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Options Basics – Core Concepts and Fundamentals

Mathew Cashman

Principal / OCC Investor Education
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Options Basics - Core Concepts and Fundamentals

Mat Cashman
Principal, Investor Education
OCC



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Options involve risks and are not suitable for everyone. Individuals should not enter into options transactions until they have read and understood the risk disclosure document, *Characteristics and Risks of Standardized Options*, available by visiting theocc.com. To obtain a copy, contact your broker or The Options Industry Council at 125 S. Franklin St., Suite 1200, Chicago, IL 60606.

In order to simplify the computations used in the examples in these materials, **commissions, fees, margin, interest and taxes have not been included.** These costs will impact the outcome of any stock and options transactions and must be considered prior to entering into any transactions. Investors should consult their tax advisor about any potential tax consequences.

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Presentation Outline

- Options Defined
- Calls and Puts
- Basic Strategies
- Contract Terms
- Exercise and Assignment



Options Defined

Defining an Option

- Options are **contracts** that give:
 - The **buyer** the *right* to buy or sell an underlying asset
 - The **seller** the *obligation* to buy or sell an underlying asset

at a *specified price*, on or before a *given date* in the future.

- **Buyers** have **rights**
- **Sellers** have **obligations**



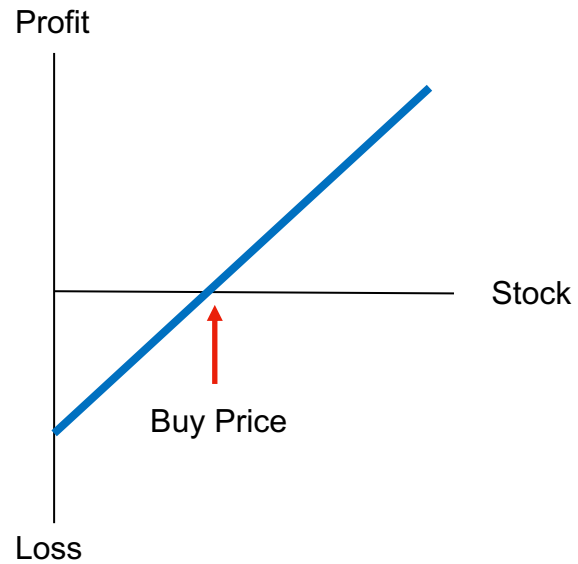
Why Options?

- Options give you more ways to implement your market research
- Options make it possible to target a variety of investment objectives:
 - *Risk Reduction*
 - *Income Generation*
 - *Stock Acquisition*
 - *Speculation*
- Options offer **FLEXIBILITY!**

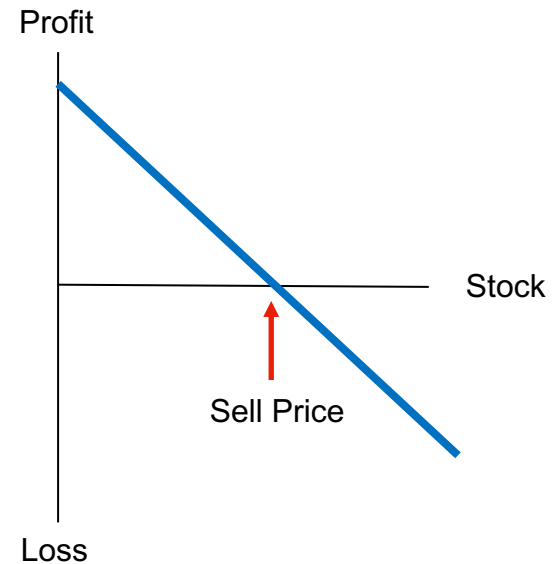


Long Stock vs. Short Stock

In a world without options, stock investors have limited choices.



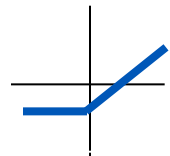
Long Stock



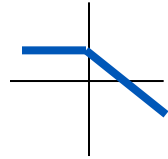
Short Stock

Flexibility

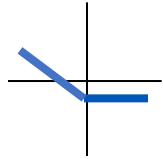
With options, these are some of the available choices.



