Introduction To Stock Options: The Basics

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Read my blog, written for rookies: http://blog.mdwoptions.com/options_for_rookies/

This is a free eBook. You may distribute it to anyone.

Additional copies are available: http://www.mdwoptions.com/TheBasics.pdf

Introduction

This eBook is intended to give you a taste of the world of stock options. There's enough information for you to decide if you truly want to learn more. If the answer is "yes" links to additional information are provided.

The language of options is introduced, but words that are new to you are kept to a minimum. These new words are in bold the first time they appear. For those interested in learning additional option terminology, a larger glossary is available here.

Your study of this subject can be as simple or complex as you desire. The purpose of this booklet is to provide the most basic introduction, and everything is at an introductory level.

Let's get started.

Chapter 1
What is An Option?

An option is an agreement, or a contract, between 2 people: The buyer and the seller.

The price paid for the option is the **premium**.

There are 2 types of options: **calls and puts**.

A call is the right to buy (and a put is the right to sell):

- A specific item (the **underlying** asset).
- At a specific price (the **strike price**).
- For a specific time (until **expiration**).

That is all there is to an option. It’s not complicated.

If you ever received a rain check at a supermarket, then you've used a call option. The rain check gives you the right to return to the store to buy a certain item at a sale price. The rain check is good for a short period of time.

The premium is zero, because you received the rain check for free. The underlying is the item on sale. The strike price is the sale price. The expiration is the last day the rain check is valid.

Rain checks are very simple items. Stock options are no more complicated than that.

Chapter 2
How Does An Option Work?

An option owner has **rights.** An option seller has **obligations.**

A call owner has the right to buy the underlying by paying the strike price. But, he/she does not have to do so. There is no obligation. If the option owner chooses to do what the contract allows, then he or she is said to **exercise** the option**.**

An option seller has no control over when, or if, the option owner exercises the option. If the owner does exercise, then the seller is **assigned an exercise notice** and is obligated to honor the conditions of the contract:

- The call seller sells 100 shares of stock and receives the strike price per share
- The put seller buys 100 shares of stock and pays the strike price per share

How does an option work in our everyday lives? When you return to the supermarket to use the rain check, you are exercising your call option. When you hand it to the cashier, that is the store owner's notification that he/she has been assigned an exercise notice and must sell the underlying at the strike price.

Chapter 3
Buying Selling, Exercising Options

When you use options in the stock market, the underlying asset is 100 shares of stock.

When you enter an order to buy or sell options, your broker sends it to one of the options exchanges where the order is executed.   This is the same method used to buy or sell shares of stock.

If you ever elect to exercise an option, notify your broker, who takes care of the rest of the process for you.

If you sell an option and later are assigned an exercise notice, it’s your broker who notifies you (before the markets open for business the following morning).

Chapter 4
Getting Started

You must have a brokerage account before you can trade options. If you don't already have one, several good brokers are available.

Because trading options is not for everyone, it's a good idea to read an educational pamphlet before you begin trading: **Characteristics and Risks of Standardized Options**.

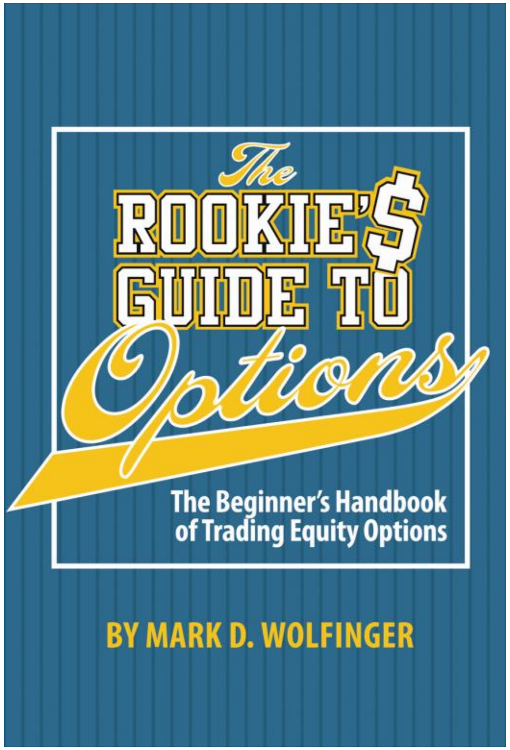
Your broker will send a copy, but it's also available online:
http://www.optionsclearing.com/publications/risks/riskchap1.jsp

You must open a margin account. Don't let this concern you, because it's a requirement for options trading. A margin account allows you to borrow money from your broker, but you don't have to do so.

