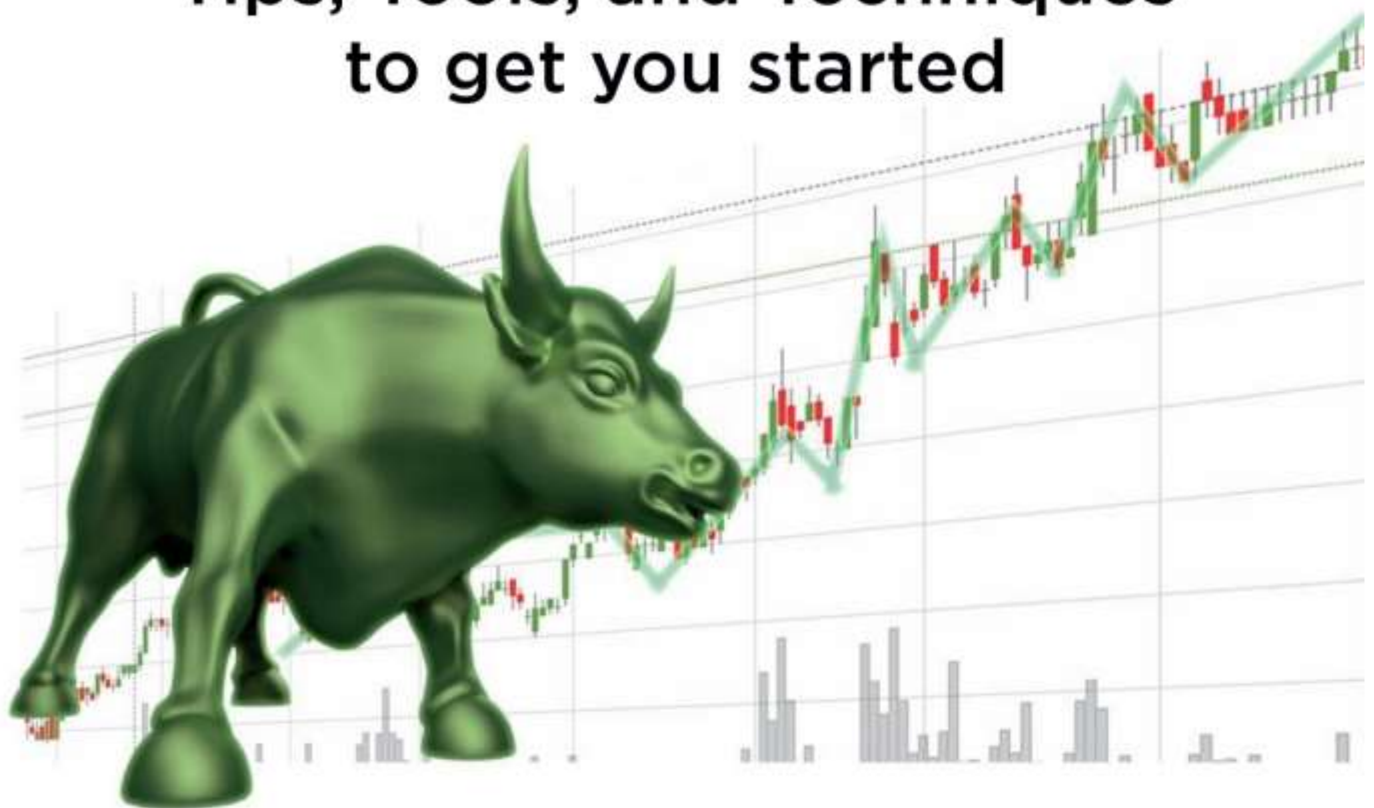
OPTIONS BASICS

Tips, Tools, and Techniques to get you started



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The options contract

We use the term "option contract" for a reason. Options transaction is literally a binding contract between the buyer and seller. Contracts come in two forms: puts and calls.

A call option gives the buyer the right, but not the obligation, to buy shares in a security at a specified price (known as the strike price) within a given time frame that ends on a specific date (which we call the expiration date).

On the other side of the trade, the seller of the call option has the obligation to sell said security at the specified strike price within the time frame. In a standard option, each contract represents 100 shares of the underlying equity. This ability to control 100 shares for a fraction of the cost of actual ownership is what gives options leverage. The 100 multiplier is reflected in how option price are quoted; a call priced at $2.00 per contract costs $200 to purchase.

If the call owner decides to purchase the underlying shares, we say they are "exercising" their right to do so. If the call writer is forced to sell shares, they are being "assigned" their obligation.

A put option gives the buyer the right to sell shares at a specified strike price prior to the expiration date. And on the other side, the seller of a put option has the obligation to purchase shares at the strike price prior to the expiration date

Options Come with Premiums

It is interesting to note quite a bit of options terminology overlaps with that of the insurance industry. An option's price or value is referred to as its premium (like an insurance premium). The purchaser of an option has losses limited to the amount of the premium. The seller of an option is regarded as a writer (like an insurance underwriter). And an option's expiration date is analogous to a term insurance policy.

Options with intrinsic value are said to be "in-the-money", while those strikes above the current stock price and whose value is solely extrinsic are said to be "out-of-the-money".

For example, Apple (AAPL), with shares trading at $125 a call option with the $120 strike would be $5 in-the-money, and therefore have $5 of intrinsic value. The owner of such a call has the right to purchase shares at $120 a contract. A call with a $130 strike is $5 out-of-the money and therefore it’s value all “extrinsic” and is comprised of time and implied volatility.

Let’s bring the two concepts of leverage and premiums together. Sticking with Apple (AAPL), trading at $125 share it would cost or require $12,500 to purchase 100 shares.