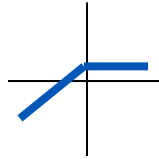
Long Call



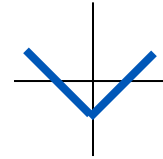
Short Call



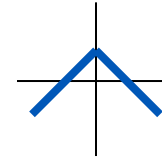
Long Put



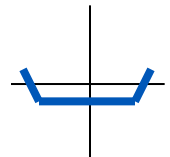
Short Put



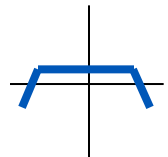
Long Straddle



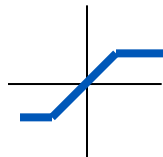
Short Straddle



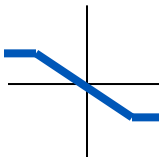
Long Strangle



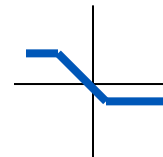
Short Strangle



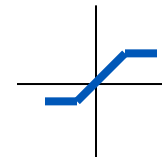
Long Call Spread



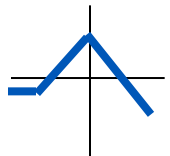
Short Call Spread



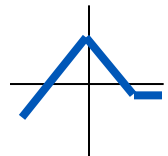
Long Put Spread



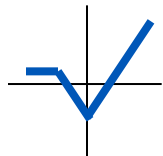
Short Put Spread



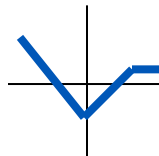
Ratio Call Spread



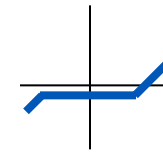
Ratio Put Spread



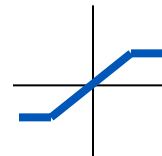
Call Volatility Spread



Put Volatility Spread



Long Split-Strike Synthetic



Collar

Calls & Puts



Calls and Puts

- There are two “types” of options:
 - **Calls**
 - **Puts**
- For **equity** or **ETF** options, the underlying asset to be purchased or sold:
 - 100 shares of underlying stock or
 - 100 shares of an ETF (Exchange Traded Fund)



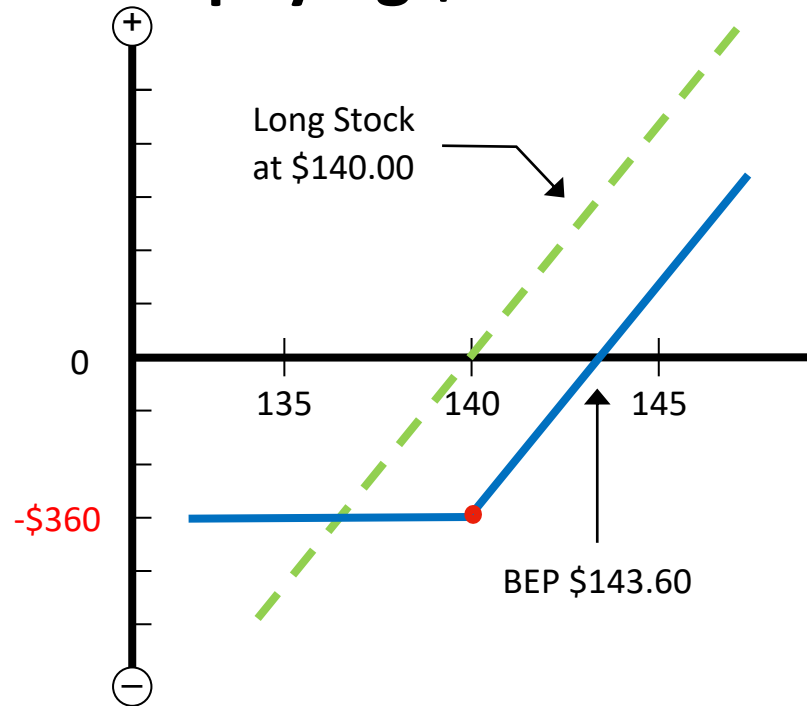
Equity Call Options

- An equity call **buyer**:
 - Owns the **right to buy** underlying stock/ETF
 - Bullish on underlying
 - Needs stock movement > time decay
- An equity call **seller**:
 - Has the **obligation to sell** underlying stock/ETF
 - Likely already owns shares



Outright Call Buying Example (Speculative)

**Buying 140.00 strike call
paying \$3.60**



Does not include commissions, fees, margin interest or taxes.

