Options Trading

For

Beginners

Everything you need to know about options and how to trade them

(The One Hour Expert Series)

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Dedication

To my wonderful children

Kim and Simon

Markets are never wrong, but opinions often are.

Jesse Livermore

(The Original Wolf of Wall Street)

This is a 'Short Read'

After writing four full-sized books, and having lots of questions and comments from readers, I realized that sometimes people just want to know about a particular stock market topic without having to wade through an entire book, much of which they already know. Sometimes they just need a refresher on a specific subject but can't remember exactly where they read it, so they have to delve through several books to find it.

To address this need, I decided to write a series of short books on individual topics in the stock market. I selected the twelve topics based on what elicited the most questions from readers.

This book, Options Trading for Beginners, is the second 'short read' to be published and is part of the **One Hour Expert** stock market series. The information covered in these books is too much for a simple report, but the scope is too limited for a full-sized book. It's more like a short story rather than a novel or a newspaper article. These books are designed to be read in an hour or so, I know everyone has a busy life.

Contents

Introduction 13

Ch 1. A Brief History of Options 16

Ch 2. Options Basics 20

Ch 3. How Call Options Work 30

Ch 4. In and Out the Money 36

Ch 5. How Put Options Work 40

Ch 6. Time Value & Intrinsic Value 44

Ch 7. Options Chains 52

Ch 8. Expiring Worthless 58

Ch 9. Option Pricing 60

Ch 10. The Greeks 64

Ch 11. Options Strategies 68

Epilogue 71

About the Author 73

Books by this Author 77

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Introduction

here’s no doubt about it: options have a bad reputation. Google ‘options dangerous’ and you will get more than 8 billion results (yes, that’s right, million with a ‘b’). That’s a lot of people warning you about them and telling you that only expert investors should use them. But do they actually deserve this condemnation?

Today the top result is from Investopedia and starts:

Option contracts are notoriously risky due to their complex nature.

And next from The Motley Fool:

Sometimes options are used for pure speculation. The contracts are so risky that they're more gambling device than investment strategy.

Well, with a reputation like that it is no wonder that people stay away from them and warn other people about how dangerous they are. But what if you knew that, despite their bad reputation, buying options can be less risky than buying stocks? And that far from being complex, they are very easy

to understand? And that they have the ability to increase your money way beyond simply buying stocks? And by only using a fraction of the money that a stock trade would require they can protect your capital much more?

Yes, options do all those things. They are not hard to understand, and after reading this 1-Hour book you will wonder why you ever thought so. Options can be used safely, to increase your profits and to protect your capital. Who doesn't want that?

So, let's get started. Firstly, let's demystify options and debunk some myths and then we can find out how to use options to increase our portfolio value – quickly and safely!

Chapter 1. A Brief History of Options

Options are not a recent invention. They started thousands of years ago in Sumeria, which is now Southern Iraq. Farmers wanted to lock in the prices for their future harvests before they were grown so they used a futures contract which meant that they could go ahead and plant their crops knowing that they were sure of selling them and the price they were going to get for them.

Futures contracts are still around today, and are quite different to options contracts. Futures contracts are 'locked-in' contracts: you MUST buy the asset on the date specified. This could get very messy.

For example, imagine you bought a futures contract of oil intending to sell it before the delivery (expiry) date. Imagine too that the oil price dropped hugely, like it did at the start of the Covid pandemic when in April 2020 it dropped below zero dollars a barrel, and you couldn't sell your futures contract.

There were no buyers – after all, who wants to buy something that is worth less than nothing? On the contracted date you would have to take delivery of 1,000 barrels of oil. Imagine the logistics!

Options are different to futures in that they are not ‘locked in’ contracts, so you don’t HAVE to take delivery.

The first options contract was made by a Greek philosopher called Thales, a part time astronomer and olive grower, who one year had an omen that he was going to have a huge crop of olives. He didn’t have an olive press of his own but rented time on the press from a neighboring farmer.

He wanted to be sure that he could press his olives if he had a good season – but he didn’t want to have to pay for the use of the olive press if he had a bad season. So, he used a contract where he paid the olive press owner a fee to let him use the olive press if he needed to, but not the obligation to use it if he didn’t. That’s what an option contract is: it gave him the right to use the press but not the obligation.

