LEARNING THE LANGUAGE OF OPTIONS: A REFRESHER COURSE – PART 6

By Nick Katiforis

In last week's article *Learning the Language of Options* we outlined some other key concepts that are unique to options. This week we look at the components of an option order.

Once you have chosen an option you need to be able to transmit a clear and unambiguous order into the market that will be understood without confusion and efficiently acted on. There is some basic information that is required to transmit a valid option order. This includes:

- ➢ If the order is to buy or sell
- ➢ Number of option contracts
- ➢ Name of underlying stock
- ➢ Stock or option code
- ➢ Expiry month and year
- ➢ Strike price or prices
- ➢ If the option is a call or put
- ➢ Price in option premium per share
- ➢ Limit or market order.
  Here's an example below:

This example shows almost all the elements that go into a valid option order. Let's go through the example in a little more detail:

- ➢ *Buy or sell*

In this case it is a buy order. If this is an opening order then it is a straight call buying strategy. If it were an order to sell as an opening order then it would be an option writing strategy.

- ➢ *Number of option contracts*

In the example the order is to buy 10 contracts. Remember that each option contract represents 100 CBA shares which at $1.00 per share mean an outlay of $100 per option. The purchase is for 10 contracts so that means the total outlay will be $1,000.

- ➢ *Stock name or stock code*

CBA is the three-letter stock code generated by the relevant exchange (in this case ASX).

➢ *Expiry month*

The month designated in the example is June. The year is not required unless you were specifying the following year June options instead of the current year.

➢ *Strike price*

The strike price in the example is on an Australian option market so it is denoted in cents. In the example the strike price is 50.00 which is $50.

➢ *Call or put option*

In the example the option is a call option.

➢ *Option price*

In the example the price specified is 100. This price refers to the price per option which, being an Australian option, is designated in cents per share so it is 100 cents or $1.00 per share. US options would be written as 1.00. The price of $1.00 means that the person placing the order is prepared to pay no more than $1.00 per share, however, if a lower price than $1.00 can be achieved then it will be.

Limit orders and market orders

In the above example a price is specified for a buy limit order. Limit orders to sell instead of buy mean you wish to sell at the price specified or higher. Buy limit orders are placed if you don't wish to pay more than a specified price. It may mean that you miss out on the order being filled if the price doesn't reach your limit. You can, however, alter the price of your order with your broker in order to get your order filled. Some brokers also accept limit orders with discretion which means that you can specify a limit but are prepared to pay a certain amount more if required. For example, the order could be to buy at $1.00 with 5 cents discretion which means that you could pay up to $1.05 if required. The alternative to a limit order is a market order. It is also known as an order at best. A market order means that you want your order filled and you are prepared to pay or receive whatever price is available at the time on the market. There is a fair degree of urgency with this order so you wouldn't expect the broker to hang around long before getting the order completed. A good broker will be a tremendous help in getting you the best price. For example, in Australia, brokers who are Market Participants of the ASX can get quote requests directly from market makers which will often result in a much tighter spread and often as a result means a better price is achieved. Market orders are preferable as they ensure that you are in the market. There is nothing more frustrating than missing a good move that you have anticipated because you didn't want to pay a few cents more for an option.

Reducing risk for option traders through spread trading

Spread trading refers to trading in more than one option series. For example, simultaneously buying a long-dated call option and writing a short-dated call is a spread or combination. Another example is to replace a call option that you had bought and which was nearing expiry, with a longer-dated call option of the same strike. The problem with transacting the two options trades (legs) separately is that it puts you at a greater risk than if you transacted both legs of the trade together.

For example, in a fast-moving market you may only be able to transact one leg of the spread and not the other, which places you at a greater risk because you are unhedged.

Market mechanisms are in place for Australian and US options that allow for multiple legs that are part of a spread to be transacted together. Instead of pricing the individual legs separately it allows for the pricing and execution of a combined spread price. Under these systems, as the share price moves, an automatic adjustment is made to the individual leg prices to maintain the required overall spread price. This reduces risk greatly, particularly for more complicated spread strategies and it is a much more efficient and safer way to trade.

Measuring option sensitivities – The "Greeks"

If you have traded or read about options, then at some stage you will probably have come across the Greeks. The term Greeks refers to the delta, gamma, vega and theta of option positions. They provide a way to measure the sensitivity of an option's price against certain quantifiable factors that can impact on an option's value. It is not imperative that you know all the ins and outs of the Greeks, however many of the principles behind the strategies have an edge and so can be useful.

Delta

Delta tells you how much a given move in the share price will translate to that of the option price. It is measured as a figure between zero and 1 for call options and zero and -1 for put options. For example, a call option delta of 0.50 or 50 per cent means that a $1.00 move in the underlying share price will roughly translate into a 50 cent move in the option price. Delta is also used as a measure of theoretical probability of an option reaching its strike price at expiry. So again using a call option delta of 50 per cent would mean that the option has a 50 per cent chance of reaching its strike price at expiry. As a rough rule of thumb, a call option strike price that is close to where the current share price is will have a delta of around 0.50 or 50 per cent. Put options work the same way except they will be a negative figure. For example, an at the money put option will typically have a delta of -0.50. Delta doesn't remain static and instead changes as a result of changes in the underlying share price. A call option's delta will increase as the share price rises until it reaches 1 or 100 per cent at which time the option gains or losses at the same rate as the underlying share.

Gamma

Gamma is a measure of the speed of change of the delta as a result of a move in the underlying share price. In other words, it measures how fast the option delta is rising. It is always expressed as a positive number for both puts and calls. If the delta of an at the money call option is 0.50 or 50 per cent, and the gamma of the same option was 0.05 or 5 per cent, this would mean that for a $1.00 share price rise the call option will now have a delta of 0.55 or 55 per cent. We simply add the gamma figure (5 per cent) to the delta figure (50 per cent) to come up with a new delta figure of 55 per cent.

Vega

Vega is a measure of the amount that the option price will change as a result of a change in implied volatility. When implied volatility rises, the price of the option rises along with it. An option's vega measures how much that rise is for every one per cent rise in implied volatility. Vega is most sensitive when the option is at the money.

Theta

Theta is a measure of the amount of time decay that an option has on a daily basis, expressed in cents per day. It is negative for bought options and positive for written options. For example, if you bought a call option with a theta of -0.03 it means that the option will lose $0.03 in premium value per day. An option writer of the same option will have a positive theta of 0.03 which means that he or she will earn $0.03 per day in premium.
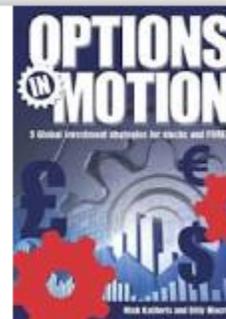

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Book by Billy Macris and Nick Katiforis

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