

## chapter 1

# Introduction to Options

Why is it that options are so misconceived as a minefield of danger and risk? How can we make sense of this and look at options as tools to limit our risks, maximize our returns, and SEE WHAT WE'RE DOING at the same time? This is the essence of *OptionEasy* and this book—how to make seemingly complex things simple.

Options are becoming more and more popular each day. Far from being confined solely to the institutions and professional money managers, options trading is now a worldwide phenomenon for “retail” traders of all walks of life. The concept of options is still, however, treated with fear and trepidation in some quarters. When I first embarked upon serious trading, one of my friends warned me profusely about what I was getting into. I calmly pointed out that I wasn't a gambler and that I would be perfectly safe and successful. And so can you.

## Criteria for Successful Investing

- patience
- perseverance
- knowledge
- honesty
- pre-planning
- discipline

## Patience

Learning that you can make a lot of money on the markets is one of the most exciting moments you can experience in your professional life. A whole new world of possibilities opens up before you as you begin to imagine your dream house, car, boat, and vacations with your family. I've seen people get so excited after just one little seminar that they actually started trading right there and then. Not smart! Give yourself some time to get used to the idea. And never start trading on an emotional wave of any kind whatsoever. You need to be switched on, alert and calm. Many workshops give you the emotional high but without the substance of real experience (and sometimes many other things, like knowledge!).

**I've seen people get so excited after just one little seminar that they actually started trading there and then. Not smart!**

Think about it this way. Would you consider yourself able to do brain surgery after just one conference? Well, in a different context the same applies to trading, and even more so for options trading (although the same principles apply). Give yourself time to learn. By reading this book, you are doing just that, giving yourself a learning opportunity. By now, you're probably used to trading stocks or futures in the markets. So now is the next step. And just as you had to get comfortable with trading stocks or futures at first, you also now have to get comfortable with trading options.

Furthermore, when you are comfortable enough to trade, you need to have an abundance of patience to do the trading itself. We've all had the experience of jumping into an investment too early even when we weren't quite convinced it was the right thing to do. Be patient, take a deep breath if you have to, and stick to your plan of action.

Finally, patience also involves selecting a trading strategy where time works in your favor and where your downside is covered. Be patient in your attitude to acquiring wealth. The more patient you are in this way, the better off you will be. This doesn't mean sitting back and doing nothing—that's apathy, not patience! Give yourself time to learn, gain experience and then start to apply consistently time and time again so that you begin a process of making money and building wealth.

Consistent with the art of patience is your embracing the concept of *compounding*. If you can make just 1% per week, this would mean more than 67% in just one year, a record of which any fund manager would be envious. The following table illustrates the power of compounding if you start with just \$10,000 in your account:

<b>Weekly Return %</b>	<b>Monthly Return %</b>	<b>1 year</b>	<b>2 years</b>	<b>3 years</b>	<b>3-year return %</b>
1%	4%	\$16,777	\$28,146	\$47,220	472%
2%	8.24%	\$28,003	\$78,418	\$219,597	2,196%
3%	12.55%	\$46,509	\$216,307	\$1,006,021	10,060%
4%	16.99%	\$76,866	\$590,836	\$4,541,517	45,415%
5%	21.55%	\$126,428	\$1,598,406	\$20,208,201	202,083%

This table is simply here to convince you about the need to be patient. Allow your returns to accumulate, and let the magic of compounding do its work for you. We're not suggesting these as consistent, realistic growth targets for you, but it helps to see where you'd be in three years even if you were succeeding with modest returns.

## Perseverance

Keep going for it! If there's one thing I've learned in life, it's that if you believe in something you have to keep at it until you reach your goal. And once you've reached your goal, then set another target.

Having embarked on the mission of becoming a successful trader (whether full-time or part-time), you must stick to it. Anyone can do it. Even those who don't think they can. Babies don't give up trying to walk or talk after a few unsuccessful attempts, do they? Well, follow their example and now you're here, stick to it and prepare yourself to be rewarded richly from this process of learning.

To be practical, give yourself attainable targets to reach in a realistic time frame. So by next week you'll be fully familiar with the four main options risk profiles. You may be able to do it tonight. Keep on setting the attainable targets (do make them a slight challenge, though!) and in this way you'll be able to keep up the momentum of learning and gaining experience. You'll also start to build up your confidence as you go along, reassuring yourself of your ability to understand anything you put your mind to. This book will help you in building your confidence because it's a practical book and it's easy to follow and understand. So keep going and enjoy the process of accumulating. . .

## Knowledge

Having established the need for patience for both acquiring the knowledge and for trading itself, let's remember that knowledge is attainable now with such ease and speed that it is eminently achievable in a reasonably quick time. Tools exist now to simulate the trading experience, and there are myriad publications and web sites designed to help you build up your knowledge database.

The best knowledge you will ever get is experience. It's all very well to say, "trade mechanically," but very few people do. Why? Because we're human beings and have emotions and feelings. It's true to say that they are best left away from the trading environment, but we have to learn how to do that first. It's no good just saying, "Do it!" Moreover, why can't we use our feelings and emotions to our advantage? Well, we can, and that's what we discuss in Chapter 10 on trading psychology.