On the other hand, one could by a call option with a $120 strike that has 6 months until expiration for $10 per contract. The call currently has $5 of intrinsic value and $5 of extrinsic value. The owner of that call has the right to buy shares at $120 but she paid $10, meaning shares of Apple need to be above $130 at the expiration date for a profit to be realized. Of course, profit can be taken at any point prior to expiration.

Assume shares of Apple rallied to $135 over the next three months. The call option would then be worth approximately $19, as it would have $15 of intrinsic value and $4 of time premium.

The owner of the call could realize a $9 or 90% profit on just an 8% increase in the stock price. That is the power of leverage.

On the other hand, if Apple shares declined the losses to the call owner would be limited to the price paid, or $1,000, no matter how far the shares fall. Understand this does represent a 100% loss. The owner of the stock has the full $12,500 at risk on the very unlikely but theoretically possible chance shares fall to zero.

The seller of that $120 call stands to make or collect the full $1,000 of premium if shares declined below $120 by expiration. The seller actually would make money even if shares rose slightly; i.e. if Apple were at $128 at expiration the call would be worth $800 and the seller would realize a $200 profit even as shares. But it's important to note the seller of the call would face theoretically unlimited losses if Apple shares rallied to infinity and beyond.

Understanding how option prices behave will allow us to control our risk, choose appropriate strategies and target realistic profits.

The 75% Solution

While I have the probability of profit in my favor I want to further manage risk. I use basic rule of thumb to close positions once either 75% of profit has been realized or a 75% loss has incurred.

For instance, in the original Apple credit spread example, if shares quickly rallied above $130 the value of the put spread might decline to 30c way before the expiration. At this point I would look to close the position for a profit.

Conversely, if shares of Apple quickly slumped to $120 and the value of the spread might only expand to $2.50, at which point I'd accept the 80c loss.

You can create a sliding scale along a time frame. For instance, if a 50% profit could be realized within a matter of days it may make sense to close the position. If you're suddenly facing a 50% loss clearly something in your thesis of range bound or declining volatility environment was wrong and it may be best to just vacate.

But no matter the time frame, if an option you've sold short has declined to less than $0.10 a contract, then buy it back and cover yourself. At that point, the risk/reward becomes too asymmetrical. Don't try to squeeze out the last dime of premium, it could cost you multiple dollars.

Obviously, the credit-spread position has a much higher probability of achieving a profit. To go back to the baseball analogy, credit spreads allow you to be the batter to the market's pitcher, forcing it to do all the work by throwing strike after strike.

To set up a position with a high probability of profitability and acceptable risk/reward profile I use to basic parameters.

I want at least 70% probability of a profit; that means choosing the inside or short strikes that have less than 25% probability of expiring in-the-money. While many option chains will provide probabilities of expiration a basic rule of thumb is to look at delta. I'm using strikes with a 0.30 delta, meaning they have only 30% chance of being in-the-money on expiration.

I also want to achieve a 20% return on my risk capital. This means there must be enough premium to generate sufficient income while mitigating the limited risk of a spread.

Credit positions benefit primarily from time decay and a decline in implied volatility. This makes them best suited for sideways or stocks that exhibits a reliably steady trend.

Trade Setup

In setting up a trade I take three basic steps:

1. Use the chart to find an attractive entry level and define your trade parameters. This means buying near support and selling at resistance levels. This not only provides an attractive initial price, but also helps you set a realistic price or profit target. It also limit risk, if support is broken the position gets closed for a small loss. Ideally the price target should be at least twice the price magnitude as the stop loss level.

2. Choose a strategy that will deliver at least a 2:1 risk/reward if the price target is achieved. If the target is small and the stop is tight one can simply buy an at-the-money call. If the parameters are wider then using a spread might make more sense.

3. Allow sufficient time for your thesis to play out. If this is a turnaround story you'll want options that have an expiration that is at least 8-12 months away. If you just looking for a quick technical bounce or an earnings announcement using a shorter term of options, anywhere from two week to three makes, will provide better returns.

A great example is a trade I set up in Priceline (PCLN) as the stock sold off in the wake of competitor's Expedia (EXPE) weak earnings. I identified the $1,000-$1100 level as significant support and therefore a good entry point.

A close below the old lows at $995 would mean I'm wrong and trigger the stop loss.

The initial price target would be a move back to the 50 dma near the 1180 level. So now I have a target price that is of approximately $65 price move versus a stop loss of a $15 or a 4:1 ratio. Next, I wanted to make sure the position had enough time to play out and to take into account the upcoming earnings report on February 19th. I chose the April expiration.

Finally, the strategy I chose was a basic vertical spread. When the shares of Priceline dipped to 1,010 I was able to buy the April $1040 calls and sell the April $1080 calls for a $14 net debit for the spread.

The higher strike, $1080, aligns with my price target and would make the spread fully in-the-money. Of course do to time premiums it won't reach maximum value of $40 until expiration. So I have a profit target to close the position if the value of the spread doubles to $28 for the spread.

To limit the losses am using a combination of a close below $995 or if the value of the spread slips to $10 level. These two numbers should align.

Therefore I have a position that has a risk/reward profile of over 3:1, $14 potential profit versus $4 loss. On a position that can deliver an impressive 100% return on a very reasonable 7% gain in Priceline shares over the next two months.

As the chart above shows the stock rallied quickly over the next several days and I was able to sell the spread at $28 for a quick 100% return.

For credit spreads I look for stocks that have shown steady trends. Two great examples: United Health (UNH) and Kroger (KR). In United Healthcare I was able to sell call credit spreads (bullish) and collect an average of $1.70 for 5 consecutive months before the trend broke.

In Kroger I was in for nearly a year before it the trend failed.

To sum up the balance of profit and profitability; it's important to understand how risk is measured, knowing how to identify the fat pitches but also having in your arsenal the skill set and patience to occasionally take a walk.

