



OPTIONS GUIDEBOOK  
LEARN HOW  
STOCK OPTIONS  
COULD ENHANCE  
AND PROTECT  
YOUR PORTFOLIO



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# LEARN HOW STOCK OPTIONS COULD ENHANCE AND PROTECT YOUR PORTFOLIO

## TRADING OPTIONS AT SAXO

Options are an interesting product for experienced investors to consider adding to their trading armoury. In this guide we have focused on how investors might use options for positioning (buy call or buy a put), protection (buy a put) or income enhancement (the covered call). Trading options is not without risk, and this should be remembered; those risks are most prominent when traders are selling.

Options of course have their own jargon and behavioural characteristics. They are not magic and do not provide a guaranteed return. Time spent studying how they can help your overall investment strategy could prove beneficial.

Saxo offers investors the opportunity to access over 200 of the most liquid Options on Stocks and Stock Indices. Trading is conducted via our award-winning cross device trading platform, SaxoTraderGO. SaxoTraderGO delivers an advanced environment to trade Options, including a recently launched Options Chain featuring: In-The-money highlighting of strikes, collapsible strikes and customizable number of strikes shown for each expiry.

Combined with competitive pricing and tight spreads, Saxo provides clients with ongoing support from our team of trading experts.

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# WHAT ARE STOCK OPTIONS?

Stock Options are listed instruments that trade on exchanges around the world. For example, the Chicago Board Options Exchange offers listed options on companies such as Apple and Google, while Eurex offers options on companies such as Deutsche Telecom. Because they are listed on an exchange, options are more transparent than instruments that trade over-the-counter (outside an exchange).

## SOME BASIC STOCK OPTION DEFINITIONS

- An equity option is a contract that conveys to its holder the right, but not the obligation, to buy (in the case of a call) or sell (in the case of a put) shares of the underlying security at a specified price (the strike price) on or before a given date (expiration day). After this given date, the option ceases to exist.
- The seller of an option is, in turn, obliged to sell (in the case of a call) or buy (in the case of a put) the shares to (or from) the buyer of the option at the specified price upon the buyer's request.

	HOLDER (BUYER)	WRITER (SELLER)
CALL OPTION	Right to buy	Obligation to sell
PUT OPTION	Right to sell	Obligation to buy

- US Equity option contracts usually represent 100 shares of the underlying stock.
- Strike prices (or exercise prices) are the stated price per share for which the underlying security may be purchased (in the case of a call) or sold (in the case of a put) by the option holder upon exercise of the option contract.
- Premium is the price at which the contract trades. This price fluctuates daily.
- Equity option holders do not enjoy the rights due stockholders (e.g., voting rights, regular cash or special dividends). A call holder must exercise the option and take ownership of underlying shares to be eligible for these rights.
- Buyers and sellers set option prices in the exchange markets. All trading is conducted in the competitive manner of an auction market.

# WHO TRADES OPTIONS?

Options are no longer traded exclusively by professional investors. More and more retail traders are using them due to their versatility and flexibility. For the inexperienced investor, however, options can seem a complicated instrument. Education and patience are important ingredients for potential success with options.

# BENEFITS OF TRADING OPTIONS

**VERSATILITY** – Although not suitable for every investor, investors who favour a versatile trading strategy may want to become more familiar with the product. For example, if an investor who owns Apple shares is concerned that the shares may drop in value, she/he could buy a protective put to protect that position.

**INCOME** – As with the above example if shares of Apple were trading in a range, the shareholder could sell a covered call option and receive a premium or an income from it while still holding the stock.

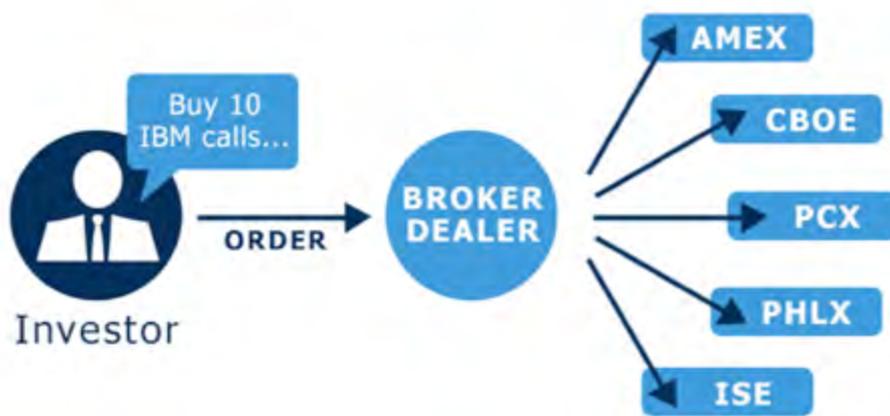
**COST EFFICIENCY** – Suppose you had \$5,000 to invest and wanted to invest in shares of Google, currently trading at \$670 per share, anticipating that the stock would rise in value. You could purchase 7 shares of Google ( $7 \times \$670 = \$4,690$ ). If the shares moved up to \$700, you would realize a profit of \$210 ( $\$700 \text{ minus } \$670 = \$30 \times 7$ ), or 4% return on your initial investment of \$5,000 (not including commissions).