Remember that learning is *experience*-based. We can all remember the most extreme of our teachers at school, right? You can recall the funniest, the scariest, the prettiest and the ugliest, but I'll bet you have a problem remembering anything about the teachers who were somewhere in the middle—those who barely made an experiential impact on you in years of being in the same classroom!

The same applies to trading. A lot of the learning involved in trading is experience-based. In fact, the most pertinent form of learning about trading is experience-based. It's through the extreme experiences that you find more out about yourself in good times and bad. Most brilliant traders have had terrible experiences but, crucially, have stepped back up to the plate and *applied* what they had learned. Just like me. I made a lot of money very fast, thought I was "the don" (tut-tut!) and then gave some of it back again! Believe me, then I didn't feel too good at all, but did I learn! And more importantly, did I apply those lessons? . . . you bet I did!

So, remember, learning is based on experience, so allow yourself to get experience, which is what this book and our workshops are all about—building experience. As you continually acquire experience, apply it consistently, continually, and carefully.

## Honesty

You must be honest with yourself if you're to develop into a decent trader or investor. A company has not made you make or lose money, so part of being honest is to cut out the emotions of trading. Ultimately, your decisions are down to YOU! No matter what you were taught, even if it was by someone who had no right to teach, you're the one who's in control, and when you look in the mirror, make sure you're being true to yourself. I've always found that blaming other people never really helps, and in trading you'll save yourself a lot of time if you can apply this lesson fast. Blaming the stock or the teacher or tipster only wastes energy and stops you asking what more you can do to improve your technique, your knowledge, and your performance. We'll cover more of this in Chapter 10.

## Pre-Planning

You *must* pre-plan each and every trade. By this you must know your:

- maximum *risk*.
- maximum *reward*.
- breakeven points.

You also must plan

- your entry point.
- your exit point whether it's to . . .
  - take profit or
  - stop losses.

With options trading, I tend to base any loss cut on the basis of the underlying asset. In most cases the underlying asset will be more liquid than the options chain, so it makes it easier to make your loss-cutting decision based on the price of the stock, future, or whatever the underlying asset is.

This pre-planning stage also embraces the choice of the underlying asset itself, the strategy you're using, and using fundamental and technical analysis to assist you in the decision-making process. The most important thing, though, is to make a good plan and then stick to it by using massive. . .

## Discipline—the Key to Success

When you have had the patience to acquire the knowledge and apply the principles above, it's imperative not to waste it all. You must be disciplined and apply that discipline rigorously each and every time.

This means that:

- you do your pre-planning every time.
- you use your (and others') experience.
- you do not deviate from your stated sensible plan.

In this way you are taking the first steps to becoming more mechanical. Discipline is the single most important part of trading. In other words, it is *money management*, and without money management, even the most sophisticated of trading systems will not work.

By sticking rigorously to sensible money-management principles, you will ensure that your losses are minimized and your profits are allowed to run.

By sticking rigorously to sensible money-management principles, you will ensure that you will avoid suicidal risk profiles. I'm often amazed at so-called experts teaching options strategies that have terrible risk profile curves. So let's have a look at a risk profile and why it is so important to your success as an options trader. . .

## Risk Profile Charts

Do you know what buying an asset such as a stock or a future looks like? To find out, we need to learn how to draw a *Risk Profile Chart*. This is the cornerstone on which we build far more complex strategies, so it's important to understand this right now.

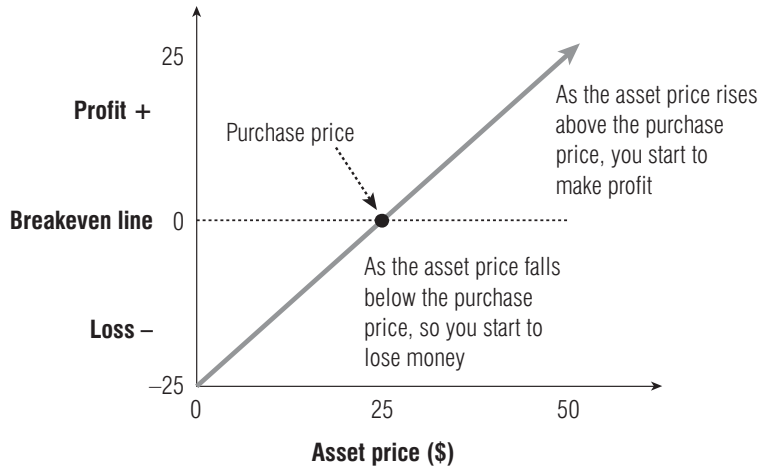
### Example 1.1

Consider a stock XYZ Inc. You buy the stock for \$25.

