LEARNING THE LANGUAGE OF OPTIONS – A REFRESHER COURSE – PART 3

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In last week's article *Learning the Language of Options* we delved into the world of equity options by focusing on some of the key inputs and components that combine to make up a tradeable option. This week we continue the theme by outlining some other key concepts that are unique to options.

The link between the stock price and the option strike price

At the heart of options trading is the ability of an individual investor to be able to take a view of an underlying market in a leveraged way. The bottom line for directional traders is that they require the underlying share or market to move in the right direction for them to have a chance of being successful. There is therefore a strong link between the option and the underlying market or share that it is linked to. There are three terms used to describe where the strike price is situated in relation to the underlying share price. These are:

At the money
In the money
Out of the money

- **At the money (ATM)**

An option is said to be at the money when its strike price is equal to the current share price of the underlying share. For example, both a call option and a put option that have a 10.00 strike price are said to be at the money when the underlying share price is trading at or near $10.00.

- **In the money (ITM)**

A call option is said to be in the money when its strike price is below the current share price of the underlying share.

For example, a call option that has a 10.00 strike price is said to be in the money when the underlying share price is trading at $11.00.

A put option is said to be in the money when its strike price is above the current share price of the underlying share. For example, a put option that has a 10.00 strike price is said to be in the money when the underlying share price is at $9.00.

- **Out of the money (OTM)**

A call option is said to be out of the money when its strike price is above the current share price of the underlying share.

For example, a call option that has a 10.00 strike price is said to be out of the money when the underlying share price is trading at $9.00. A put option is said to be out of the money when its strike price is below the current share price of the underlying share.

For example, a put option that has a 10.00 strike price is said to be out of the money when the underlying share price is trading at $11.00.

Option intrinsic value and time value

The value that an option has is called its premium value. An option's premium value is made up of two components: intrinsic value and time value. Option intrinsic value and time value are both directly related to the concepts of an option being in the money, at the money and out of the money.

Intrinsic value – call option

This is the value attributable to a call option by the amount that the underlying share price is above the strike price. Only options that are in the money will have intrinsic value.

Example:

If a call option has a 10.00 strike price, and the underlying share price is $11.00, it will be in the money. The options intrinsic value will be the difference between $10.00 and $11.00 which is $1.00.

Intrinsic value – put option

The intrinsic value of a put option is the amount that the underlying share price is below the strike price.

Example:

If a put option has a 10.00 strike price, and the underlying share price is $9.00, it will be in the money. The option's intrinsic value will be the difference between $10.00 and $9.00 which is $1.00.

Time value – call and put options

Time value is the value attributable to a call and put option that isn't intrinsic value. The premium of at the money and out of the money options is made up only of time value. Premiums of in the money options can be made up of intrinsic and time value.

Example:

If a call option has a 10.00 strike price and the share price is at or below $10.00 the option premium will be made up entirely of time value.

If a put option has a 10.00 strike price and the share price is at or above $10.00 the option premium will be made up entirely of time value.

Next week we look at elements of the options market.