

# What Is an Option?

An option is a contract to buy or sell a specific financial product officially known as the option's underlying instrument or underlying interest. For equity options, the underlying instrument is a stock, exchange-traded fund (ETF), or similar product. The contract itself is very precise. It establishes a specific price, called the **strike price**, at which the contract may be **exercised**, or acted on. And it has an **expiration date**. When an option expires, it no longer has value and no longer exists.

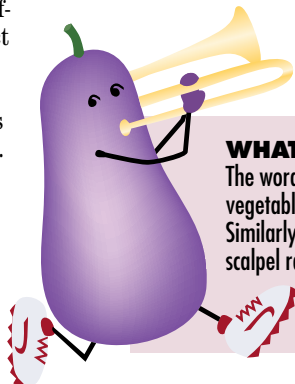
Options come in two varieties, **calls** and **puts**, and you can buy or sell either type. You make those choices—whether to buy or sell and whether to choose a call or a put—based on what you want to achieve as an options investor.

## BUYING AND SELLING

If you buy a call, you have the right to buy the underlying instrument at the strike price on or before the expiration date. If you buy a put, you have the right to sell the underlying instrument on or before expiration. In either case, as the option holder, you also have the right to sell the option to another buyer during its term or to let it expire worthless.

The situation is different if you **write**, or sell, an option, since selling obligates you to fulfill your side of the contract if the holder wishes to exercise. If you sell a call, you're obligated to sell the underlying interest at the strike price, if you're assigned. If you sell a put, you're obligated to buy the underlying interest, if assigned.

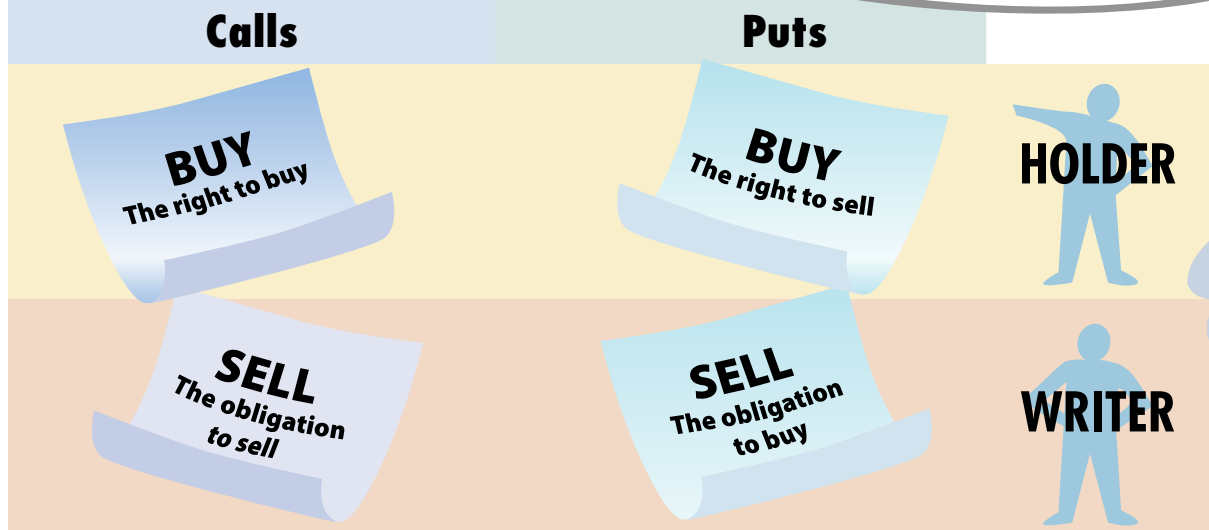
As a writer, you have no control over whether or not a contract is exercised, and you need to recognize that exercise is always possible at any time until the expiration date. But just as the buyer can sell an option back into the market rather than exercising it, as a writer you can purchase an off-setting contract and end your obligation to meet the terms of the contract.



## WHAT'S A FINANCIAL PRODUCT?

The word *product* is more likely to conjure up images of vegetables or running shoes than stocks or stock indexes. Similarly, *instrument* might suggest a trombone or a scalpel rather than a debt security or a currency. But both terms are used to refer to the broad range of investment vehicles.

## TYPES OF OPTIONS CONTRACTS



An options contract gives the buyer rights and commits the seller to an obligation.

## RULE OF THUMB

For options expiring in the same month, the more in-the-money an option is, the higher its premium

## AT A PREMIUM

When you buy an option, the purchase price is called the **premium**. If you sell, the premium is the amount you receive. The premium isn't fixed and changes constantly—so the premium you pay today is likely to be higher or lower than the premium yesterday or tomorrow. What those changing prices reflect is the give and take between what buyers are willing to pay and what sellers are willing to accept for the option. The point at which there's agreement becomes the price for that transaction, and then the process begins again.

If you buy options, you start out with what's known as a **net debit**. That means you've spent money you might never recover if you don't sell your option at a profit or exercise it. And if you do make money on a transaction, you must subtract the cost of the premium from any income you realize to find your net profit. As a seller, on the other hand, you begin with a **net credit** because you collect the

premium. If the option is never exercised, you keep the money. If the option is exercised, you still get to keep the premium, but are obligated to buy or sell the underlying stock if you're assigned.

## THE VALUE OF OPTIONS

What a particular options contract is worth to a buyer or seller is measured by how likely it is to meet their expectations. In the language of options, that's determined by whether or not the option is, or is likely to be, in-the-money or out-of-the-money at expiration. A call option is in-the-money if the current market value of the underlying stock is above the exercise price of the option, and out-of-the-money if the stock is below the exercise price. A put option is in-the-money if the current market value of the underlying stock is below the exercise price and out-of-the-money if it is above it. If an option is not in-the-money at expiration, the option is assumed to be worthless.

An option's premium has two parts: an intrinsic value and a time value. Intrinsic value is the amount by which the option is in-the-money. Time value is the difference between whatever the intrinsic value is and what the premium is. The longer the amount of time for market conditions to work to your benefit, the greater the time value.

Finding values	For example
Share market price	\$25
– Exercise price	– \$20
<b>= Intrinsic value</b>	<b>= \$ 5</b>
Premium	\$ 6
– Intrinsic value	– \$ 5
<b>= Time value</b>	<b>= \$ 1</b>

## OPTIONS PRICES

Several factors, including supply and demand in the market where the option is traded, affect the price of an option, as is the case with an individual stock. What's happening in the overall investment markets and the economy at large are two of the broad influences. The identity of the underlying instrument, how it traditionally behaves, and what it is doing at the moment are more specific ones. Its volatility is also an important factor, as investors attempt to gauge how likely it is that an option will move in-the-money.

## OLD AND NEW

American-style options can be exercised any time up until expiration while European-style options can be exercised only at the expiration date. Both styles are traded on US exchanges. All equity options are American style.