OPTIONS ON STOCKS

OPTIONS are securities that are under the general classification of Derivative Products. Derivatives are securities that derive their value from the movement in the price of another asset (the underlying asset). In the case of Options, the underlying asset is usually common stock.

An option comes in two forms: CALLS and PUTS.

A CALL option gives the holder the right, but not the obligation, to BUY 100 shares of the underlying stock for a predetermined price for a specific period of time. Each call option controls one "round lot" of stock which is 100 shares.

A PUT option gives the holder the right, but not the obligation, to SELL 100 shares of the underlying stock for a predetermined price for a specific period of time. Each put option controls one "round lot" of stock which is 100 shares.

Before 1973, option contracts were not standardized but specific to the individuals that wanted to engage in a transaction. This lack of standardization made the contracts ill-liquid.

In 1973, the Chicago Board Options Exchange was established for call options. The market response was huge. Within three years, the American, Pacific and Philadelphia exchanges were trading calls.

WHY OPTIONS? Options are used for both Insurance and Speculation. In the mid-1980's derivative instruments were given a "once-over" by the press when some firms that used these products found themselves in deep financial trouble when the derivatives that they purchased caused serious losses.

From a speculation standpoint, people and companies can and do lose money on derivative instruments. They also can and do lose money on stocks, bonds, real estate, mutual funds, art, etc. Derivative instruments can and do have a place in many portfolios.

FOUR PRIMARY OPTION TRANSACTIONS

BUY A CALL OPTION

Let's say that AOL stock is trading on the New York Stock Exchange with a price of 100 per share. To own a round lot of AOL, an investor would need $10,000 (100x100).
If the investor felt that AOL was about to move up in the very near future, the investor could buy a call option. The call gives the investor the right, but not the obligation to buy AOL at a predetermined price, say 95. If the call buyer is correct and AOL rises to 105, she can buy 100 shares at the predetermined 95 price. [Called the STRIKE PRICE].

BUY A PUT OPTION

Say that AOL stock is trading on the New York Stock Exchange with a price of 100 per share. To own a round lot of AOL, an investor would need $10,000 (100x100). If the investor felt that AOLs price was about FALL in the very near future, the investor could buy a put option. The put gives the investor the right, but not the obligation to SELL AOL at a predetermined price, say 105. If the put buyer is correct and AOL falls to 90, she can sell 100 shares at the predetermined 105 price.

SELL A CALL OPTION

The seller or "writer" of an option HAS an obligation to SELL or DELIVER shares of the underlying security for the strike price. If an investor sells or writes the MAY 100 Call on AOL, the call seller would be obliged to deliver 100 shares to the call buyer if the call buyer chose to exercise his call option. The call seller has all of the obligation, the call buyer has the rights [but NOT the obligation]. The call seller enters into this transaction for the benefit of receiving the premium from the buyer as income. Confused? You betcha!

SELL A PUT OPTION

Remember the discussion on buying puts. The put buyer wants the price of the stock to fall. Put buyers are in the same camp as short sellers, they believe that stocks will fall in price, speculating on that move OR purchasing insurance on a long portfolio.

Put sellers want the price of the stock to RISE. The put writer or seller has an obligation to BUY 100 shares of stock per contract at the strike price by the exercise month.

Put sellers are in the same camp as CALL BUYERS. Except that the put seller will earn the premium and no more. Let's use another example.

If QCOM is trading for 140 and I think that the stock is going to rise, I could buy a call to capitalize on the increase in price. I could also SELL the 130 Put. As usual, two things could happen: (1) the stock could rise. In this case, I would keep the premium. (2) the stock could fall, to say, 125. In that case, I would be forced to BUY 100 shares at 130.

Put selling has brought me several $ in premiums over the years. Only on a couple of very memorable occasions did the stock go below the strike price. If you don't get greedy, these can work well.

The other way to look at put selling is that it is, in essence, a limit order to buy the stock that pays you money to wait!

Check out: www.cboe.com. For options information, seminars, free literature, free material on options etc.. It is the Chicago Board Options Exchange.

OPTION POSITIONS

Buy A Call	Buy A Put
Call buyer is like the stock buyer.	Put buyer is like the short seller.
Both want stock price to ↑	Both want stock price to ↓
Call buyer has the RIGHT to BUY stock	Put buyer has the RIGHT to SELL stock
At the STRIKE price, before EXPIRATION.	At the STRIKE price, before EXPIRATION.
Call buyer faces: Unlimited GAINS	Put buyer faces: Limited GAINS
Limited LOSSES	Limited LOSSES
To Speculate: Just buy the call.	To Speculate: Just buy the put.
To Insure: Against a short position.	To Insure: Against a long position.
Buy a call option if you think the price of the stock is about to increase within a short period of time. Call buyers want to take advantage of an event happening to the stock.	Buy a put option if you think the price of the stock is about to fall within a short period of time. Put buyers want to take advantage of an event happening to the stock.

Sell a Call	Sell a Put
Call seller wants stock price to ↓	Put seller wants stock price to ↑
Call seller has the OBLIGATION to SELL stock	Put seller has the OBLIGATION to BUY stock
At the STRIKE price, before EXPIRATION.	At the STRIKE price, before EXPIRATION.
Call seller faces: Limited GAINS	Put seller faces: Limited GAINS
Unlimited LOSSES	Limited LOSSES
To Speculate: Sell the option NAKED	To Speculate: Sell the option Naked
To Insure: Sell the option COVERED	To Insure: Sell option against a short position
Sell call option if you think the price of the stock is about to fall within a short period of time. Call sellers will have to produce the stock if the stock price is above the strike price! Selling the option COVERED means you own the stock and can deliver it to the call buyer. Selling the option NAKED is selling the call and you DON'T own the stock. Meaning, you would need to buy it off of the exchange and deliver it to the call buyer.	Sell a put option if you think the price of the stock is going to rise. Selling a put is like making a deal with the market to BUY the stock at the strike price. This is a familiar strategy to those that have been in the market and have the appropriate option permission. If a stock is trading at $10 per share and you want to buy it at $8 per share, you could sell the put with a strike price of 8. If the stock falls to 8 or below, you would have to buy it. If it never falls to 8 you keep the premium as income.