Break-even at Expiration:

Strike Price + Call Premium Paid

$$\$140.00 + \$3.60 = \$143.60$$

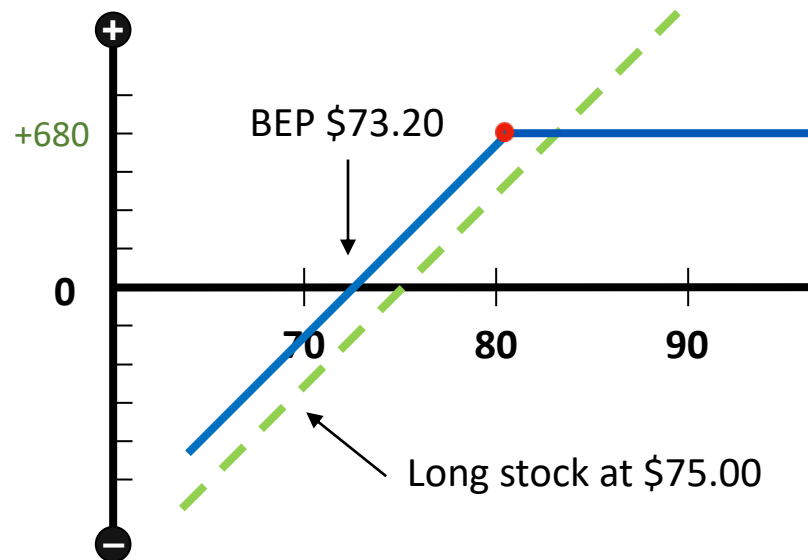
Maximum Loss:

\$3.60 Call Premium Paid

\$360.00 Total

Covered Call Example

Own 100 shares XYZ at \$75.00
Sell 1 XYZ 80 call at \$1.80



Does not include commissions, fees, margin interest or taxes.

Break-even at Expiration:

Stock Price Paid –
Call Premium Received
 $\$75.00 - \$1.80 = \$73.20$

Maximum Profit if Assigned:

Effective Stock Sale Price –

- Stock Price Paid
 $(\$80.00 + \$1.80) - \$75.00 = \6.80
- \$680.00 Total

Equity Put Options

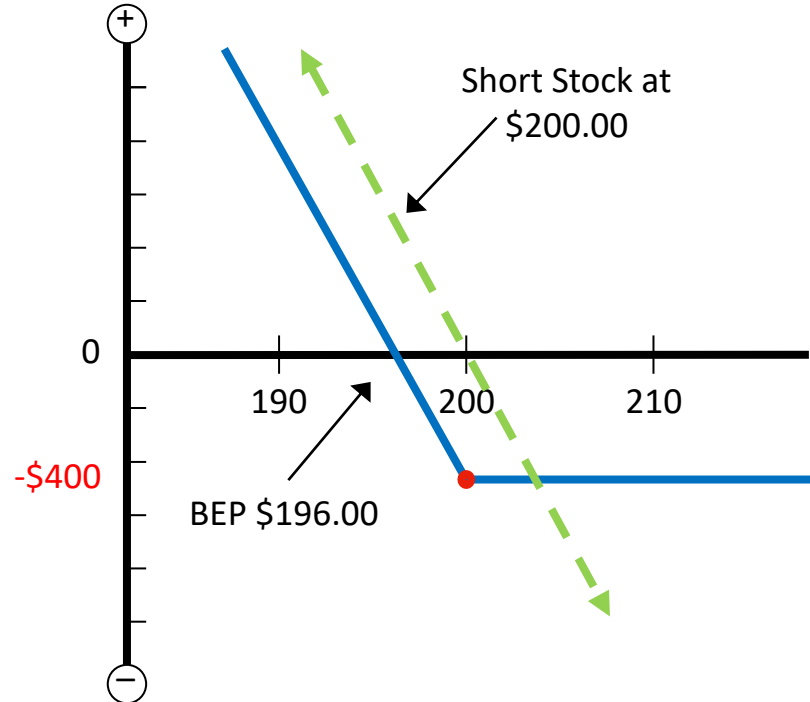
- An equity put **buyer**:
 - Owns the **right to sell** underlying stock/ETF
 - If speculating, is bearish on underlying
 - If shares are already owned, is buying protection