**ALTERNATIVELY** – With \$5,000 investment capital you can buy 7 call options at \$6.40 per contract ( $7 \times \$6.40 \times 100 = \$4,480$  excluding commissions) that would allow you to buy Google shares at \$670. If the shares moved up to \$700, you could buy 700 shares (7 contracts  $\times$  100 shares) at \$670 and sell them in the market for \$700 a share or \$2,100 profit ( $\$30 \times 700$  shares). This is a return of 40% on the initial investment of \$5,000.

As illustrated above, 700 shares of Google can be controlled with \$5,000. While investors can reap good profits from options, they are not risk-free and investors can also lose the entire amount that they paid to own an option. It is also important to remember that when selling an option ‘naked’ (without physical stock cover), losses can indeed exceed deposits.

# OPTIONS ABCS

Above, you will see a summary of some basic option definitions. Just like stocks, options are listed and traded on exchanges. For instance, options on shares of IBM are multiply listed on US equity option exchanges, while Eurex lists options on shares of Adidas. An investor will access the exchange through a broker like Saxo.



## STANDARDIZATION

Whether you choose to trade options listed on US options exchanges such as CBOE, NYSE, NASDAQ etc, or on Eurex or on the Hong Kong Stock Exchange, the contract specifications will be uniform on that exchange. This uniformity is also called standardization, i.e. same in type, style, underlying stock, unit of trade, exercise and expiration. The process of standardization resembles a production line where a bottle of Coca-Cola will have the same size, label, colour and content.

## TYPE OF OPTIONS

The two types of option contracts are calls and puts. A call option gives the right to its buyer to purchase a specific number of shares of underlying stock at a predetermined price and amount of time.

**FOR EXAMPLE** – One contract of Delta Airlines (DAL) December 45 call option will give the buyer the right (but not the obligation) to buy 100 shares at \$45 per share, before December expiration.

Instrument	Last Traded	Net Change	% Change	Bid	Ask	Volume	Open	High	Low
Delta Air Lines Inc.	47.50	0.40	0.85	47.49	47.50	11,128,009	47.31	48.18	46.88
<b>Calls</b>					<b>Puts</b>				
		Last Traded	Strike			Last Traded			
Delta Air Lines Inc. (47.50) – 100 shares		Dec-2015		Expiry Date: 18-Dec-2015 (91 Days)					
	6.70	42.00	▲	1.38					
	5.70	43.00		1.69					
	5.10	44.00		2.01					
	4.77	45.00		2.45					
	4.12	46.00		2.87					
	3.30	47.00		2.90					
	2.90	48.00		4.15					
	2.70	49.00		5.15					
	1.85	50.00		5.30					
	1.15	52.50		9.60					
	0.75	55.00		8.80					
	0.21	60.00	▼	14.80					

A put option gives the owner of the option the right (but not the obligation) to sell a specific number of shares of the underlying stock at a predetermined price within a certain time period.

One contract of a Caterpillar Inc. November 77.50 put option will give the buyer the right to sell 100 shares of the company at \$77.50 at any time before November expiration.



Instrument	Last Traded	Net Change	% Change	Bid	Ask	Volume	Open
Eq Caterpillar Inc.	74.11	-1.58	-2.09	74.10	74.11	1,619	75.40
<b>Calls</b>				<b>Puts</b>			
^		Last Traded	Strike			Last Traded	
^ Caterpillar Inc. (74.11) - 100 shares		Nov-2015		Expiry Date: 20-Nov-2015 (63 Days)			
	20.85	55.00	^				0.37
	14.39	60.00					0.45
	9.62	65.00					1.01
	7.50	67.50					1.33
	5.50	70.00					2.05
	4.76	72.50					2.69
	2.75	75.00					4.00
	1.55	77.50					5.35
	0.89	80.00					7.50
	0.52	82.50					8.40
	0.21	85.00					11.95
	0.12	87.50	v				16.10

### STRIKE PRICE

Also known as the exercise price, this is the price at which a buyer can purchase shares of the underlying stock. As in the above example, a buyer of a Delta December 45 call option can exercise or purchase the share of the underlying stock at \$45 per share.

### WHAT IS EXPIRATION?

Options contracts are for a specified period. Similar to an insurance policy, they expire at a predetermined date and time. Standard US equity options expire on the third Friday of the calendar month that contract is assigned to. For instance, the Caterpillar Inc. November 77.50 put will expire on the third Friday of November. Therefore, investors who wish to exercise their options must do so by the third Friday of the expiration month.

JANUARY						
SUN	MON	TUE	WED	THU	FRI	SAT
X	X	X	X	X	X	X
X	X	X	X	X	X	X
X	X	X	X	X	X	X
X	X	X	X	X	X	X
X	X	X				

Expiration Friday is the third Friday of the month (if Friday is holiday then Thursday). It is the last day expiring equity options and the last day option may be exercised by contract buyer.