As a final "P" I like taking an overall Portfolio approach. Having a balance of long and short positions, a balance of debit and credit positions. Adjusting overall exposure up or down based on market conditions.

As an option trader I love market volatility, as it presents opportunity. But I do not want volatility within my portfolio. I want to achieve consistent, repeatable returns without big drawdowns.

To sum up:

1. Only entering trades that meet given criteria.

2. Keeping the number of positions and the size of each position to appropriate levels for the portfolio size

3. Sticking to the trade parameters. Use stop loss levels to manage risk don't turn a losing "trade" into a "position of hope".

Common Mistakes

When trading in the options market, there are many variables to consider. Due to the large number of variables that exist, option traders are susceptible to making several different kinds of mistakes. The mistakes can range from the very simple and most basic mistakes to very large and expensive mistakes.

Understanding the basics of options is essential to options trading success as well as understanding the basics of trading. Trading sounds like a great idea and possibly an easy way to make money, but if it was easy, everyone would be a trader. Trading in general is as much an art as it is a science. Many traders believe that they can jump into the options market and trade with no experience and no knowledge. Losing money on consecutive trades due to a lack of knowledge will knock new traders out of the market quicker than anything else.

A very common mistake that options traders make is that they don't understand how options work. Many new options traders believe that you buy call options and you sell put options. It is true that both put options and call options can be bought or sold to open a position. But many new traders believe that each of type of option is used specifically for buying or selling. The belief that calls are purchased and puts are sold likely comes from the direction that the underlying stock must go in to make the trade work. The underlying stock must rise for a call position to be successful and it must fall for a put position to be successful. Both calls and puts are commonly purchased to open a position. Due to the way that put options are priced their value rises as the price of the stock falls. For any option purchase to be successful the price of the option must rise.

Another very common mistake that options traders make is buying an option that is too risky. Generally speaking, the safest options to purchase are in-the-money options, the second safest options are at-the-money options and the riskiest options are out-of-the-money options. In-the-money options will typically be the most expensive, so traders will sometimes look for cheaper options. A cheaper option that they can turn to is at-the-money options and the cheapest options are out-of-the-money. When it comes to trading options cheaper is not necessarily better, in fact, in this case cheaper can be very detrimental. The reason that an out-of-the-money option is cheaper is because there is a much smaller chance that the option will go in-the-money and become profitable so though the cost is lower the risk is higher.

Buying an option too close to the expiration date of the option is a big mistake. The time value of an option will erode its value at an increasing rate throughout the life of the option but it really reduces the options value quickly in the last few weeks of the options life. Buying an option that will expire within the next few weeks is very risky, even an in-the-money option will fall in value and expire worthless.

Risking too much on one position is a common trading mistake regardless of the security that is traded. This occurs when an option is purchased that is very expensive or if too many less expensive options are purchased. Risking a large percentage of a trading account on any one trade does not make sense. Taking on a huge position size in one trade is great when the trade is profitable but it can be devasting to the account when the position loses. The point of trading for

most traders is to make a profit on a continuous flow of trades. Hitting a home run on one trade is certainly possible but most of the time risking too much on any given position jeopardizes the overall health of the account and won't work out.

Many traders do not have a good sound way to analyze the underlying stock for their option purchases which can quickly make any trade fail. If a clear direction for the underlying stock cannot be projected, there is no reason to buy the options of the stock. Buying an option without seeing a clear path for the direction of the stock is akin to trading blind. When there is no clear projected path for the price movement of a stock, trading its options becomes guessing which at that point is gambling and hoping the trade may become successful at some point in the future.

It is very common for traders to be scared of options which makes them avoid trading them altogether. They do not understand the risks that are involved with options. When a trader purchases an option, the maximum risk is the amount that is paid for the option which is the option premium. An option purchaser can never lose more than the option premium so the risk of buying an option can be very low and known well in advance of the purchase. The full amount of the option premium does not have to be lost; a liquid option can be sold at most any time so if the price of the option falls it can easily be sold.

Buying options that are not highly liquid can be a mistake. The ability to sell an option at some point in the future is a direct function of the liquidity of the option. The liquidity of an option is determined by its open interest. The open interest is the number of contracts that exist for that specific option. The higher the open interest is the higher the options liquidity will be and the easier it will be to sell the option in the future.

Here is a glossary of words courtesy of the CBOE.
https://www.cboe.com/education/getting-started/options-dictionary

A

American-style Exercise
An option contract that may be exercised at any time between the date of purchase and the expiration date. Most exchange-traded options are American-style.

Arbitrage
The process in which professional traders simultaneously buy and sell the same or equivalent securities for a riskless profit.

Ask Price
The price at which a seller is offering to sell an option or stock.

Assignment
The receipt of an exercise notice by an option writer (seller) that obligates him to sell (in the case of a call) or purchase (in the case of a put) the underlying security at the specified strike price.

At-the-money
An option is at-the-money if the strike price of the option is equal to the market price of the underlying security.

Automatic Exercise
A protection procedure whereby the Options Clearing Corporation attempts to protect the holder of an expiring in-the-money option by automatically exercising the option on behalf of the holder.

Average Down
To buy more of a security at a lower price, thereby reducing the holder's average cost. (Average Up: to buy more at a higher price.)

B

Bearish
An adjective describing an opinion or outlook that expects a decline in price, either by the general market or by an underlying stock, or both.

Bear Spread
An option strategy that makes its maximum profit when the underlying stock declines and has its maximum risk if the stock rises in price. The strategy can be implemented with either puts or calls. In either case, an option with a higher striking price is purchased and one with a lower striking price is sold, both options generally having the same expiration date.

Beta
A measure of how a stock's movement correlates to the movement of the entire stock market. The Beta is not the same as volatility.