- An equity put **seller**:
 - Has the **obligation to buy** underlying stock/ ETF
 - Generate income while waiting for share price drop
 - Small profit if stock rallies



Outright Put Buying Example (Speculative)

**Buy 200.00 strike put
paying \$4.00**



Break-even at Expiration:

Strike Price – Put Premium Paid

$$\$200.00 - \$4.00 = \$196.00$$

Maximum Loss:

\$4.00 Put Premium Paid

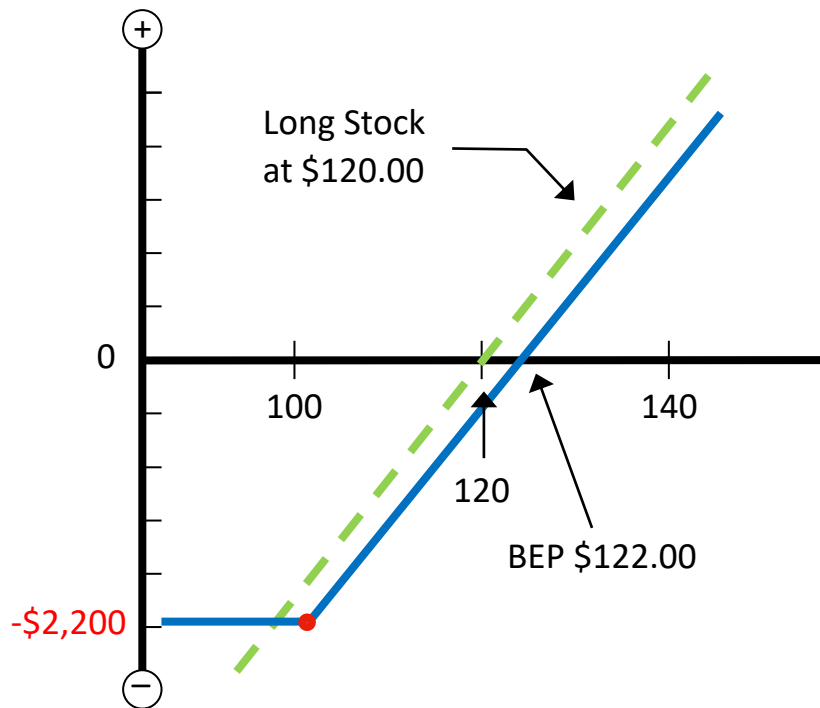
\$400.00 Total

Protective Put Example

Long Stock at \$120

Buy 100.00 strike put paying \$2.00

(180 Days until expiration, 25% Volatility)



Break-even at Expiration:

Initial Share Price + Put Premium Paid

$$\$120.00 + \$2.00 = \$122.00$$

Maximum Loss:

Difference between strikes + Put
Premium Paid

$$\$120.00 - \$100.00 + \$2.00 = \$2,200.00$$

Calls and Puts

Options contracts **give...**

	Call	Put
Long (buyer or holder)	Right to buy	Right to sell
Short (seller or writer)	Obligation to sell	Obligation to buy

- 100 shares of the underlying
- at the strike price
- any time before expiration

Contract Terms

...BUSINESS WHEREOF, I, _____, the testator/testatrix, sign and execute this Will and I sign it willingly (or willingly direct another to sign for me), that I am of legal age and under no constraint or undue influence.