- 1 The X-axis is the stock price, with the price rising as the line moves right.
- 2 The Y-axis is your profit for the trade.
- 3 The 45° diagonal line is your risk profile for the trade. As the price of the stock (or underlying asset) rises, so does your profit in this example. So when the asset price rises to \$50, you make \$25 of profit:

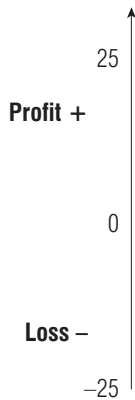
Current price	–	Buy price	=	Profit (loss)
\$50	–	\$25	=	+\$25
\$10	–	\$25	=	(\$15)

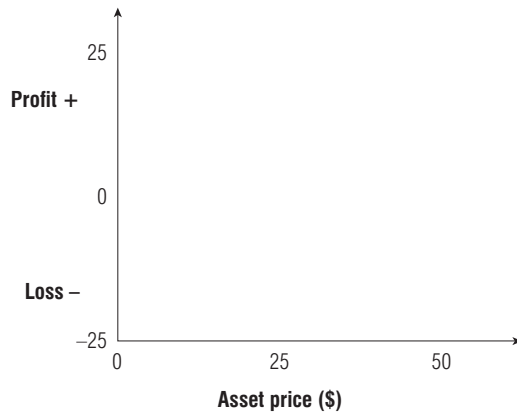
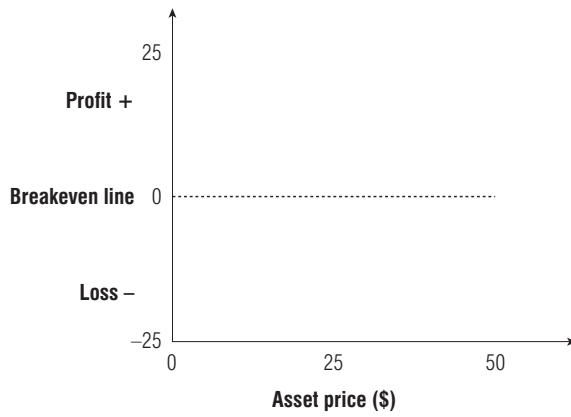
**Chart 1.1 ● Buying an asset risk profile.**



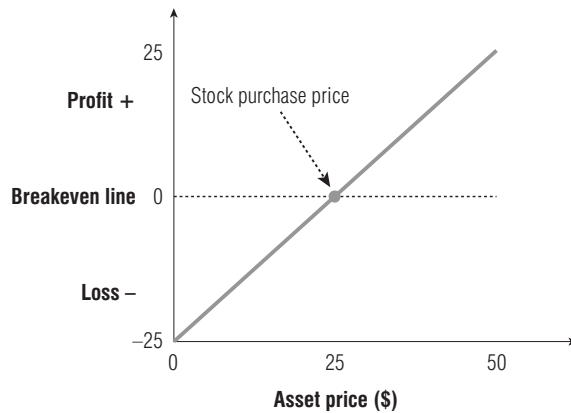
## Steps to Creating a Risk Profile Chart

### Step 1 ● Y-axis for profit/loss position



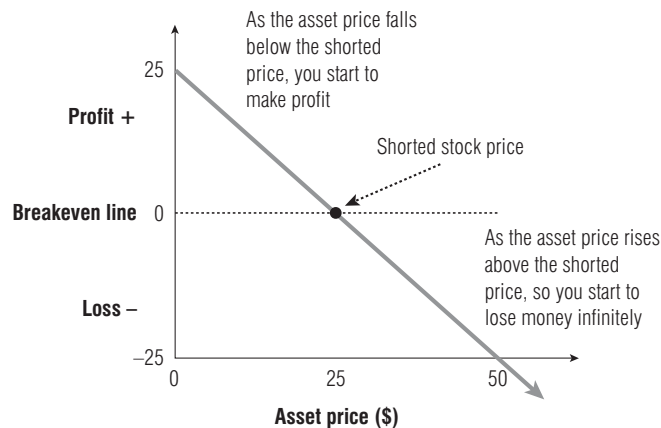
**Step 2 ● X-axis for underlying asset price range****Step 3 ● Breakeven line**



**Step 4 ● Risk profile line**

Now that you know what buying an asset looks like, we can move straight onto what *shorting* an asset looks like. Shorting simply means selling something that you don't already own. Shorting is an accepted concept in some stock markets such as the USA, but is not currently allowed in some other stock markets such as the UK.

Remember that when you short you can lose an unlimited amount as the asset price rises, and your maximum profit is the shorted price. To make maximum profit from a short stock position, the asset would have to fall to zero.

**Chart 1.2 ● Shorting an asset risk profile.**

So now that you know how to draw the most basic risk charts, let's talk about options. . .

## The Definition of an Option

An *option* is defined as the “right, not the obligation, to buy (or sell) an asset at a fixed price before a predetermined date.”

Let's have a look at that definition and see if we can pick out the component parts:

- the right, not the obligation
- to buy or sell an asset
- at a fixed price
- before a predetermined date

These component parts have important consequences on the valuation of an option. Remember that the option itself has a value, which we will look at after we finish with the definitions.

Before we go ahead and look at the ways in which options are valued, let's consider the words, “*right, not the obligation.*”

## The Right, Not the Obligation

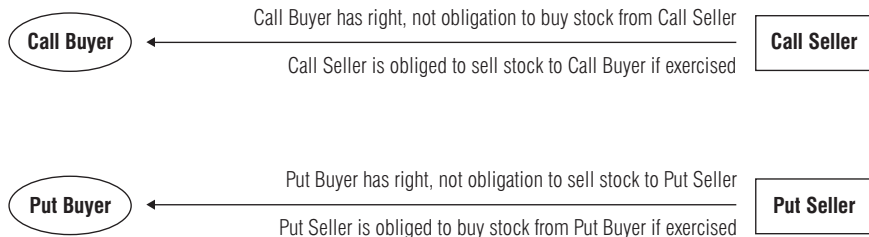
### Buying Gives You the Right

- Buying an option (call or put) conveys the *right*, not the obligation, to buy (call) or sell (put) an underlying instrument (for example, a share).
- When you buy an option, you are NOT obligated to buy or sell the underlying instrument—you simply have the right to do so at the fixed (exercise or strike) price.
- Your risk when you buy an option is simply the price you paid for it.