Bid Price
The price at which a buyer is willing to buy an option or stock.

Box Spread
A type of option arbitrage in which both a bull spread and a bear spread are established for a near-riskless position. One spread is established using put options and the other is established using calls. The spread may both be debit spreads (call bull spread vs. put bear spread) or both

credit spreads (call bear spread vs. put bull spread). Break-Even Point--the stock price (or prices) at which a particular strategy neither makes nor loses money. It generally pertains to the result at the expiration date of the options involved in the strategy. A "dynamic" break-even point is one that changes as time passes.

Broad-Based
Generally referring to an index, it indicates that the index is composed of a sufficient number of stocks or of stocks in a variety of industry groups.

Bullish
Describing an opinion or outlook in which one expects a rise in price, either by the general market or by an individual security.

Bull Spread
An option strategy that achieves its maximum potential if the underlying security rises far enough, and has its maximum risk if the security falls far enough. An option with a lower striking price is bought and one with a higher striking price is sold, both generally having the same expiration date. Either puts or calls may be used for the strategy.

Butterfly Spread
An option strategy that has both limited risk and limited profit potential, constructed by combining a bull spread and a bear spread. Three striking prices are involved, with the lower two being utilized in one spread and the higher two in the opposite spread. The strategy can be established with either puts or calls; there are four different ways of combining options to construct the same basic position.

C

Calendar Spread
An option strategy in which a short-term option is sold and a longer-term option is bought, both having the same striking price. Either puts or calls may be used.

Call
An Option contract that gives the holder the right to buy the underlying security at a specified price for a certain, fixed period of time.

Capitalization-Weighted Index
A stock index which is computed by adding the capitalization (float times price) of each individual stock in the index, and then dividing by the divisor. The stocks with the largest market values have the heaviest weighting in the index.

Capped-Style Option
A capped option is an option with an established profit cap or cap price. The cap price is equal to the option's strike price plus a cap interval for a call option or the strike price minus a cap interval for a put option. A capped option is automatically exercised when the underlying security closes at or above (for a call) or at or below (for a put) the Option's cap price.

Carrying Cost
The interest expense on a debit balance created by establishing a position.

Cash-Based
Referring to an option or future that is settled in cash when exercised or assigned. No physical entity, either stock or commodity, is received or delivered.

Cash Settlement
The process by which the terms of an option contract are fulfilled through the payment or receipt in dollars of the amount by which the option is in-the-money as opposed to delivering or receiving the underlying stock.

Cboe
The Cboe Options Exchange; the first national exchange to trade listed stock options.

Class (of Options)
Option contracts of the same type (call or put) and Style (American, European or Capped) that cover the same underlying security.

Closing Purchase
A transaction in which the purchaser's intention is to reduce or eliminate a short position in a given series of options.

Closing Sale
A transaction in which the seller's intention is to reduce or eliminate a long position in a given series of options

Closing Transaction
A trade that reduced an investor's position. Closing buy transactions reduce short positions and closing sell transactions reduce long positions.

Collateral
The loan value of marginable securities; generally used to finance the writing of uncovered options.

Combination
Any position involving both put and call options that is not a straddle.

Contingent Order
An order which can be executed only if another event occurs; i.e. "sell Oct 45 call 7.25 with stock 52 or lower".

Conversion Arbitrage
A riskless transaction in which the arbitrageur buys the underlying security, buys a put, and sells a call. The options have the same terms.

Convertible Security
A security that is convertible into another security. Generally, a convertible bond or convertible preferred stock is convertible into the underlying stock of the same corporation. The rate at which the shares of the bond or preferred stock are convertible into the common is called the conversion ratio.

Cover
To buy back as a closing transaction an option that was initially written.

Covered
A written option is considered to be covered if the writer also has an opposing market position on a share-for-share basis in the underlying security. That is, a short call is covered if the underlying stock is owned, and a short put is covered (for margin purposes) if the underlying stock is also short in the account. In addition, a short call is covered if the account is also long another call on the same security, with a striking price equal to or less than the striking price of

the short call. A short put is covered if there is also a long put in the account with a striking price equal to or greater than the striking price of the short put.

Covered Call
An option strategy in which a call option is written against long stock on a share-for-share basis.

Covered Call Option Writing
A strategy in which one sells call options while simultaneously owning an equivalent position in the underlying security or strategy in which one sells put options and simultaneously is short an equivalent position in the underlying security.

Covered Put Write
A strategy in which one sells put options and simultaneously is short an equal number of shares of the underlying security.

Covered Straddle
An option strategy in which one call and one put with the same strike price and expiration are written against 100 shares of the underlying stock. In actuality, this is not a "covered" strategy because assignment on the short put would require purchase of stock on margin. This method is also known as a covered combination.

Covered Straddle Write
The term used to describe the strategy in which an investor owns the underlying security and also writes a straddle on that security. This is not really a covered position.

Credit
Money received in an account. A credit transaction is one in which the net sale proceeds are larger than the net buy proceeds (cost), thereby bringing money into the account.

Cycle
The expiration dates applicable to various classes of options. There are three cycles: January/April/July/October, February/May/August/November, and March/June/September/December.

D

Debit
An expense, or money paid out from an account. A debit transaction is one in which the net cost is greater than the net sale proceeds.

Deliver
To take securities from an individual or firm and transfer them to another individual or firm. A call writer who is assigned must deliver stock to the call holder who exercised. A put holder who exercises must deliver stock to the put writer who is assigned.

Delivery
The process of satisfying an equity call assignment or an equity put exercise. In either case, stock is delivered. For futures, the process of transferring the physical commodity from the seller of the futures contract to the buyer. Equivalent delivery refers to a situation in which delivery may be made in any of various, similar entities that are equivalent to each other (for example, Treasury bonds with differing coupon rates).