Testator/Testatrix _____

Option Contract Terms

- Equity option contracts have standardized terms:
 - Underlying stock/ETF
 - Unit of trade
 - Expiration date
 - Strike or exercise price



Option Components

XYZ Mar 18, 2022 45 call at \$2.50

Underlying

- Typically, 100 shares of the stock/ETF on which the right or obligation exists
- Example: XYZ Mar 18, 2022 45 call at \$2.50
- 100 shares of XYZ is the underlying for this option

Expiration Date

- The day on which the option expires (last trading date)
- Example: XYZ Mar 18, 2022 45 call at \$2.50

Option Components

XYZ Mar 18, 2022 45 call at \$2.50

Strike or Exercise Price

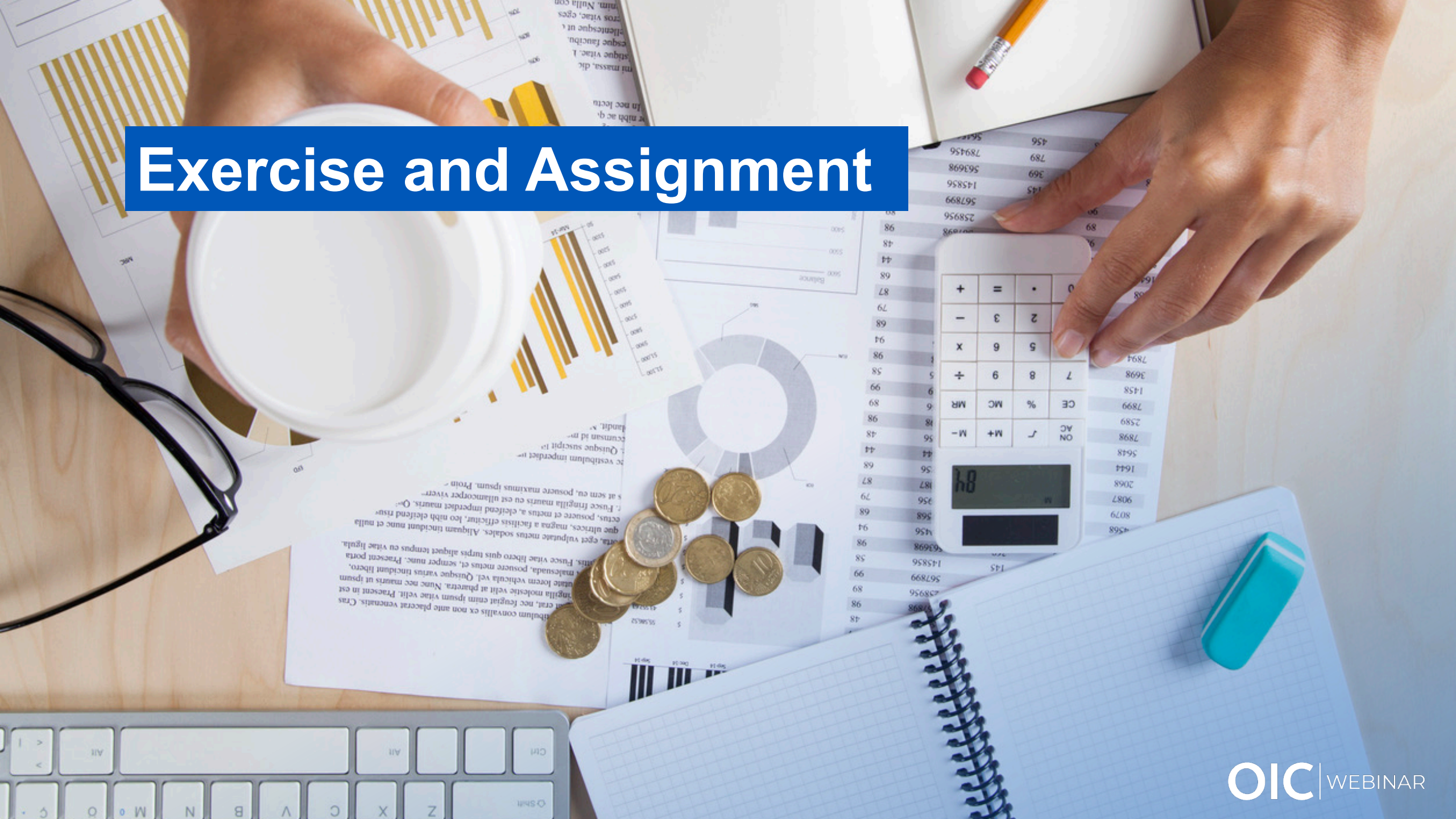
- Price at which the underlying may be bought or sold
- Example: XYZ Mar 18, 2022 45 call at \$2.50