### Selling (Naked) Imposes the Obligation

- Selling an option (call or put) *obliges* you to buy from (with sold puts) or deliver (with sold calls) to the option buyer if he or she exercises the option.
- Selling options naked (for example, when you have not bought a position in the underlying instrument or an option to hedge against it) will give you an unlimited risk profile.

Combined with the fact that you are *obliged* to do something, this is generally NOT a preferable position in which to put yourself. Only advanced traders should ever contemplate selling naked options, and even then they should have a protective strategy in mind to cover the downside (see Figure 1.1).



**Figure 1.1**

Now let's consider the words, “*to buy or sell an asset.*”

## Types of Option—Calls and Puts

A *call* is an option to BUY.

A *put* is an option to SELL.

Therefore,

- A call option is the right, not the obligation, to BUY an asset at a fixed price before a predetermined date.
- A put option is the right, not the obligation, to SELL an asset at a fixed price before a predetermined date.

### Types of Calls and Puts

Options can be either American-style or European-style.

- *American*-style options allow the option buyer to exercise the option at any time before the expiration date.
- *European*-style options do *not* allow the option buyer to exercise the option before the expiration date.

Most traded options are American-style, and all US equity options are American-style.

American-style options are slightly more valuable than European-style

### Memory Tip

**Call Is to Buy**—think of calling UP a friend on the phone.

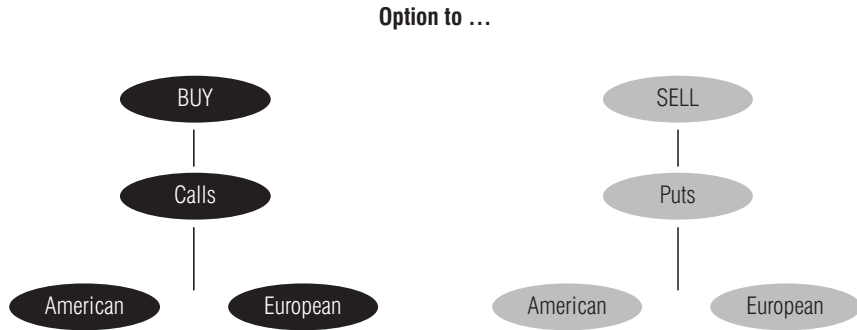
*The reason it is named a call is because when you buy a call, you can “call” the underlying asset away from the person who sold the option to you.*

**Put Is to Sell**—think of putting your pen DOWN on the table and walking away.

*The reason it is named a put is because when you buy a put, you can “put” the underlying asset to the person who sold the option to you.*

options because of their added flexibility. It is logical that being able to exercise before expiration must be more valuable than not being able to.

As a rule, stock options are generally American style. Futures options are generally European style.



**Diagram 1.1** ● American and European -style options.

Now we need to look at the words, “*at a fixed price.*”

## Exercise (or Strike) Price

The *Exercise (Strike) Price* is the fixed price at which the option can be exercised.

So if you buy a call option that has a strike price of \$50, then you have bought yourself the option to buy the asset at a price of \$50.

However, in the real world you will only want to exercise your right to buy that asset at \$50 if the underlying asset is actually worth MORE than \$50 in the market. Otherwise there would be no point. It would mean buying the asset for \$50 when it’s only actually worth, say, \$40 in the marketplace. No one would do that because they could buy it for \$40 in the market.

This leads us to the words, “*before a predetermined date.*”

## Expiration Date

This is the date before which the option can be exercised.

At expiration, the call option’s own value is only worth the price of the asset less the exercise price, and at expiration, the put option’s own value is only worth the exercise price less the price of the asset. (For US equity options, the expiration dates fall on the Saturday after the third Friday of every month.)

This leads us onto the topics of *Intrinsic Value* and *Time Value*.

## The Valuation of Options

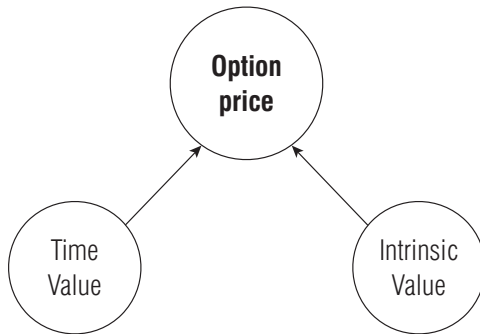
As we said before, options themselves have a value. Remember that options are totally separate entities to the underlying assets from which they are derived (hence the term, derivative). But in themselves they do have a value, which can be split into two parts: **Intrinsic Value** and **Time Value**.

In general:

- *Intrinsic Value* is that part of the option's value that is *In the Money (ITM)*.
- *Time Value* is the remainder of the option's value. *Out of the Money (OTM)* options will have no Intrinsic Value, and their price will solely be based on Time Value. Time Value is another way of saying hope value. This hope is based on the amount of time left until expiration and the price of the underlying asset.
- A call is *ITM* when the underlying asset price is greater than the strike price.
- A call is *OTM* when the underlying asset price is less than the strike price.
- A call is *At the Money (ATM)* when the underlying asset price is the same as the strike price.