Delta
The amount by which an option's price will change for a one-point change in price by the underlying entity. Call options have positive deltas, while put options have negative deltas. Technically, the delta is an instantaneous measure of the option's price change, so that the delta will be altered for even fractional changes by the underlying entity.

Delta Spread
A ratio spread that is established as a neutral position by utilizing the deltas of the options involved. The neutral ratio is determined by dividing the delta of the purchased option by the delta of the written option.

Depository Trust Corporation (DTC)
A corporation that will hold securities for member institutions. Generally used by option writers, the DTC facilitates and guarantees delivery of underlying securities if assignment is made against securities held in DTC.

Derivative security
A financial security whose value is determined in part from the value and characteristics of another security, the underlying security.

Diagonal Spread
Any spread in which the purchased options have a longer maturity than do the written options as well as having different striking prices. Typical types of diagonal spreads are diagonal bull spreads, diagonal bear spreads, and diagonal butterfly spreads.

Discount
An option is trading at a discount if it is trading for less than its intrinsic value. A future is

trading at a discount if it is trading at a price less than the cash price of its underlying index or commodity.

Discount Arbitrage

A riskless arbitrage in which a discount option is purchased and an opposite position is taken in the underlying security. The arbitrageur may either buy a call at a discount and simultaneously sell the underlying security (basic call arbitrage) or may buy a put at a discount and simultaneously buy the underlying security (basic put arbitrage).

Discretion

Freedom given to the floor broker by an investor to use his judgment regarding the execution of an order. Discretion can be limited, as in the case of a limit order that gives the floor broker.125 or.25 point from the stated limit price to use his judgment in executing the order. Discretion can also be unlimited, as in the case of a market-not-held order.

Divisor

A mathematical quantity used to compute an index. It is initially an arbitrary number that reduces the index value to a small, workable number. Thereafter, the divisor is adjusted for stock splits (price-weighted index) or additional issues of stock (capitalization-weighted index).

Downside Protection

Generally used in connection with covered call writing, this is the cushion against loss, in case of a price decline by the underlying security, that is afforded by the written call option. Alternatively, it may be expressed in terms of the distance the stock could fall before the total position becomes a loss (an amount equal to the option premium), or it can be expressed as percentage of the current stock price.

Dynamic

For option strategies, describing analyses made during the course of changing security prices and during the passage of time. This is as opposed to an analysis made at expiration of the options used in the strategy. A dynamic break-even point is one that changes as time passes. A dynamic follow-up action is one that will change as either the security price changes or the option price changes or time passes

E

Early Exercise (assignment)

The exercise or assignment of an option contract before its expiration date.

Escrow Receipt
A receipt issued by a bank in order to verify that a customer (who has written a call) in fact owns the stock and therefore the call is considered covered.

European Exercise
A feature of an option that stipulates that the option may only be exercised at its expiration. Therefore, there can be no early assignment with this type of option.

Ex-Dividend
The process whereby a stock's price is reduced when a dividend is paid. The ex-dividend date (ex-date) is the date on which the price reduction takes place. Investors who own stock on the ex-date will receive the dividend, and those who are short stock must pay out the dividend.

Equity Options
Options on shares of an individual common stock.

European-Style Options
An option contract that may be exercised only during a specified period of time just prior to its expiration.

Exercise
To implement the right under which the holder of an option is entitled to buy (in the case of a call) or sell (in the case of a put) the underlying security.

Exercise Limit
The limit on the number of contracts which a holder can exercise in a fixed period of time. Set by the appropriate option exchange, it is designed to prevent an investor or group of investors from "cornering" the market in a stock.

Exercise price
The price at which the option holder may buy or sell the underlying security, as defined in the terms of his option contract. It is the price at which the call holder may exercise to buy the underlying security or the put holder may exercise to sell the underlying security. For listed options, the exercise price is the same as the Striking Price.

Exercise settlement amount
The difference between the exercise price of the option and the exercise settlement value of the index on the day an exercise notice is tendered, multiplied by the index multiplier.

Expected Return
A rather complex mathematical analysis involving statistical distribution of stock prices, it is the return which an investor might expect to make on an investment if he were to make exactly the same investment many times throughout history.

Expiration cycle
An expiration cycle relates to the dates on which options on a particular underlying security expire. A given option, other than LEAPS®, will be assigned to one of three cycles, the January cycle, the February cycle or the March cycle.

Expiration date
The day on which an option contract becomes void. For stock options expiring prior to February 15, 2015, this date is the Saturday immediately following the third Friday of the expiration month. For stock options expiring on or after February 15, 2015, this date is the third Friday of the expiration month. Brokerage firms, however, may set an earlier deadline for notification of an option buyer's intention to exercise. If Friday is a holiday, the last trading day will be the preceding Thursday.

Expiration time
The time of day by which all exercise notices must be received on the expiration date. Technically, the expiration time is currently 5:00PM on the expiration date, but public holders of option contracts must indicate their desire to exercise no later than 5:30PM on the business day preceding the expiration date. The times are Eastern Time

F

Facilitation
The process of providing a market for a security. Normally, this refers to bids and offers made for large blocks of securities, such as those traded by institutions. Listed options may be used to offset part of the risk assumed by the trader who is facilitating the large block order.

Fair Value
Normally, a term used to describe the worth of an option or futures contract as determined by a mathematical model. Also sometimes used to indicate intrinsic value.

FLEX Options
Exchange traded equity or index options, where the investor can specify within certain limits, the terms of the options, such as exercise price, expiration date, exercise type, and settlement calculation.

Float
The number of shares outstanding of a particular common stock.

Floor Broker
A broker on the exchange floor who executes the orders of public customers or other investors who do not have physical access to the trading area.