Premium

- The price of an option that is paid by the buyer and received by the seller
- Example: XYZ Mar 18, 2022 45 call at \$2.50
 - \$2.50* per share or \$250* per option

*Not including commissions

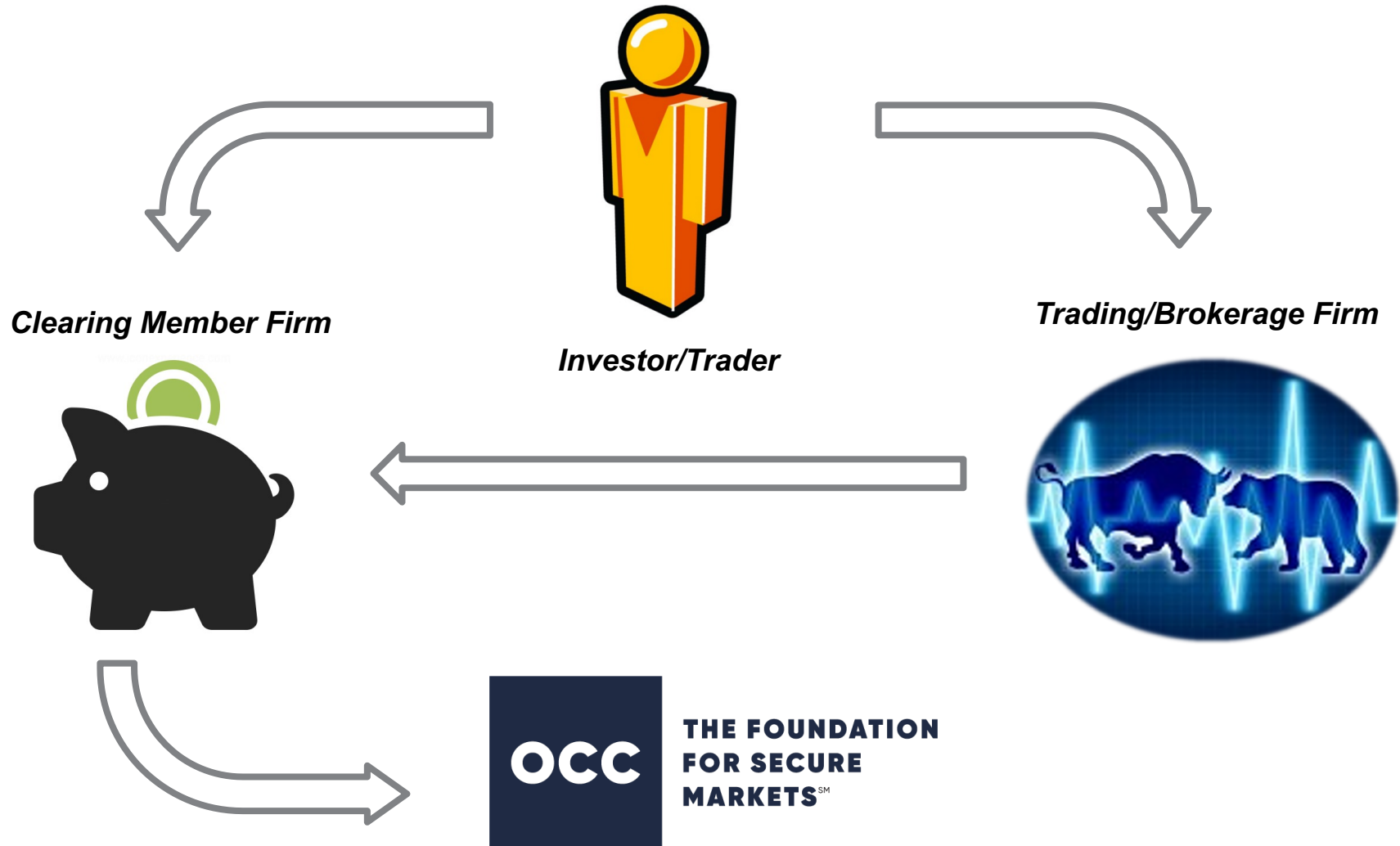
Exercise and Assignment



Exercise: Buy or Sell Underlying Stock

- The option **buyer** has the **right**:
 - to buy (for a call) or sell (for a put)
 - 100 shares of underlying stock/ETF
 - at the strike price per share
 - **if he/she exercises a long contract**
- To exercise, the buyer issues an exercise notice to his/her brokerage firm (or Auto-ex)
- Only option **buyers** may **exercise** an option contract

