Premium Income Investor: All About Options

What I'm going to do here is give you an understanding of options, then I'll get into the difference between monthly and weekly options.

The first thing to understand is that an option is nothing more than the right, but not the obligation, to buy or sell a stock for a specified price on or before a specific date.

That's all it is.

An option BUYER owns the RIGHT to buy or sell a stock at a fixed price until the option expires. An option buyer pays money to own those rights.

An option seller owns the OBLIGATION to buy or sell a stock at a fixed price until the option expires. An option seller receives money to take that obligation.

A Call option is the right to buy a stock at a specific price on or before a specific date.

A Put option is the right to sell a stock at a specific price on or before a specific date.

You can buy options and you can sell options.

You can also sell options you don't own.

The trader that purchases an option, whether it is a Put or a Call, is the option "buyer."

The trader that originally sells the Put or Call is the option "seller."

Each option contract is equal to 100 shares of the underlying stock.

There are basically two things you do with options, BUY or SELL them.

When you buy an option, you are buying the “right” to buy or sell a stock, on or before a certain date, (called the expiration date), at a certain price, (called the strike price).

When you sell an option, you are selling the “obligation” to buy or deliver a stock, on or before a certain date, (called the expiration date) at a certain price, (called the strike price).

There are four parts to an option.

1. The TYPE - Put or Call
2. The UNDERLYING STOCK
3. The EXPIRATION DATE
4. The STRIKE PRICE

1st Part Of An Option - Type: Puts and Calls

Calls

When investors anticipate a stock’s price will be rising, they would buy Calls.

When they buy a Call, they are buying the right to “call” the stock away from someone at a fixed price, (the strike price) for a fixed amount of time, until the expiration date (which is always the third Friday of the expiration month for monthly options and every Friday for weekly options).

How Does A Weekly Call Option Work?

When you buy a weekly Call, you buy the right to “Call” the stock at the strike price until Friday’s close.

When you sell a Call, you sold someone the right to Call the stock away from you at the strike price anytime through Friday’s close.

A Call Option rises when the underlying stock rises. The value will be higher, the lower the strike price is.

Lets’ say ABC is trading at 100. The investor that thinks ABC will be higher by Friday could buy an ABC weekly 100 Call and it will rise as ABC rises. The lower the strike price, relative to the price of the stock, the higher the options value. The ABC 90 Call will be worth more than the ABC 95 Call if ABC is at 110 because it allows the Call holder to lock in a bigger profit.

If ABC does not rise, the value of both options will decay over the week. If ABC is below 90, the options won’t have any value.

Puts…

When investors anticipate a stock’s price will be dropping, they would buy Puts.

When they buy a Put, they are buying the right to "Put" the stock to someone at a fixed price, (the strike price) for a fixed amount of time, until the expiration date (which is always the third Friday of the expiration month for monthly options and every Friday for weekly options).

How Does A Weekly Put Option Work?

When you buy a weekly Put, you buy the right to "Put" the stock at the strike price until Friday's close.

When you sell a Put, you have sold someone the right to Put the stock to you at the strike price at anytime through Friday's close.

A Put Option rises when the underlying stock drops. The value will be higher, the higher the strike price is.

Lets' say ABC is trading at 100. The investor that thinks ABC will be lower by Friday could buy an ABC weekly 100 Put and it will rise in value as ABC drops. The higher the strike price, relative to the price of the stock, the higher the option's value. The ABC 110 Put will be worth more than the ABC 100 Put if ABC is at 90 because it allows the Call holder to lock in a bigger profit.

If ABC does not drop, the value of the Put will decay over the week. If ABC is above 100, the options won't have any value.

OK, so that's the first part of an option, Put or Call.

2nd Part Of An Option > The Underlying Stock

Every option has an underlying stock as its root. In our example above, ABC is the underlying stock. The price fluctuation of the underlying stock will cause a fluctuation in the price of the option.

3rd Part Of An Option > The Expiration Date

Options are only traded until a fixed date called the expiration date. In our ABC example, the options expire on Friday because they are weekly options.

4th Part Of An Option > The Strike Price

Strike prices are spaced 1 - 5 points apart on stocks.

With Call options, the strike price is the price that the Call owner can buy the underlying stock at.

For Call sellers, the strike price is the price the call seller is obligated to deliver the stock at.

With Put options, the strike price is the price the Put owner could sell the stock at anytime he wants until expiration.

For Put sellers, the strike price is the price you could have the stock Put to you.

Here are a few more things you need to know about options…

"Premium"

The premium is the price of an option contract, as quoted by the exchange it trades on. It's the price that the buyer (holder) of the option pays to the option seller (writer) for the rights conveyed by the option contract.

Options are said to be in-the-money, at-the-money or out-of-the-money depending on where the stock price is relative to the option's strike price.

"In-The-Money"

A Call is in-the-money when the price of the underlying stock is greater than the option's strike price.

A Put is in-the-money when the price of the underlying stock is lower than the option's 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.

"Out-Of-The-Money"

A Call option is out-of-the-money if the strike price is greater than the market price of the underlying stock.

A Put option is out-of-the-money if the strike price is less than the market price of the underlying stock.

"Intrinsic Value Of An Option"

The intrinsic value of an option is the difference between an in-the-money option strike price and the current market price of a share of the underlying stock.

"Time Value Of An Option"

Time value of an option is the portion of the premium that is attributable to the amount of time remaining until the expiration of the option contract and to the fact that the underlying components that determine the value of the option may change during that time.

Time value is generally equal to the difference between the premium and the intrinsic value.

Three Things That Effect The Price Of An Option

1. The price of the underlying stock relative to the strike price of the option. Options in-the-money are priced higher than options that are out-of-the-money.

2. The time remaining until expiration of the option. The longer the time left in an option, the more value it will retain. As options get closer to expiration, the time decay erodes their value. We let this price erosion factor work to our benefit when we spread Puts in the current month.

3. The volatility of the underlying stock, the higher the option's premium will be.

You may want to re-read this again because you'll need a firm grasp of options in order to apply the Premium Income strategy.