Fundamental Analysis
A method of analyzing the prospects of a security by observing accepted accounting measures such as earnings, sales, assets, and so on. See also Technical Analysis.

Futures Contract
A standardized contract calling for the delivery of a specified quantity of a commodity at a specified date in the future.

G

Gamma
The rate of change in an option's delta for a one-unit change in the price of the underlying security.

Good Until Canceled (GTC)
A designation applied to some types of orders, meaning the order remains in effect until it is either filled or canceled.

H

Hedge
A conservative strategy used to limit investment loss by effectinga transaction which offsets an existing position.

Hedge Ratio
The mathematical quantity that is equal to the delta of an option. It is useful in that a theoretically neutral hedge can be established by taking offsetting positions in the underlying stock and its call options.

Holder
The purchaser of an option.

Horizontal Spread
An option strategy in which the options have the same striking price, but different expiration dates.

I

Implied Volatility
A measure of the volatility of the underlying stock, it is determined by using option prices currently existing in the market at the time rather than using historical data on the price changes of the underlying stock.

Incremental Return Concept
A strategy of covered call writing in which the investor is striving to earn an additional return from option writing against a stock position which he (she) has targeted to sell -- possibly at substantially higher prices.

Index
A compilation of the prices of several common entities into a single number.

Index Option
An option whose underlying entity is an index. Most index options are cash-based.

Institution
An organization, probably very large, engaged in professional investing in securities. Normally a bank, insurance company, or mutual fund.

In-the-money
A term describing any option that has intrinsic value. A call option is in-the-money if the underlying security is higher than the striking price of the call. A put option is in-the-money if the security is below the striking price.

Intrinsic value
The value of an option if it were to expire immediately with the underlying stock at its current price; the amount by which an option is in-the-money. For call options, this is the difference between the stock price and the striking price, if that difference is a positive number, or zero otherwise. For put options it is the difference between the striking price and the stock price, if that difference is positive, and zero otherwise.

J & K Have no words

L

Last Trading Day
The very last full day of open trading before an options expiration day, usually the third Friday of the expiration month.

LEAPS®
Long-term Equity Anticipation Securities, or LEAPS®, arelong-term stock or index options. LEAPS®, like all options,are available in two types, calls and puts, with expirationdates up to three years in the future.

Leg
A risk-oriented method of establishing a two-sided position. Rather than entering into a simultaneous transaction to establish the position (a spread, for example), the trader first executes one side of the position, hoping to execute the other side at a later time and a better price. The risk materializes from the fact that a better price may never be available, and a worse price must eventually be accepted.

Letter of Guarantee
A letter from a bank to a brokerage firm which states that a customer (who has written a call option) does indeed own the underlying stock and the bank will guarantee delivery if the call is assigned. Thus the call can be considered covered. Not all brokerage firms accept letters of guarantee. Also: letter issued to O.C.C. by member firms covering a guarantee of any trades made by one of its customers, (a trader or broker on the exchange floor).

Leverage
In investments, the attainment of greater percentage profit and risk potential. A call holder has leverage with respect to a stock holder - the former will have greater percentage profits and losses than the latter, for the same movement in the underlying stock.

Limit Order
An order to buy or sell securities at a specified price (the limit). A limit order may also be placed "with discretion". In this case, the floor broker executing the order may use his (her) discretion to buy or sell at a set amount beyond the limit if he (she) feels it is necessary to fill the order.

Listed Option
A put or call option that is traded on a national options exchange. Listed options have fixed striking prices and expiration dates.

Local
A trader on a futures exchange who buys and sells for his own account and may sometimes also fill public orders.

Lognormal Distribution
A statistical distribution that is often applied to the movement of stock prices. It is a convenient and logical distribution because it implies that stock prices can theoretically rise forever but cannot fall below zero.

Long Position
A position wherein an investor's interest in a particular seriesof options is as a net holder (i.e., the number of contractsbought exceeds the number of contracts sold).

M

To buy a security by borrowing funds from a brokerage house. The margin requirement - the maximum percentage of the investment that can be loaned by the brokerage firm -- is set by the Federal Reserve Board.

Margin Requirement (for options)
The amount an uncovered (naked) option writer is required to deposit and maintain to cover a position. The margin requirement is calculated daily.

Mark-To-Market
An accounting process by which the price of securities held in account are valued each day to reflect the last sale price or market quote if the last sale is outside of the market quote. The result of this process is that the equity in an account is updated daily to properly reflect current security prices.

Market Basket
A portfolio of common stocks whose performance is intended to simulate the performance of a specific index.

Market-Maker
An exchange member whose function is to aid in the making of a market, by making bids and offers for his account in the absence of public buy or sell orders. Several market-makers are

normally assigned to a particular security. The market-maker system encompasses the market-makers, floor brokers, and order book officials. See also Order Book Official and Specialist.

Market Not Held Order
Also a market order, but the investor is allowing the floor broker who is executing the order to use his own discretion as to the exact timing of the execution. If the floor broker expects a decline in price and he is holding a "market not held buy order", he (she) may wait to buy, figuring that a better price will soon be available. There is no guarantee that a "market not held order" will be filled.

Market Order
An order to buy or sell securities at the current market. The order will be filled as long as there is a market for the security.

Married Put and Stock
The simultaneous purchase of stock and the corresponding number of put options. This is a limited risk strategy during the life of the puts because the stock can be sold at the strike price of the puts.

Married Put Strategy
A put and stock are considered to be married if they are bought on the same day, and the position is designated at that time as a hedge.

Model
A mathematical formula designed to price an option as a function of certain variables - generally stock price, striking price, volatility, time to expiration, dividends to be paid, and the current risk-free interest rate. The Black-Scholes model is one of the more widely used models.