Put options work the opposite way:

- A put is *ITM* when the underlying asset price is less than the strike price.
- A put is *OTM* when the underlying asset price is greater than the strike price.
- A put is *ATM* when the underlying asset price is the same as the strike price.



**Diagram 1.2** ● Intrinsic Value and Time Value.

## Why Trade Options?

The main reason for trading options is that for a smaller amount of money you can control a large amount of stock, particularly with call options. Call options are always cheaper than the underlying asset and put options usually are. Options are generally more volatile than their underlying instruments, therefore investors get “more bang for their buck” or more action. Clearly this can lead to danger, but as you’ll see, it also can lead to more safety and security. You’ll also see that it can mean much greater flexibility in your trading and even give you the ability to make profit when you don’t know the direction in which the stock will move.

**Options are generally more volatile than their underlying instruments, therefore investors get “more bang for their buck” or more action.**

Those investors with portfolios can set up protective measures in the event of a market downturn. It is also quite possible to set up a position whereby you can only make profit. Perhaps not a hugely exciting profit in triple digits, but a certain profit nevertheless. Options make this type of

scenario possible, and we will cover that particular strategy in Chapter 5, “Two Popular Strategies and How to Improve Them.”

In short, options give the investor added flexibility, potentially much greater gains for a given movement in the stock price, and protection against risk. On the flip side, used in the wrong way, options can lead people to serious losses. You will be learning safe strategies only and the simple rules governing those types of trade.

## Intrinsic and Time Value for Calls

### Example 1.2 Where There is Intrinsic Value

Call Intrinsic Value		Call Time Value	
Stock price	\$56.00	Stock price	\$56.00
Call premium	\$7.33	Call premium	\$7.33
Exercise Price	\$50	Exercise Price	\$50
Time till expiration	2 months	Time till expiration	2 months
<b>Intrinsic Value</b>	$\$56 - \$50 = \mathbf{\$6.00}$	<b>Time Value</b>	$\$7.33 - \$6.00 = \mathbf{\$1.33}$

Notice how: (Intrinsic Value + Time Value) = the option price

Formulas for Intrinsic and Time Values for calls:

- Call Intrinsic Value = stock price – exercise price
- Call Time Value = call premium – call Intrinsic Value

The minimum Intrinsic Value is zero.

### Example 1.3 Where There is no Intrinsic Value

Call Intrinsic Value		Call Time Value	
Stock price	\$48.00	Stock price	\$48.00
Call premium	\$0.75	Call premium	\$0.75
Exercise Price	\$50	Exercise Price	\$50
Time till expiration	2 months	Time till expiration	2 months
<b>Intrinsic Value</b>	$\$48 - \$50 = \mathbf{\$0.00}$	<b>Time Value</b>	$\$0.75 - \$0.00 = \mathbf{\$0.75}$

## Intrinsic and Time Value for Puts

### Example 1.4 Where There is Intrinsic Value

#### Put Intrinsic Value

<b>Stock price</b>	\$77.00
<b>Put premium</b>	\$5.58
<b>Exercise Price</b>	\$80
<b>Time till expiration</b>	4 months

Intrinsic Value  $\$80 - \$77.00 = \mathbf{\$3.00}$

#### Put Time Value

<b>Stock price</b>	\$77.00
<b>Put premium</b>	\$5.58
<b>Exercise Price</b>	\$80
<b>Time till expiration</b>	4 months

Time Value  $\$5.58 - \$3.00 = \mathbf{\$2.58}$

Notice how: (Intrinsic Value + Time Value) = the option price

Formulas for Intrinsic and Time Values for puts:

- Put Intrinsic Value = exercise price – stock price
- Put Time Value = put premium (or value) – put Intrinsic Value

The minimum Intrinsic Value is zero.

### Example 1.5 Where There is no Intrinsic Value

#### Put Intrinsic Value

<b>Stock price</b>	\$85.00
<b>Put premium</b>	\$1.67
<b>Exercise Price</b>	\$80
<b>Time till expiration</b>	4 months

Intrinsic Value  $\$80 - \$85.00 = \mathbf{\$0.00}$

#### Put Time Value

<b>Stock price</b>	\$85.00
<b>Put premium</b>	\$1.67
<b>Exercise Price</b>	\$80
<b>Time till expiration</b>	4 months

Time Value  $\$1.67 - \$0.00 = \mathbf{\$1.67}$



## The Seven Factors that Influence an Option's Premium

There are seven factors that affect the pricing of an option. Again, we look to the definition of an option to give us the clues. An option is defined as the:

- right, not the obligation
- to buy or sell
- an asset
- at a fixed price
- before a predetermined date.

Now let's take the seven factors:

Quote from definition	Comment
"buy or sell"	The <i>type of option</i> (call or put) will affect the option price.
"underlying asset"	The <i>underlying asset</i> and its <i>own price</i> will affect the option price.
"at a fixed price"	The exercise price or strike price will affect the option price.
"before a predetermined date"	The <i>Expiration Date</i> and <i>Time Value</i> will affect the option price.

There are three other major influences on option pricing, which we will discuss later in further detail.