Expiration day for expiring standard equity options is the Saturday following the third Friday of the expiration month.

As a note, most options have expiration of up to 9 months from the date they are issued. However, there are longer-term US equity options that can have an expiration of up to 3 years. These options are called LEAPs or Long-Term Equity Anticipation Securities.



## AMERICAN & EUROPEAN STYLE

Most stock options traded on US equity option exchanges are American style, which means that they can be exercised at any time during the life of the option. Other options, including most currency options, trade in the European style, which means that they can only be exercised during a defined period before the expiration of the option.

## WHAT IS A PREMIUM?

The premium is the cost of the option and is the fee paid by the option buyer to the option seller. If we bought Caterpillar Inc. November 77.50 puts at \$5.35 per contract, the holder of the contract would multiply the premium of \$5.35 by 100 (a standard contract covers 100 shares of stock) and pay \$535, excluding brokerage fees.

## HOW DO WE POTENTIALLY MAKE MONEY WITH OPTIONS?

There are several elements that influence the cost of an option contract, which we will discuss in more depth in subsequent publications. As a buyer, you would gain from an option contract when the value of the contract rises. For example, if you buy an option for \$2 ( $\$2 \times 100 = \$200$ ) per contract, and then sell that option for \$4, you would profit from the difference:  $\$4 \text{ minus } \$2 = \$2 \times 100 \text{ shares or } \$200$ .



If the value of the contract we bought goes down to \$0.50, then we would lose \$1.50 per contract or \$150. When you sell (write) to open an option position, and receive the premium, you benefit if the option value decreases. Suppose you sold an option for \$400 ( $\$4 \times 100$ ). The money would go into your account as a credit of \$400. If you then subsequently bought back the same option for \$1, your net profit before commission would be  $(\$4 \text{ minus } \$1 \times 100) = \$300$ . Conversely, if the option you sold cost you more than the purchase price to buy back, you would make a loss.



**EXAMPLE:** you sold 1 option for \$5 or \$500. Two weeks later, you buy back (close out) the position on the same contract and pay \$800 for it. The loss would be the difference between initial credit of \$500 and the closing debit of \$800 = \$300. Of course, it is important to note that in instances where this option may not be bought back, the writer may be exposed to potential losses.

## SUMMARY

Exchange-traded option contracts are listed on an exchange and are standardized on that exchange in terms of their type, style, underlying stock, exercise price, cost quotation method and expiration.

The two types of options are **CALL OPTIONS AND PUT OPTIONS**. A buyer (holder) of a call has the right (but not the obligation) to purchase shares of a stock at a predetermined price during the option's life. A buyer of a put option has the right (but not the obligation) to sell the underlying stock at a specific price during the option's life.

The life of an option is typically up to nine months after which the option expires. Owners of an option can only exercise an option before expiration. The strike price is the price at which an option can be exercised, to buy in the case of a call (or sell in the case of a put) the underlying stock. The buyer of the contract is the owner and he/ she is said to be long that contract. On the other side, the seller of the contract is short the contract in his/her account.



## LONG VERSUS SHORT

BUY 1 NOV IBM 140 CALL = LONG 1 NOV IBM 140 CALL

SELL 1 NOV IBM 140 CALL = SHORT 1 NOV IBM 140 CALL

In the above case, the seller of the November IBM 140 call receives the premium and in return undertakes the obligation to fulfil the terms of the contract, i.e. sell shares of IBM at \$140 per share if requested.

## ASSIGNMENT VERSUS EXERCISE

If you had bought an IBM 140 call and decided that you wanted to buy the shares at \$140, you would need to inform your brokerage firm of your intent. The process is known as exercise. After the clearing house has been notified by your broker, the clearing house will randomly select another brokerage firm with clients who have sold the November IBM 140 call.

Ultimately, the client that receives the notice of exercise will be assigned to physically deliver the shares. Similarly, if you were long a put option and decided to exercise, the process will involve the same mechanics.

## WHAT ARE INTRINSIC AND EXTRINSIC VALUE?

An option's value is comprised of two elements: intrinsic and extrinsic value.

$$\text{PREMIUM (COST)} = \text{INTRINSIC VALUE (VALUE IF EXERCISED)} + \text{EXTRINSIC VALUE (TIME)}$$

The intrinsic value of an option is the difference between the current stock price and strike price. Extrinsic value (also known as time value) is any premium in excess of intrinsic value before expiration. Time value will decrease slowly each day and accelerates the closer the option gets to expiration.

$$\text{INTRINSIC VALUE} = \text{STOCK PRICE} - \text{STRIKE PRICE}$$

## TO ILLUSTRATE CONSIDER THE FOLLOWING EXAMPLE:

Facebook shares were trading at \$89, and a \$86 call option, with 30 days to expiration, was selling at \$6.50 premium. Therefore,

$$\text{INTRINSIC VALUE} = \$3 (\$89 - \$86)$$

## WHAT WOULD BE THE TIME VALUE FOR THE CONTRACT?

The answer would be the difference between the premium and the intrinsic value, or \$6.50 minus \$3 = \$3.50

Depending whether you bought or sold an option contract, the time value could work to your advantage or disadvantage. Remember, at expiration the option only has intrinsic value. Understanding how both intrinsic and extrinsic value works could make the difference between making and losing money when trading options.

