Call Options

On the surface, call options may appear to be a rather simple investment vehicle, however, these products have a great deal of complexity. In this article where you have a call option explained, you will gain a better understanding of how to take advantage of this useful trading tool.

What are Call Options?

A call option contract is an agreement between two parties that grants one party (the option buyer) the right to buy a stock at a fixed price (strike price) from another party (the option seller) on or before a pre-determined date (expiration date). Stock options are typically issued with a contract size of 100 shares. As an option trader you can function as either a buyer or seller depending on your outlook on the underlying security.

How to Determine Call Option Value

Now that we have a call option definition and a basic understanding of how they work, it is important understand how to determine a call option price. Call option pricing or the call option premium is affected by two factors, the intrinsic value and time value of the contract. Determining the intrinsic value is the first building block in determining an options value.

Moneyness is an options trading term that represents the underlying or intrinsic value of an option at a moment in time. Options can be described as “in the money,” “out of the money,” or “at the money.”

When a call option is “in the money” this means that if a contract is executed immediately, it will provide a profit. “Out of the money” means the contract has no intrinsic value, meaning it cannot be immediately sold for a profit, and “at the money" means that the contract is currently in a break-even state.

To calculate the intrinsic value of an option contract we would simply take the market price of the stock and subtract the strike price of our option. For example if the market price of our stock is $80 and the strike price of our call option is $75, the intrinsic value of our option would be $5.

The time value on the other hand is calculated by subtracting the intrinsic value from the total option premium. Let’s take a look at a call option example to further illustrate the point.

It’s late February and John owns a General Electric (GE) March 15 call option. The option currently is selling at a premium of $12 and GE is currently trading at $25 per share. To determine the components of the pricing we first calculate the intrinsic value

which is $10 ($25 market price less the strike price of on our option of $15). We then subtract the intrinsic value from the option premium and we get a time value of $2 per share.

How Do Expiration Dates Affect Call Option Pricing

Option expiration dates also affect our option pricing. As a general rule of thumb, the longer the timeframe in which an option has to maturity, the greater the time value option premium. Assuming all things are equal, an option for a stock that has 1 year to maturity has a greater likelihood of reaching the strike price than an option for the same stock that has 1 month to maturity.