Factor	Comment
<b>VOLATILITY</b>	Worthy of a book in itself. Volatility is a crucial and major influence in the pricing of options. Understanding volatility gives the options trader the ability to select specific trades most profitably. The most advanced traders will always use volatility to their advantage.
<b>Risk-free rate of interest</b>	This is the short-term rate of government money. It is known as risk free owing to the perceived covenant strength of (developed world economy) governments.
<b>Dividends payable</b>	This applies to any asset that offers an income "reward" for owners of the underlying asset. For stock options, this will be the dividend payable.

## Quick Summary

Option prices are affected by the type of option (call or put):

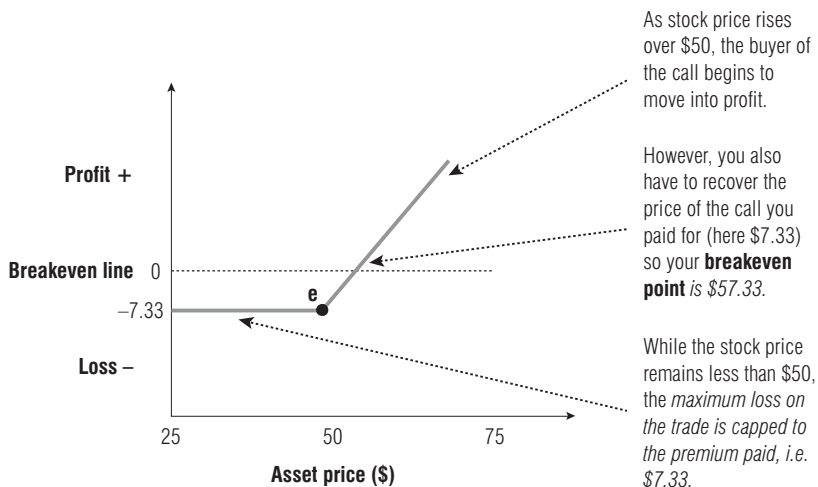
1. the price of the underlying asset
2. the exercise price (or strike price) of the option
3. the expiration date
4. volatility—Implied and Historical (see Chapter 6, “An Introduction to the Greeks”)
5. risk-free interest rate
6. dividends and stock splits

## Risk Profile Charts for Call Options

Now that you know what makes up the valuation of an option, let’s look at the risk profile of a call option.

We already know that a call option is the right to *buy* an asset. Logically, this suggests that the call option risk profile direction will be similar to that of buying the asset itself. So let’s have a look at an example:

**Chart 1.3** ● Long Call option risk profile.



Look back to Example 1.2 where you buy a call option:

<b>Stock price</b>	\$56.00
<b>Call premium</b>	\$7.33
<b>Exercise price</b>	\$50
<b>Time till expiration</b>	2 months

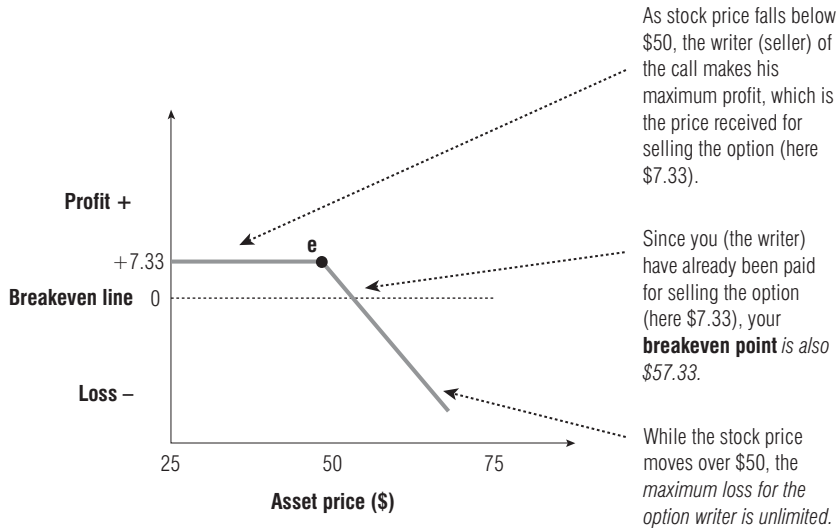
Remember that. . .

## Buying Gives You the Right

- *Buying a call option gives you the right, not the obligation, to buy an underlying instrument (that is, a share).*
- *When you buy a call option, you are not obligated to buy the underlying instrument—you simply have the right to do so at the fixed (exercise or strike) price.*
- *Your risk, when you buy an option, is simply the price you paid for it.*
- *Your reward is potentially unlimited.*

For every call that you buy, there is someone else on the other side of the trade. The seller of an option is called an *option writer*. Logic and common sense tell us that the option seller's risk profile must be different from that of the option buyer.