### WHAT IS MONEYNES?

'Money' describes the option's strike price in relationship to the stock price. Options with intrinsic value are considered in-the-money, while options with no intrinsic value are out-of-the-money.

### A CALL IS CONSIDERED: IN-THE-MONEY (ITM)

when its strike price is less than the stock price

### AT-THE-MONEY (ATM)

when the strike price is the same as the stock price

### OUT-OF-THE-MONEY (OTM)

when strike price IS HIGHER than the stock price

Instrument	Last Traded	Net Change	% Change	Bid	Ask
Facebook Inc.	89.29	0.08	0.09	89.27	89.30

Calls					
	Last Traded	Bid	Ask	Volume	Strike
	0.00	6.50	6.85	0	86.50
	7.25	6.25	6.60	5	87.00
	0.00	5.95	6.30	0	87.50
	6.00	5.75	5.95	19	88.00
	5.49	5.50	5.70	25	88.50
	5.45	5.25	5.40	15	89.00
	4.96	5.00	5.15	100	89.50
	4.71	4.70	4.90	9	90.00
	6.15	4.45	4.65	0	90.50
	4.25	4.20	4.40	127	91.00
	4.15	3.95	4.15	15	91.50
	3.80	3.75	3.95	29	92.00

ITM  
ATM  
OTM

### A PUT IS CONSIDERED: IN-THE-MONEY

when the strike price is greater than the stock price

### AT-THE-MONEY

when the strike price is equal to the stock price

### OUT-OF-THE-MONEY

when the strike price IS LESS than the stock price

Instrument	Last Traded	Net Change	% Change	Bid	Ask
Facebook Inc.	88.78	-0.43	-0.48	88.77	88.79

Puts					
	Strike	Volume	Bid	Ask	Last Traded
	86.00	6	3.80	3.95	3.76
	86.50	27	4.00	4.20	3.80
	87.00	31	4.20	4.40	4.00
	87.50	OTM		4.60	5.01
	88.00	27	4.65	4.80	4.80
	88.50	6	4.90	5.00	4.65
	89.00	ATM		5.30	5.10
	89.50	22	5.35	5.50	4.85
	90.00	ITM		5.80	6.15
	90.50	13	5.80	6.05	5.80
	91.00	21	6.10	6.30	6.60
	91.50	12	6.35	6.60	6.35

### SUMMARY

A buyer of an option is said to be long that contract. A seller of an option is said to be short. If the option buyer exercises the option to purchase a stock (in the case of a call), or sell a stock (in the case of a put) he/she has to notify their brokerage firm. The broker will notify the clearing house, which will randomly assign the exercise notice to a customer with the exact opposite position. The premium of an option consists of **INTRINSIC AND EXTRINSIC (OR TIME) VALUE**. Time value is extinguished at the option's expiration and also by exercise.



Moneyness refers to the relationship between the strike price and the stock price. In-the-money options have intrinsic value. At-the-money options may have little intrinsic value, and out-of-the money options have none.

FACEBOOK NOVEMBER 90 CALL	
CALL OWNER WHO EXERCISES	CALL WRITER (SELLER) WHO IS ASSIGNED
Buy 100 shares of Facebook per call option. Pays \$9,000 (\$90 x 100)	Sells 100 shares per call option exercised. Receives \$9,000

FACEBOOK NOVEMBER 90 PUT	
PUT OWNER WHO EXERCISES	PUT WRITER (SELLER) WHO IS ASSIGNED
Sells 100 shares of Facebook per put option. Receives \$9,000	Buys 100 shares per put option exercised. Pays \$9,000

## STRATEGIES

As with all investments, investors should carry out their research and understand the profit and risk implications of the position that they are establishing.

## TRADING A LONG CALL

### CHOOSING AN EXPIRATION DATE

If the stock price moves as planned in the short run, you can sell back the option ahead of the expiration date. Selling an option that still has time to run also enables the investor to realise any time value. It could be a good idea to have more time left in the contract, than to run out of time and not give a chance for the stock price to move your way. Therefore, if you believe that in 2-3 weeks the shares of Facebook will reach \$115, you could look at an option with an expiration of at least 30 days.

### CHOOSING A STRIKE PRICE

There are variations of selecting a strike price. Many inexperienced investors tend to purchase calls with strike prices that are out-of-the money (OTM). OTM options are cheaper compared to in-the-money options. The cheaper the option, the more leverage it will have, but the price will also have to move more for it to become profitable. In our example, we will use a Facebook April 105 call as a more conservative use of leverage. The cost or the premium to own it is \$5.30 per contract x 100 shares, a total investment of \$530 excluding commissions.

