LEARNING THE LANGUAGE OF OPTIONS: A REFRESHER COURSE – PART 1

By Nick Katiforis

INVESTORS and professionals alike have been fascinated by options and drawn to them for decades. The reason for this deep level of appeal is because of the focused involvement that you can exert in the market through using them. Just as a blow torch concentrates a small flame to cut through the toughest metal, options can be similarly used to help investors deliver a concentrated return in any market environment.

The Use of Options in the Current Volatile Environment

S&P/ASX 200 (Source E*TRADE)

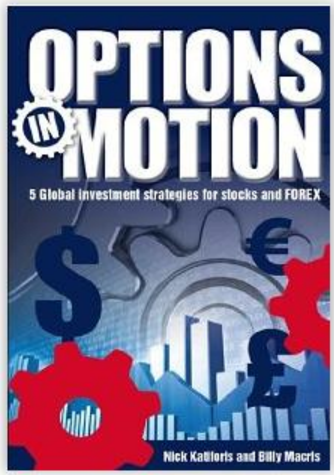
In this series we will be exploring options and in particular the way that they can be used to effectively manage a position through all the ups and downs that a market can (and usually will) throw at you as a private trader/investor. With everything going on in the world, just being involved in the markets presents a risk, so it is important to look beyond the simple buy/hold strategy of old as the new norm is now learning to live with the potential for volatility which is ever present.

This new environment can lead you to go one of two ways. The first is to be so paralysed by fear as to not do anything and in the process miss out on some great trading opportunities. The second and I think the smarter way, is to use tools such as options to address and overcome some of the risk related issues that traders now have to confront, on an almost daily basis.

Cutting through the Jargon

I pride myself on my ability to cut through all the jargon and get to the heart of the matter. Through experience I know that confusion is a killer when it comes to the trading. That is why I have pared down options to their core, focusing on the things that are important to you as a trader or investor, and leaving the rest for those wanting to peruse the many esoteric option text books that are available.

My aim is to help you not only get a better understanding of options by answering many of the questions about trading options, but to also get an insider's view on how to trade options on a practical level with the view of helping to stack to the odds in your favour when it comes to trading.



Many of the ideas in these articles have been taken from my most recent published book – ***Options in Motion – 5 Global Investment Strategies for Stocks and FOREX,*** which is based on many years of practical experience in the markets. In the following articles I talk exclusively about stock options however the same principles apply for FOREX, futures or commodities options.

LEARNING THE LANGUAGE OF OPTIONS

The four things that make up an exchange traded stock option. Exchange traded stock options are standardised contracts that allow a person to buy or sell a parcel of shares at a certain price by a certain date. These options are listed by an exchange such as the Australian Securities Exchange (ASX) in Australia, and the Chicago Board Options Exchange (CBOE) in the United States.
They use a standardised set of four inputs as follows:

1. Option Type: Call or Put
2. Underlying stock
3. Strike Price
4. Option Expiry Date

1. Option type: call and put

Call option: A call option gives the buyer the right to buy the underlying shares at an agreed upon price known as the strike price or exercise price. The call buyer takes a view on the underlying stock that is bullish. In other words he expects the share price to rise, which is why he buys a call option. It is another way of attempting to profit from an upward move in the share price rather than buying stock. The call option buyer is usually not interested in exercising his right to buy shares, but instead will attempt to sell his call option at a higher price than he bought it for to make a profit.

Put option: A put option gives the buyer the right to sell the underlying shares at an agreed upon price also known as the strike or exercise price. The put buyer takes a view on the underlying stock that is bearish. In other words he expects the share price to fall which is why he buys a put option. The put option buyer is usually not interested in exercising his right to sell shares, but instead will attempt to sell his put option at a higher price than he bought it for to make a profit.

2. The underlying stock
This is the underlying stock which the option is derived from. It is to this stock that the option is linked. The option price will fluctuate based on the movements of the underlying stock. This stock will be listed through an exchange such as the ASX in Australia and the CBOE in the United States. All stocks have a stock code that is unique to them. For example in Australia Telstra has a stock code of TLS.

3. Strike price
The strike price is the price at which the stock may be bought or sold by the option holder if he chooses to exercise his right. Each listed option, both calls and puts, have available many strike prices from which to choose. They are typically spaced at regular price intervals.

4. The expiry date of the option
Options have a fixed monthly expiry date (although weekly options are available for some US options) after which time they cease to exist. Up to that time the option can be bought or sold at the holder's discretion or exercised to buy or sell the underlying stock. There are various options available that have expiry dates that can extend several years into the future. Most options will have expiry dates of up to one year into the future, with the number of months available to trade becoming fewer after that time.

Next week we look at the six components that impact on the value of an option.

Nick Katiforis is the author of *Options in Motion – 5 Global investment strategies for stocks and FOREX.* Nick can be contacted by phone on +61 3 9667 1912 or via email at nick@halifaxonline.com.au.