‘Modern’ options trading started in Belgium in the 1500s, when a huge market called The Bourse was set up. What was different about The Bourse was that unlike other markets at that time it did not sell actual goods, but the right to buy and sell goods at a future date. In 1791 the New York Stock Exchange (NYSE) opened and had options trading, but it wasn’t until 1968 that this was regulated and became the options market as we know it today.

In the 1970s computers changed everything as there could now be a central clearinghouse and prices could be listed. In 1992 (surprisingly late I always think) trading became

electronic so there was an upsurge worldwide in trading stocks, commodities, and derivatives.

Options work a bit like an insurance premium. When you pay for an insurance contract it gives you the right to make a claim (and know that the insurance company will pay), but if you don't make a claim then you don't get a refund of your premium.

What Are Options?

If you google 'what is an option' you will find Investopedia telling us:

> ***Options are financial derivatives that give the buyer the right to buy or sell the underlying asset at a stated price within a specified period.***

This may be accurate, but it's not particularly helpful. It is a bit like googling 'what is a dog'. If you do that then Wikipedia will tell you:

> ***The dog or domestic dog (Canis familiaris or Canis lupus familiaris) is a domesticated descendant of the wolf which is characterized by an upturning tail.***

Again, it is technically correct, but completely unhelpful. If you were trying to explain what a dog was to someone who had never seen one, then you wouldn't use this explanation because it doesn't help us in understanding or visualizing what a dog is. Showing someone a video or photos of a dog,

or the practical experience of actually meeting a dog will help them understand much better what a dog was.

So that's what we are going to do with options. Let's ignore the stock market for a short time while we look at options in an area most people are more familiar with. Their own home. Let's play 'let's pretend' and learn about options an easy way.

Chapter 2. Options Basics

Mark is thinking of moving house. He would like something a little bigger, and a bit more upmarket. He decides to take action. But what is his first step?

First, get the money side of it sorted, of course. He has to work out what his current house is worth. Mark checks the real estate websites and sees that in the last year two houses in his street have been sold, and both are very similar to his. One went for $102,000 and the other for $104,000.

He has heard that the market has slipped a little recently, so he estimates that his house should be worth around $100,000. (Yes, I know that this is a bit low, but we are keeping all the figures nice and easy so that you can concentrate on the concept and not worry about the arithmetic.)

He has a mortgage on his house, and he still owes $40,000 on it. He works out that his equity in the house (the bit that he owns) is $60,000 (How? $100K house price -$40K owing on mortgage). He checks with his bank, and because he is a good customer and has never missed any payments, they

are quite happy to give him a loan of $110,000. Excellent! That means he can start looking at houses in the $170,000 range. (How? The $60,000 equity plus the $110,000 loan). But first, of course, he has to sell his current house.

Now you'll have to work with me here and use your imagination. Imagine that just then Mark's doorbell rings. It's a well-dressed woman who says that she is interested in his house and hands him a business card which says Prestige Property Investments. Goodness! What a coincidence!

Mark asks her how much she is prepared to pay for his house. The woman explains that she is not buying today, but that her company options properties. Mark has never heard of this and has no idea what she is talking about, so he asks her to clarify what she means.

'How it works,' she explains, 'is that we option properties. We offer above the market rate and as well we pay you a premium. Your house, for example. We would be willing to option it for one year at $120,000. And we would pay you a premium up front, of $10,000.'

Mark doesn't really understand what she means. Her explanation is not exactly helpful, but Mark hears the figures she is quoting and thinks they sound good. Should he be interested? Not interested? Is it a good deal? A bad deal? What should Mark do? Let's unpack the Prestige Property offer to see whether he should be interested or not.

- Mark is being offered a selling price of $120,000. He knows that this is quite a bit over the market price of $100,000.

- The period of the option is one year, which means that anytime within the year they have the right to buy it from Mark at $120,000.

- Mark is getting $10,000 'premium' up front. This means that if he agrees to the option contract, he will get $10,000 today – and that is on top of the $120,000.

Do Prestige Property Investments ***have*** to buy the house from Mark? No, they don't. They have the ***right*** to buy it but not the ***obligation*** to buy it. But if they do decide to buy it then the selling price is $120,000.

What about the $10,000 premium? Mark gets to keep that whether they buy the house or not. That's his, right now, and he never has to pay it back whether the house is sold or not. In other words, the premium is a payment for entering into the contract. So, let's look at the pros and cons to see whether Mark should be interested or not.

The Pros:

- Mark is thinking of moving anyway and getting $120,000 is a lot better than the $100,000 he was expecting.