**BREAKEVEN POINT IS THE PRICE POINT WHERE THE INVESTOR WILL NOT MAKE OR LOSE MONEY.**

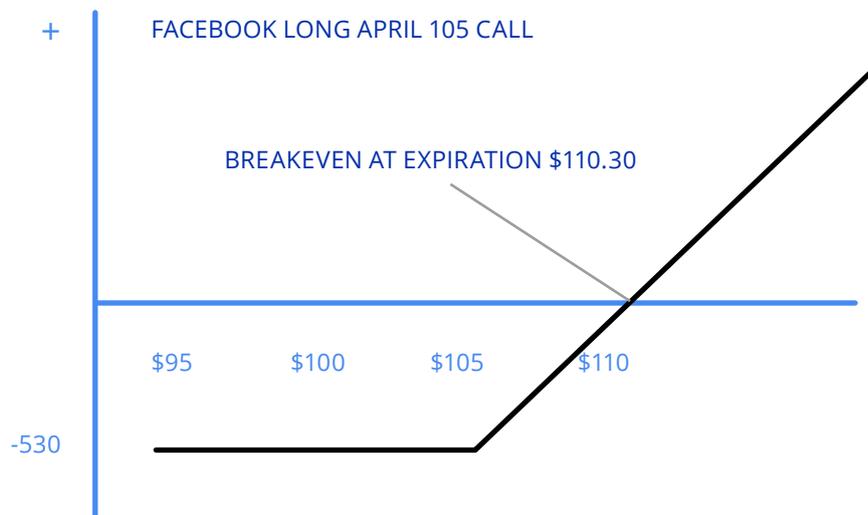
**STRIKE PRICE PLUS OPTION PREMIUM COST = BREAKEVEN POINT FOR A CALL OPTION.**

**IN OUR FACEBOOK EXAMPLE: \$105 + \$5.30 = \$110.30 IS THE BREAKEVEN POINT.**

## TRADING A LONG CALL – PROFIT, LOSS, EXERCISE AND ASSIGNMENT

**MAXIMUM GAIN** – The maximum gain (MG) for a call option in theory is unlimited. Shares of Facebook could appreciate to infinity. To realize the gains you will need to sell the option before it expires. Selling the option is often better than exercising it as that way time value can be captured. If you exercise the option you extinguish any time value. Some investors will set themselves a target of 30%-50% return on investment.

**MAXIMUM LOSS** – While the maximum gain can in theory be unlimited, the maximum loss (ML) of the call option is limited to the premium paid, which can of course still be the investor's total investment. In the preceding example, the premium is \$530 for purchasing the call. The y-axis of the graph below shows the profit/loss of the call, while the x-axis indicates the stock price and the breakeven point at \$110.30.



**EXERCISE AND ASSIGNMENT** – As a buyer of a call option, you have the right to exercise the contract and purchase 100 shares of Facebook at any time on or before the expiration date. To do so you could exercise directly from the Saxo platforms or you could call Saxo's client trading services and they will assist you with that. If not closed out before expiration, an American-style option will be automatically exercised if in-the-money by 1 tick. The risk of assignment is non-existent in a long call.

## SUMMARY

Buying a call option can be a speculative activity, and is based on the belief that the stock price will rise. Take time to familiarize yourself with the stock's direction before purchasing a call as a substitute to just buying the stock.

Other steps that novice investors and traders can take to manage the risk more effectively include careful selection of expiration and strike price. Options that have more time to expire have less time decay and devalue more slowly. Options that have more value, typically deeper in-the-money will move more in line with the underlying stock price.

# TRADING A LONG PUT

**BACKGROUND** - A put option gives the buyer the right, but not the obligation, to sell a stock at an agreed price. As with a long call, a long put also has a directional bias but here we expect the underlying stock price to fall. The put option will appreciate in value as the underlying share price falls.

**MARKET OUTLOOK** – The investor is looking for a sharp decline in the underlying stock's price during the life of the option. Aside from capitalizing on bearish market moves, investors also buy put options to protect their portfolios or individual stock positions against bearish markets. Let's walk through the steps of purchasing a put

The steps to purchasing a put option are similar to the long call strategy, but reversed. First, we study the movements of the price over, say, the last 9 months. In this example, we will use the share of Goldman Sachs, Inc. (GS: xny)



SOURCE: SAXOTRADERGO

The general direction of the underlying stock has been mostly down and we are comfortable that the trend will continue in the near future. Our first step is to choose the expiration month for our long put.

## TRADING A LONG PUT - SETTING UP THE TRADE

### CHOOSING AN EXPIRATION DATE

The selection of the expiration date depends to a degree on whether the stock price movements are short term (a few days to a few weeks) or longer (weeks to months). For this example, let's assume that it took 2-3 weeks for the underlying stock price to move from top to bottom. This could suggest that we need to purchase a put with at least 1 month to expiration. In Saxo's trading platform you could access the Option Chain and get an idea of the expiration listings.