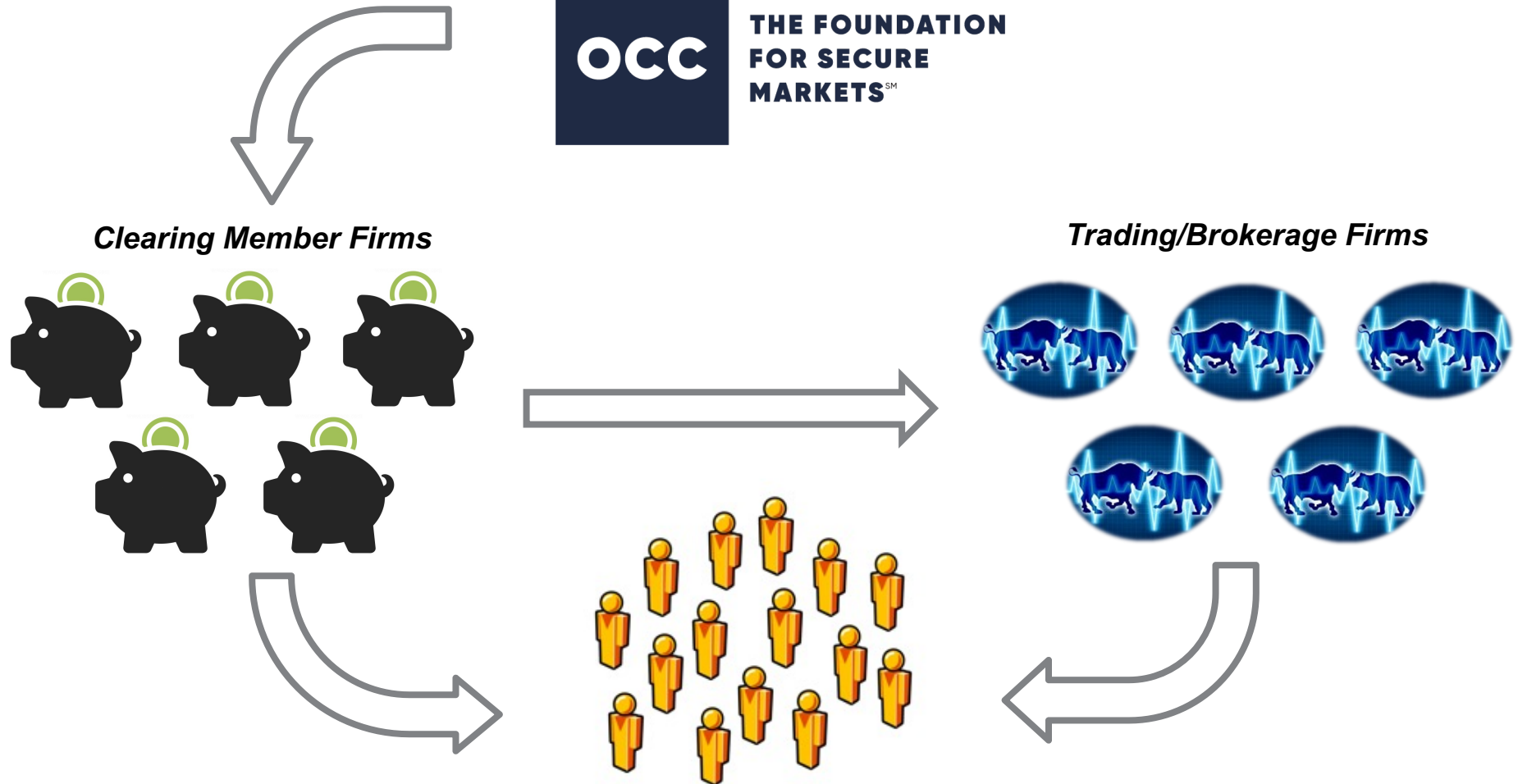
Exercise Process



Assignment: Buy or Sell Underlying Stock

- The option seller has the obligation:
 - to sell (for a call) or buy (for a put)
 - 100 shares of underlying stock/ETF
 - at the strike price per share
 - **if he/she is assigned an exercise notice**
- Assignment notice is received from seller's brokerage firm
- Only option sellers may be assigned on an option contract

Assignment Process

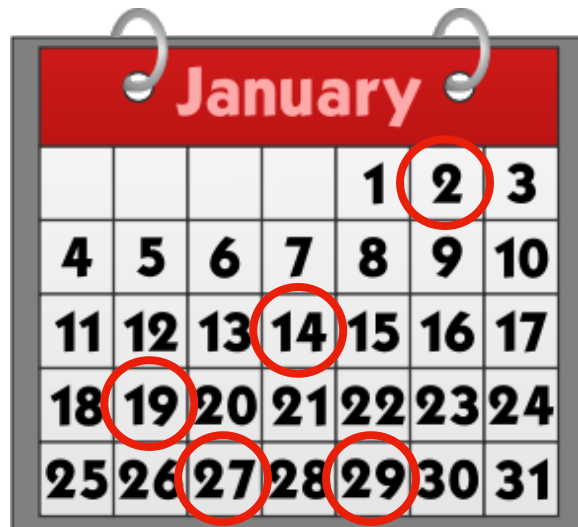


Investors/Traders

Exercise Style

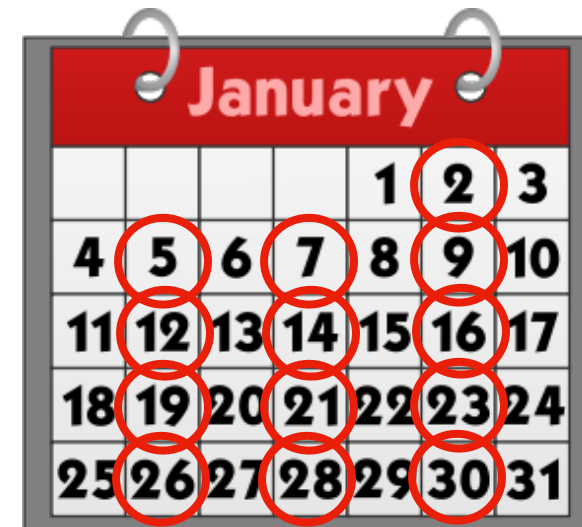
American

- Long side can exercise **at any time** during the life of the option.
- Short side can be assigned **at any time** during the life of the option.



European

- Exercise and assignment can take place **only at expiration** — typically 3rd Friday of the month for monthly contracts.
- *WeeklysSM expire more often



Settlement Style

Physical

- Securities credited to and cash debited from investor's account (purchase transaction).
- Securities debited from and cash credited to investor's account (sale transaction).



Cash

- Investor receives or pays out the cash difference between the in-the-money strike price and the settlement value of the index (intrinsic value).



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