N

Narrow-Based
Generally referring to an index, it indicates that the index is composed of only a few stocks, generally in a specific industry group.

Neutral
Describing an opinion that is neither bearish nor bullish. Neutral option strategies are generally designed to perform best if there is little or no net change in the price of the underlying stock or index.

Non-Equity Option
An option whose underlying entity is not common stock; typically refers to options on physical commodities and index options.

Notice Period
The time during which the buyer of a futures contract can be called upon to accept delivery. Typically, the 3 to 6 weeks preceding the expiration of the contract.

O

A transaction in which the purchaser's intention is to createor increase a long position in a given series of options.

Opening Sale
A transaction in which the seller's intention is to create or increase a short position in a given series of options.

Opening Transaction
A trade which adds to the net position of an investor. An opening buy transaction adds more long securities to the account. An opening sell transaction adds more short securities.

Open Interest
The number of outstanding option contracts in the exchange marketor in a particular class or series.

Option Pricing Curve
A graphical representation of the projected price of an option at a fixed point in time. It reflects the amount of time value premium in the option for various stock prices, as well. The curve is generated by using a mathematical model. The delta (or hedge ratio) is the slope of a tangent line to the curve at a fixed stock price.

Options Clearing Corporation (OCC)
The issuer of all listed option contracts that are trading on the national option exchanges.

Order Book Official
The exchange employee in charge of keeping a book of public limit orders on exchanges utilizing the "maker-maker" system, as opposed to the "specialist system", of executing orders.

Out-of-the-money
A call option is out-of-the-money if the strike price is greaterthan the market price of the

underlying security. A put optionis out-of-the-money if the strike price is less than the marketprice of the underlying security.

Over-the-Counter Option (OTC)
An option traded off-exchange, as opposed to a listed stock option. The OTC option has a direct link between buyer and seller, has no secondary market, and has no standardization of striking prices and expiration dates.

Overvalued
Describing a security trading at a higher price than it logically should. Normally associated with the results of option price predictions by mathematical models. If an option is trading in the market for a higher price than the model indicates, the option is said to be overvalued.

P

Parity
Describing an in-the-money option trading for its intrinsic value; that is, an option trading at parity with the underlying stock. Also used as a point of reference - an option is sometimes said to be trading at a half-point over parity or at a quarter-point under parity. An option trading under parity is a discount option.

Physical Option
An option whose underlying security is a physical commodity that is not stock or futures. The physical commodity itself (a currency, treasury debt issue, commodity) - underlies that option contract.

Position
As a noun, specific securities in an account or strategy. (A covered call writing position might be long 1,000 XYZ and short 10 XYZ January 30 calls). As a verb, to facilitate; to buy or sell - generally a block of securities - thereby establishing a position.

Position Limit
The maximum number of put or call contracts on the same side of the market that can be held in any one account or group of related accounts. Short puts and long calls are on the same side of the market. Short calls and long puts are on the same side of the market.

Premium
The price of an option contract, determined in the competitive marketplace, which the buyer of the option pays to the option writer for the rights conveyed by the option contract.

Price-Weighted Index
A stock index which is computed by adding the prices of each stock in the index, and then dividing by the divisor.

A graphical representation of the potential outcomes of a strategy. Dollars of profit or loss are graphed on the vertical axis, and various stock prices are graphed on the horizontal axis. Results may be depicted at any point in time, although the graph usually depicts the results at expiration of the options involved in the strategy.

Profit Range
The range within which a particular position makes a profit. Generally used in reference to strategies that have two break-even points - an upside break-even and a downside break-even. The price range between the two break-even points would be the profit range.

Profit Table
A table of results of a particular strategy at some point in time. This is usually a tabular compilation of the data drawn on a profit graph. .

Protected Strategy
A position that has limited risk. A protected short sale (short stock, long call) has limited risk, as does a protected straddle write (short straddle, long out-of-the-money combination).

Public Book (of orders)
The orders to buy or sell, entered by the public, that are generally away from the current market. The order book official or specialist keeps the public book. Market-Makers on the Cboe can see the highest bid and lowest offer at any time. The specialist's book is closed (only he knows at what price and in what quantity the nearest public orders are).

Put
An option contract that gives the holder the right to sell the underlying security at a specified price for a certain fixed period of time.

Q has no words

R

Ratio Calendar Combination
A strategy consisting of a simultaneous position of a ratio calendar spread using calls and a similar position using puts, where the striking price of the calls is greater than the striking price of the puts.

Ratio Calendar Spread
Selling more near-term options than longer-term ones purchased, all with the same strike; either puts or calls.

Ratio Spread
Constructed with either puts or calls, the strategy consists of buying a certain amount of options and then selling a larger quantity of more out-of-the-money options.

Ratio Strategy
A strategy in which one has an unequal number of long securities and short securities. Normally, it implies a preponderance of short options over either long options or long stock.

Ratio Write
Selling of call options in a ratio higher than 1 to 1 against the stock that is owned.

Resistance
A term in technical analysis indicating a price area higher than the current stock price where an abundance of supply exists for the stock and therefore the stock may have trouble rising through the price.

Return (on investment)
The percentage profit that one makes, or might make, on his investment.

Return if Exercised
The return that a covered call writer would make if the underlying stock were called away.

Reversal Arbitrage
A riskless arbitrage that involves selling the stock short, writing a put, and buying a call. The options have the same terms.

Rho
The expected change in an option's theoretical value for a 1 percent change in interest rates.

Risk Arbitrage
A form of arbitrage that has some risk associated with it. Commonly refers to potential takeover situations where the arbitrageur buys the stock of the company about to be taken over and sells the stock of the company that is effecting the takeover.

Roll Down
Close out options at one strike and simultaneously open other options at a lower strike.

Roll Forward (Out)
Close-out options at a near-term expiration date and open options at a longer-term expiration date.