Instrument: GS:ixcbf		Strikes: 12		Reset (ATM)				
Instrument	Last Traded	Net Change	% Change	Bid	Ask	Volume	Open	High
Goldman Sachs	149.91	0.00	0.00	149.93	149.95	6,083	152.11	152.11
Calls				Puts				
Last Traded	Ask	Bid	Strike	Last Traded	Bid	Ask		
Goldman Sachs (149.91) – 100 shares			Mar-2016	Expiry Date: 11-Mar-2016 (1 Day)				
Goldman Sachs (149.91) – 100 shares			Mar-2016	Expiry Date: 18-Mar-2016 (8 Days)				
Goldman Sachs (149.91) – 100 shares			Mar-2016	Expiry Date: 24-Mar-2016 (14 Days)				
Goldman Sachs (149.91) – 100 shares			Apr-2016	Expiry Date: 01-Apr-2016 (22 Days)				
Goldman Sachs (149.91) – 100 shares			Apr-2016	Expiry Date: 08-Apr-2016 (29 Days)				
Goldman Sachs (149.91) – 100 shares			Apr-2016	Expiry Date: 15-Apr-2016 (36 Days)				
Goldman Sachs (149.91) – 100 shares			Apr-2016	Expiry Date: 22-Apr-2016 (43 Days)				
Goldman Sachs (149.91) – 100 shares			Apr-2016	Expiry Date: 29-Apr-2016 (50 Days)				
Goldman Sachs (149.91) – 100 shares			Jul-2016	Expiry Date: 15-Jul-2016 (127 Days)				
Goldman Sachs (149.91) – 100 shares			Oct-2016	Expiry Date: 21-Oct-2016 (225 Days)				
Goldman Sachs (149.91) – 100 shares			Jan-2017	Expiry Date: 20-Jan-2017 (316 Days)				
Goldman Sachs (149.91) – 100 shares			Jan-2018	Expiry Date: 19-Jan-2018 (680 Days)				

### STRIKE PRICE

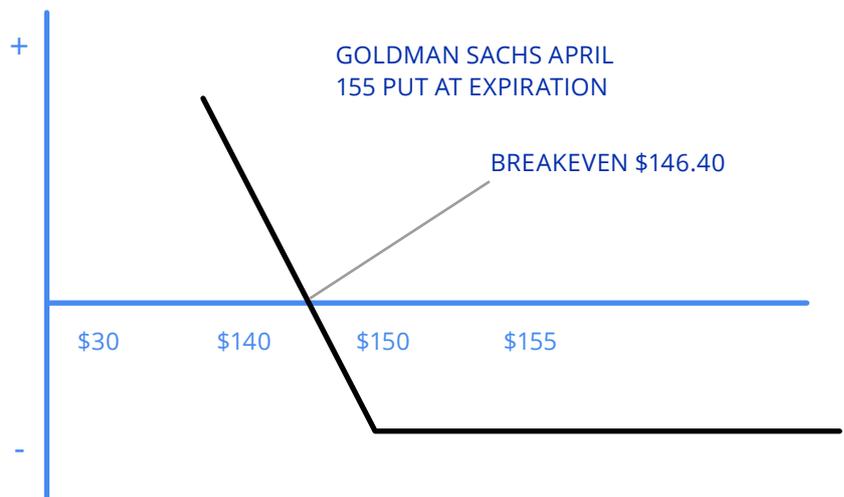
The selection of strike price depends also on how quickly you expect the price to fall or how aggressive you want to be. Just as in a long call, a more conservative approach to buying a put option will be to select one or two strike prices in-the-money. For the above example, we will select strike price of \$155.

Calls				Puts			
Last Traded	Ask	Bid	Strike	Last Traded	Bid	Ask	
Goldman Sachs (150.44) – 100 shares			Mar-2016	Expiry Date: 11-Mar-2016 (1 Day)			
Goldman Sachs (150.44) – 100 shares			Mar-2016	Expiry Date: 18-Mar-2016 (8 Days)			
Goldman Sachs (150.44) – 100 shares			Mar-2016	Expiry Date: 24-Mar-2016 (14 Days)			
Goldman Sachs (150.44) – 100 shares			Apr-2016	Expiry Date: 01-Apr-2016 (22 Days)			
Goldman Sachs (150.44) – 100 shares			Apr-2016	Expiry Date: 08-Apr-2016 (29 Days)			
Goldman Sachs (150.44) – 100 shares			Apr-2016	Expiry Date: 15-Apr-2016 (36 Days)			
Goldman Sachs (150.44) – 100 shares			Apr-2016	Expiry Date: 22-Apr-2016 (43 Days)			
0.00	10.65	9.90	144.00	0.00	3.35	3.95	
0.00	9.95	9.20	145.00	3.23	3.65	4.25	
8.80	9.25	8.50	146.00	0.00	3.95	4.55	
0.00	8.60	7.75	147.00	0.00	4.30	4.90	
8.80	7.90	7.25	148.00	4.60	4.65	5.30	
6.56	7.30	6.65	149.00	0.00	5.05	5.60	
6.19	6.70	6.05	150.00	5.00	5.45	6.00	
4.85	5.35	4.75	152.50	7.15	6.60	7.20	
3.75	4.20	3.55	155.00	8.00	7.90	8.60	
2.88	3.25	2.59	157.50	0.00	9.40	10.15	
2.00	2.35	1.88	160.00	9.00	10.80	11.95	
1.45	1.74	1.29	162.50	9.70	12.70	14.30	
Goldman Sachs (150.44) – 100 shares			Apr-2016	Expiry Date: 29-Apr-2016 (50 Days)			
Goldman Sachs (150.44) – 100 shares			Jul-2016	Expiry Date: 15-Jul-2016 (127 Days)			
Goldman Sachs (150.44) – 100 shares			Oct-2016	Expiry Date: 21-Oct-2016 (225 Days)			
Goldman Sachs (150.44) – 100 shares			Jan-2017	Expiry Date: 20-Jan-2017 (316 Days)			
Goldman Sachs (150.44) – 100 shares			Jan-2018	Expiry Date: 19-Jan-2018 (680 Days)			