Chapter 5
Option Books

If you want to learn more about options, there are many books on the subject. Visit your local library, bookstore, or browse Amazon.com.

I've written three books specifically for the options beginner, the most recent is The Rookie's Guide to Options.



Chapter 6
Trading

When trading options, you require a source of option quotes and your broker should provide them. If that doesn't work for you, get quotes from one of the options exchanges.

CBOE: http://www.cboe.com/DelayedQuote/QuoteTable.aspx

Fair value of options

An option can be described in mathematical terms and it's possible to calculate a theoretical, or fair, value for an option. Fortunately it's unnecessary to get involved with the math because calculators are available to do the work.

One such calculator can be found at my web site:
http://www.mdwoptions.com/OptionCalculator.html

Or use one provided by the CBOE (Chicago Board Options Exchange):
http://www.cboe.com/LearnCenter/OptionCalculator.aspx

To use the calculator, you must have some idea of the inputs used in the calculation. They are:

- Stock Price
- ·Strike Price
- **Volatility**
- Interest Rate
- Dividend
- Days remaining before expiration

The only one of these terms that should be new to you is ‘volatility.’ In simple terms volatility is a measure of the tendency of a stock to experience price change. Stocks that have frequent, large price changes are volatile and their options trade at much higher prices than options of stocks that don’t move much.

Volatility is very important to options traders and a more thorough discussion is available here.

Chapter 7
Option Strategies

Options are versatile and there are many ways to use them. Some are highly speculative. Some are conservative. I recommended that you learn conservative strategies when you begin trading options. Later, if you must, you can attempt other methods.

I believe that conservative strategies are so beneficial in helping you earn additional profits from your investment portfolio, that I not only highly recommend them, but stress them in my books.

You can find detailed instruction on how to adopt, and manage, my favorite strategies in The Rookie's Guide to Options. Or you can visit my blog and get started with short discussions on various strategies. In the right-hand column, click on the strategy you want to read about.

Chapter 8
Conclusion

The material presented in this eBook is meant to be an introduction to the options universe. If this is your first time you have encountered options, you have much to learn before being ready to use real money to buy or sell options.

Continue to read and learn. Ask your broker to open a paper trading (practice) account in which you can gain option trading experience, using play money.

More information is available:

- Library
- Bookstore
- Ask your broker
- http://www.mdwoptions.com
- http://blog.mdwoptions.com/options_for_rookies/

Good trading!

This information was provided with the sincere hope you become interested in learning more about using options wisely.

Glossary

Premium – The price of an option

Call – An option contract giving its owner the right to buy the underlying asset at the strike price for a specified period of time

Put - An option contract giving its owner the right to sell the underlying at the strike price for a specified period of time

Underlying – The item the call owner may buy and the put owner may sell

Strike Price – The price at which the option owner may buy or sell the underlying

Expiration – The day, after which an option is no longer a valid contract

Rights – Attributes given to the option owner

Obligations – Attributes accepted by the option seller

Exercise – The process by which an option owner does what the contract allows

Assigned – Notification that the option owner has exercised rights and you are now required to fulfill the conditions of the contract

About the Author

I began trading options for my own account in 1975 and two years later became an options professional as a market maker on the trading floor of the Chicago Board Options Exchange (CBOE). Since mid-2000, I've been teaching individual investors how to adopt risk-reducing, profit-enhancing option strategies.

I've published three books and many magazine articles .

My latest book was released in February, 2008. **The Rookies Guide to Options: The Beginner's Handbook of Trading Equity Options** provides a thorough introduction to options, helping readers *understand* how options are used to make money and reduce risk. The book allows the reader to follow along as a seasoned trader makes trading decisions.

Six option strategies are described in detail.
If you always wanted to learn about options, this is the book for you.

More information is available: book (at) mdwoptions (dot) com.