Rolling
A follow-up action in which the strategist closes options currently in the position and opens other options with different terms, on the same underlying stock.

Roll Up
Close out options at a lower strike and open options at a higher strike.

S

Secondary Market
A market that provides for the purchase or sale of previouslysold or bought options through closing transactions.

Series
All option contracts of the same class that also have the sameunit of trade, expiration date and strike price.

Settlement Price
The official price at the end of a trading session. This price is established by The Options Clearing Corporation and is used to determine changes in account equity, margin requirements, and for other purposes.

Short Position
A position wherein a person's interest in a particular seriesof options is as a net writer (i.e., the number of contracts soldexceeds the number of contracts bought).

Specialist
An exchange member whose function it is to both make markets--buy and sell for his own account in the absence of public orders--and to keep the book of public orders. Most stock exchanges and some option exchanges utilize the specialist system of trading.

Spread Order
An order to simultaneously transact two or more option trades. Typically, one option would be bought while another would simultaneously be sold. Spread orders may be limit orders, not held orders, or orders with discretion. They cannot be stop orders, however.

Spread Strategy
Any option position having both long options and short options of the same type on the same underlying security.

Standard Deviation
A measure of the volatility of a stock. It is a statistical quantity measuring the magnitude of the daily price changes of that stock.

"Static" Return
The return that an investor would make on a particular position if the underlying stock were unchanged in price at the expiration of the options in the position.

Stop-Limit Order
Similar to a stop order, the stop-limit order becomes a limit order, rather than a market order, when the security trades at the price specified on the stop.

Stop Order
An order, placed away from the current market, that becomes a market order if the security trades at the price specified on the stop order. Buy stop orders are placed above the market while sell stop orders are placed below.

Straddle
The purchase or sale of an equal number of puts and calls having the same terms.

Strategy
With respect to option investments, a preconceived, logical plan of position selection and follow-up action.

Strike Price
The stated price per share for which the underlying security may be purchased (in the case of a call) or sold (in the case of a put) by the option holder upon exercise of the option contract.

Striking Price Interval
The distance between striking prices on a particular underlying security. Normally, the interval is 2.50 points for stocks under $25, 5 points for stocks selling over $25 per share, and 10 points (or greater) is acceptable for stocks over $200 per share. There are, however, exceptions to this general guideline.

Suitability
A requirement that any investing strategy fall within the financial means and investment objectives of an investor.

Suitable
Describing a strategy or trading philosophy in which the investor is operating in accordance with his (her) financial means and investment objectives.

Support
A term in technical analysis indicating a price area lower than the current price of the stock, where demand is thought to exist. Thus a stock would stop declining when it reached a support area.

Synthetic Put
A strategy equivalent in risk to purchasing a put option where an investor sells stock short and buys a call.

Synthetic Stock
An option strategy that is equivalent to the underlying stock. A long call and a short put is synthetic long stock. A long put and a short call is synthetic short stock.

T

Technical Analysis
The method of predicting future stock price movements based on observation of historical stock price movements.

Terms
The collective name denoting the expiration date, striking price, and underlying stock of an option contract.

Theoretical Value
The price of an option, or a combination of options, as computed by a mathematical model.

Theta
A measure of the rate of change in an option's theoretical value for a one-unit change in time to the option's expiration date.

Time Decay
A term used to describe how the theoretical value of an option "erodes" or reduces with the passage of time.

Time Value
The portion of the option premium that is attributable to the amount of time remaining until the expiration of the option contract. Time value is whatever value the option has in additionto its intrinsic value.

Time Value Premium
The amount by which an option's total premium exceeds its intrinsic value.

Total Return Concept
A covered call writing strategy in which one views the potential profit of the strategy as the sum of capital gains, dividends, and option premium income, rather than viewing each one of the three separately.

Tracking Error
The amount of difference between the performance of a specific portfolio of stocks and a broad-based index with which they are being compared.

Trader
An investor or professional who makes frequent purchases and sales.

Trading Limit
The exchange-imposed maximum daily price change that a futures contract or futures option contract can undergo.

Treasury Bill/Option Strategy
(90/10 strategy) a method of investment in which one places approximately 90% of his funds in risk-free, interest-bearing assets such as Treasury bills, and buys options with the remainder of his assets.

Type
The classification of an option contract as either a put or a call.

U

Uncovered Call Writing

A short call option position in which the writer does not own an equivalent position in the underlying security represented by his option contracts.

Uncovered Option
A written option is considered to be uncovered if the investor does not have an offsetting position in the underlying security.

Uncovered Put Writing
A short put option position in which the writer does not have a corresponding short position in the underlying security or has not deposited, in a cash account, cash or cash equivalents equal to the exercise value of the put.

Underlying Security
The security subject to being purchased or sold upon exercise of the option contract.

Undervalued
Describing a security that is trading at a lower price than it logically should. Usually determined by the use of a mathematical model.

Unit of Trading
The minimum quantity or amount allowed when trading a security. The normal minimum for common stock is 1 round lot or 100 shares. The normal minimum for options is one contract (which normally covers 100 shares of stock).

V

Variable Ratio Write
An option strategy in which the investor owns 100 shares of the underlying security and writes two call options against it, each option having a different striking price.

Vega
A measure of the rate of change in an option's theoretical value for a one-unit change in the volatility assumption.

Vertical Spread
(1)Most commonly used to describe the purchase of one option and sale of another where both are of the same type and same expiration, but have different strike prices. (2)It is also used to describe a delta-neutral spread in which more options are sold than are purchased.

Volatility
A measure of the fluctuation in the market price of the underlying security. Mathematically, volatility is the annualized standard deviation of returns.

W

Write
To sell an option. The investor who sells is called the writer.

X,Y, and Z have no words