## TRADING A LONG PUT – BREAKEVEN POINT

To calculate where the strategy breaks even look at the strike price of \$155 and the premium price ('Ask' in the above table) of \$8.60. After subtracting the cost for the put option from the strike price, you arrive at the point of breaking even at expiration.

**STRIKE PRICE MINUS PREMIUM COST = BREAKEVEN POINT FOR A PUT OPTION. IN OUR EXAMPLE: \$155 MINUS \$8.60 = \$146.40**



## TRADING A LONG PUT – PROFIT, LOSS, EXERCISE AND ASSIGNMENT

**MAXIMUM PROFIT** – The maximum profit of the put option could be substantial if the stock price falls quickly over a short period of time. Still, the gain is not unlimited but capped as the stock can only fall to zero. After the stock has moved to your target level, the sooner you sell the put option then the more money you will be able receive for it, as you are minimizing time decay.

**MAXIMUM LOSS** – The maximum loss of the contract is limited to the initial investment of  $\$8.60 \times 100 = \$860$ . It is important to stress that exchange-traded options are precisely that – tradable, meaning that investors can sell an option position that is not working for them, and potentially reduce their losses.

On the Saxo platform, to sell an April 16 155 put, go to the Account Summary page and find the contract in the Open Positions. Next, click on the position to expand it and then simply click on the X to close it.

**EXERCISE AND ASSIGNMENT** – Just as with calls, a holder of put option has the right to exercise the contract at any time before expiration. When the option is exercised, you have the right to sell Goldman Sachs at \$155. By doing so, you will have a short position of 100 shares. These would need buying to satisfy the market if you do not already hold the shares. Of course, you cannot be short a physical share. This is why most investors will choose to sell the put option well before expiration. Also, as mentioned above, selling a put option that still has some time to run enables you to capture any time (or extrinsic) value.

The risk of assignment is non-existent as the owner of the put option is in control.

For holders of long put options profit can be substantial as long as a drop in the price of the stock takes place. It is a bearish strategy. To manage the trade properly investors need to allow enough time and consider buying options that will follow the stock price more closely. Options that are more sensitive to the stock price movement are in-the-money (ITM). As discussed above, ITM put options are those with a strike price above the current stock price.

Selling a covered call is one of the most popular strategies among option users, both institutional and retail. Popular in the US, European investors have been slower to discover the benefits of this option strategy.



# THE COVERED CALL

## ANATOMY OF A COVERED CALL

This strategy consists of long stock and short call. For US exchange traded equity options, one contract can be sold for every 100 shares of stock that the investor owns in their account, hence the term “covered” call. By selling a call against a stock, the investor receives money (premium) from the buyer of that call. By selling the call, the writer commits himself to the obligation to deliver stock if the call he has sold is exercised.

## COVERED CALL BENEFITS/RISKS

For the seller of a covered call there are a couple of benefits. In a low or negative interest rate environment, that investor can create additional income from selling the call.

Also, sometimes we hold on to a stock and fall in love with it even when the price is falling. Selling a call against stock can help reduce the cost of the stock, by the premium received.

**EXAMPLE.** An investor purchases 500 shares of Wells Fargo at \$50, a total investment, excluding brokerage fees, of \$25,000. The most that the investor could lose is the price she paid for Wells Fargo shares (\$50 each).

By employing a covered call strategy, she could help reduce the cost of her overall position. With a current market price of \$44.80, she could sell 5 x 45 calls with 35 days to expiration, for \$1.50, reducing the cost of the stock from \$50 to \$48.50, a 3% reduction in just over one month.

