of an investment, which makes options highly effective.

Risks Involved in Options Trading

One of the great attractions to investing in stock options is the ability to take a large position in a stock for a fraction of the investment of a full position. This is known as leverage, and it can greatly enhance bottom line returns. This ability to leverage a position however comes with a price tag.

Options contracts have limited life expectancies because of expiration dates. As the expiration date of the option approaches, if the stock does not move in a favorable direction, the contract will expire “out of the money,” and the entire stake is lost. It is estimated that upwards of 60% or more of contracts expire worthless. Some strategies such as short calls come with unlimited risk. When learning how to do option trading, understanding these risks is vital.

What to Look For When Choosing an Options Broker

If you are a novice investor and need options trading explained in a straightforward manner, finding the right options broker is vital. Price is one factor in finding a good broker, but not the only factor. Timeliness of trading, a good online interface and advice if needed are all additional elements that should be considered.