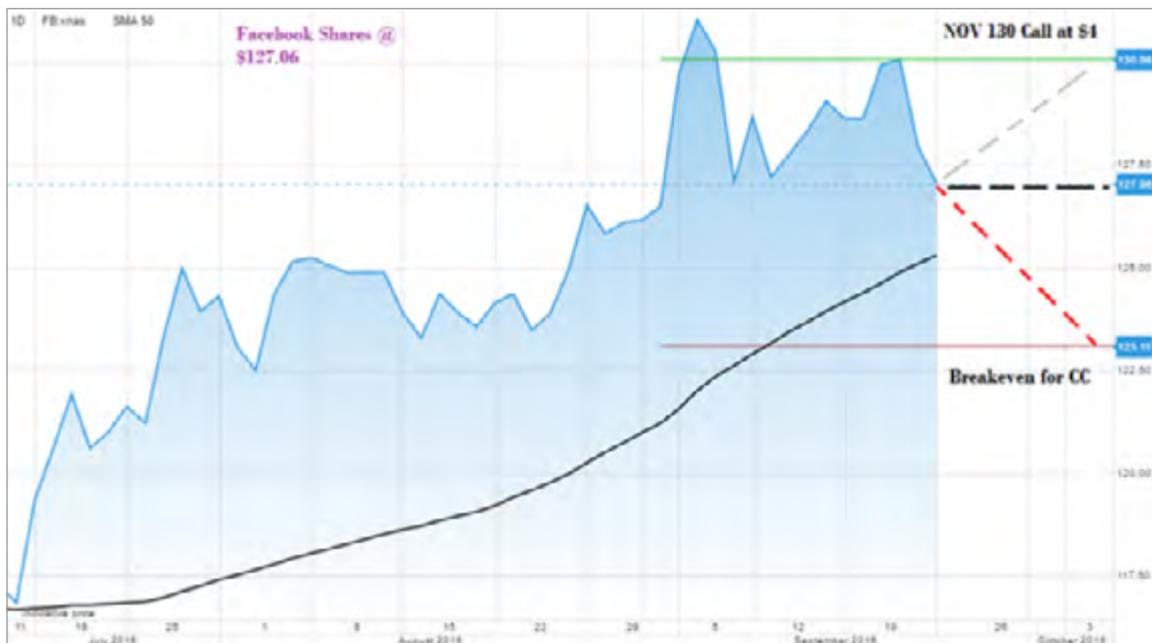
## WHAT'S THE WORST THAT COULD HAPPEN IN A COVERED CALL?

The worst that could happen to that investor is for the shares to continue to fall. In that case, the option premium received would act as a partial buffer to any loss on the stock.

The preferred outcome will be for the stock to stay at current levels or move slightly higher. If it moves through \$45, then the option could be exercised. If this looks likely and is not what the investor wants (i.e. she wants to keep the stock), then she could buy back the call sold (probably at a loss) and continue to hold the stock. She could then sell another call, but with a higher strike that is less likely to be exercised, depending on her market view.

This is a good example of how options can be used as a strategic tool. For more information on covered calls, please check out an educational webinar provided by our parent company, Saxo Bank on covered calls from [MAY 16 HERE](#).

**EXAMPLE**, Setting up a covered call. Shares of Menlo Park, a California-based social media company, are up some 20% year-to-date and have been trading in a steady, predictable pattern. More recently the shares have been trading between \$126 and \$132.



SOURCE: SAXO BANK

If you own shares at current levels or lower, this pause in the overall uptrend could be the right time to sell a covered call and enhance your overall return in the position.

The first question to ask is what expiration should you sell and what price? Most investors will sell 30-50 days out; some will extend as far out as six months. There are many ways to skin a cat and options are no exception.

The strike price selection depends on your market view. If mildly bullish and you don't expect shares to rocket up, you could sell calls at a technical resistance level above the current market price. If very bullish, however, and you feel that the price will explode, a covered call is not the right strategy as it will cap your upside potential.

For the trade example above we would sell November 130 calls for \$4 per contract (100 shares) against 100 shares of Menlo Park bought at \$127.31



# MANAGEMENT AND RISK DESCRIPTION

The risk in a covered call lies in the underlying stock price and not on the short call that you have sold. Remember to purchase the shares first.

Investors can make adjustments at any time during the life of the option, based on their market view of the underlying shares. Set the trade and monitor it.

You can also close out of this at any time. Simply buy back the same call option you sold.

## PARAMETERS

**UNDERLYING PRICE (MENLO PARK): \$127.31**

**TRADE: SELL -1 MP 18 NOV 16 130 CALL AT \$4 LIMIT**

**TRADE RISK: PURCHASE PRICE MINUS PREMIUM RECEIVED**

= \$127.31 minus \$4

= \$123.31.

This is the new cost basis in the stock and also the breakeven at expiration.

## RETURN ON RISK

If called at \$130 =  $\$123.31/\$130$

= 9.5% over 52 days or 28% annualized (assuming the strategy can be successfully repeated, which may not be the case).

Learn more about Saxo Options by visiting [WWW.HOME.SAXO](http://WWW.HOME.SAXO)

You can also find further information on the links below.

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