So, staying with calls, let's see the option writer's risk profile perspective:

**Chart 1.4 ● Short Call option risk profile.**

Still taking Example 1.2 of the following call option:

<b>Stock price</b>	\$56.00
<b>Call premium</b>	\$7.33
<b>Exercise price</b>	\$50
<b>Time till expiration</b>	2 months

Remember that we already discussed the implications of selling an option—here’s a reminder:

## Selling (Naked) Imposes the Obligation

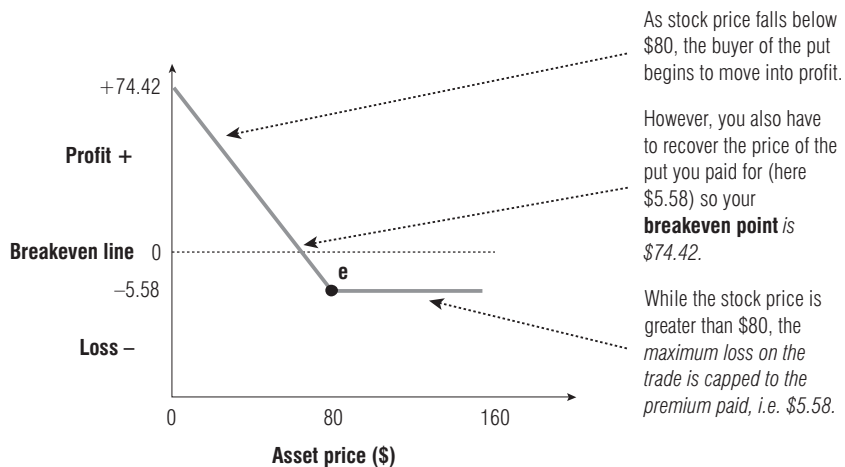
- *Selling a call option obliges you to deliver the underlying asset to the option buyer.*
- *Selling options naked (for example, when you have not bought a position in the underlying instrument or an option to hedge against it) will give you an unlimited risk profile. The continuous downward line is generally not a good sign because it means unlimited potential risk.*
- *Combined with the fact that you are obliged to do something, this is generally not a preferable position in which to put yourself.*

## Risk Profile Charts for Put Options

Now that you know what long and short calls look like, let's look at the risk profile of a put option.

We already know that a put option is the right to *sell* an asset. Logically, this suggests that the put option risk profile direction will be the opposite to that of calls or buying the asset itself. So let's have a look at an example:

**Chart 1.5** ● Long put option risk profile.



Look back to Example 1.4 where you buy a put option as follows:

<b>Stock price</b>	\$77.00
<b>Put premium</b>	\$5.58
<b>Exercise price</b>	\$80
<b>Time till expiration</b>	4 months

Remember that. . .

## Buying Gives You the Right

- *Buying a put option gives you the right, not the obligation, to sell an underlying instrument (that is, a share).*
- *When you buy a put option, you are not obligated to sell the underlying instrument—you simply have the right to do so at the fixed (exercise or strike) price.*
- *Your risk, when you buy an option, is simply the price you paid for it.*
- *Your reward is potentially unlimited. With long puts your reward is unlimited to the downside, for example, the exercise price less the price you paid for the put itself. In this example that is:  $\$80 - \$5.58 = \$74.42$ .*

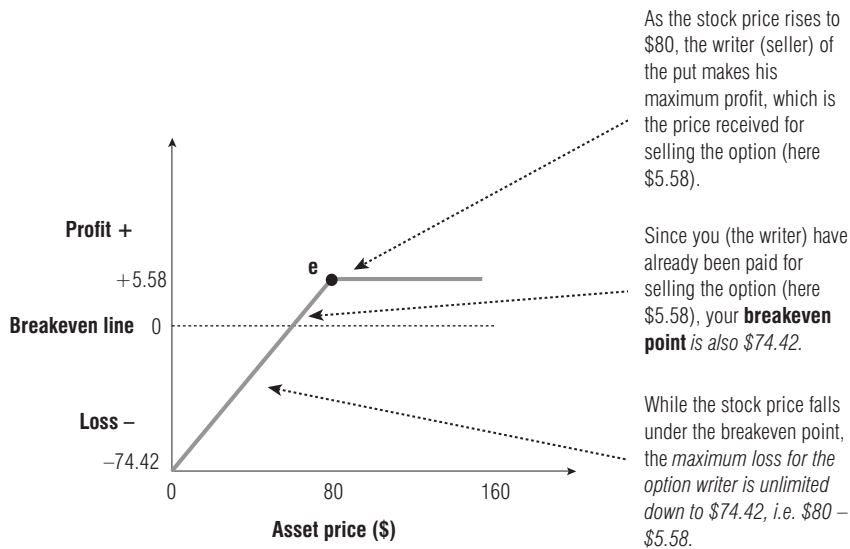
For every put you buy, there is someone else on the other side of the trade. The seller of a put option will have a different risk profile to that of the put option buyer.

### Chart 1.6 ● Short put option risk profile.

Still taking Example 1.4 of the following put option:

<b>Stock price</b>	\$77.00
<b>Put premium</b>	\$5.58
<b>Exercise price</b>	\$80
<b>Time till expiration</b>	4 months

Remember that we already discussed the implications of selling an option—here's another reminder for puts:



## Selling (Naked) Imposes the Obligation

- *Selling a put option obliges you to buy the underlying asset to the option buyer. Remember, when you sell a put, you have sold the right to sell to the person who bought that put.*
- *Selling options naked (for example, when you have not bought a position in the underlying instrument or an option to hedge against it) will give you an unlimited risk profile. The continuous downward line is generally not a good sign because it means unlimited potential risk.*
- *Combined with the fact that you are obliged to do something, this is generally not a preferable position in which to put yourself.*

If any of that was slightly confusing to you, here are some simple ways to remember:

## Memory Tips for Long and Short Calls and Puts

### Step 1 ● Remember your basic math at school:

$++ = +$   
 $+ - = -$   
 $- + = -$   
 $-- = +$

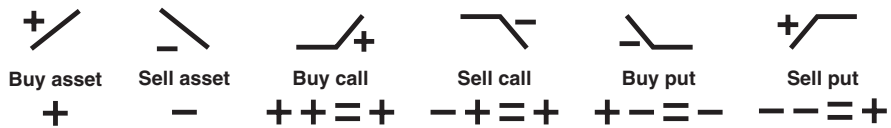
### Step 2 ● Think buying something as a + and selling something as a -, therefore:

Buying a call would be a ++  
 Selling a call would be a - +  
 Buying a put would be a + -  
 Selling a put would be a - -

### Step 3 ● Remember your risk profiles:

Where you end up with a + risk profile, the diagonal line will be upward from left to right.

Where you end up with a - risk profile, the diagonal line will be downward from left to right.



## Basic Risk Profiles Summary

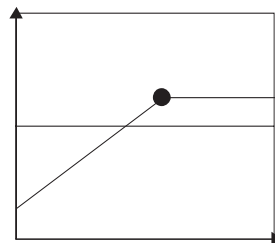
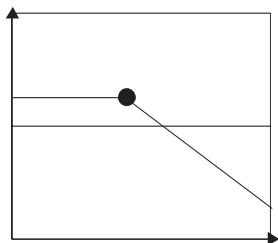
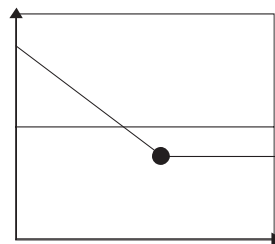
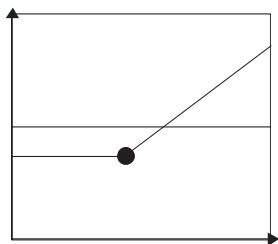
These are the four charts you need to remember. Even if you just remember the long call option risk profile, you should now be able to construct the other three basic option positions. When you are comfortable with these and the logic behind them, you'll be ready to look at spreads and combinations with ease.



## The Four Basic Risk Profiles for Options

### The four basic options risk profiles

Imagine the dotted lines are mirrors and see how each strategy is the opposite of the one on the other side of the mirror.



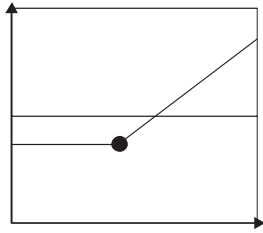
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### The four basic options risk profiles

Imagine the dotted lines are mirrors and see how each strategy is the opposite of the one on the other side of the mirror.

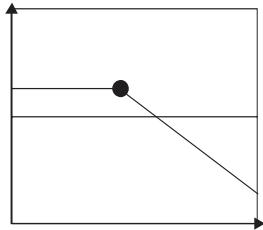
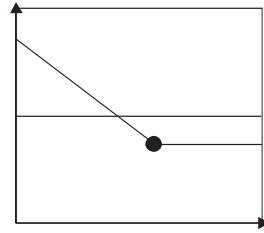
#### Buying a call

- belief that stock will rise (bullish outlook)
- risk limited to premium paid
- unlimited maximum reward



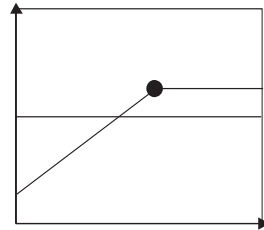
#### Buying a put

- belief that stock will fall (bearish outlook)
- risk limited to premium paid
- unlimited maximum reward up to the strike price
- less the premium paid



#### Writing a call

- belief that stock will fall (bearish outlook)
- maximum reward limited to premium received
- risk potentially unlimited (as stock price rises)
- can be combined with another position to limit the risk



#### Writing a put

- belief that stock will rise (bullish outlook)
- maximum risk is the strike price less the premium received. We can think of this as either being "unlimited" until the stock reaches zero, or "limited" to the [strike price – premium] formula.
- maximum reward limited to the premium received
- can be combined with another position to limit the risk

## Chapter 1 Major Learning Points

Remember the six major prerequisites:







- patience
- perseverance
- knowledge
- honesty
- pre-planning
- discipline

Start to build a plan. The plan should encompass the following:

1. **What stocks or other assets should I be considering for successful trading?**
2. **What direction do I feel comfortable trading in (up or down)? Could I consider trading put options if a stock or the market is falling?**
3. Have I checked the news items for the particular asset I am trading? Are quarterly or other results out soon? Is there a major announcement from the government out soon? Could these announcements affect my trade? Can I use them to enhance my position, or shall I wait until the announcements are made?
4. Do I want to check whether this company makes money and other Fundamental Analysis?
5. Have I checked the graphs and done any Technical Analysis? Am I missing something obvious like a basic Double Top or Triple Top chart pattern?
6. What strategy and risk profile do I feel comfortable with trading?
7. For each trade, what is my entry point, exit point, and time of exit?
8. Do I know my Risk, Reward, and Break-even Points?
9. What price am I looking for to execute my trade?
10. Where do I take my profits, and where is my STOP LOSS?

We'll review this list as we go along every chapter. So far, the **main questions** you should be able to start to consider are **those in bold**. By the end of the book, you'll be able to answer all of them and begin to build your own plan.

You have now learned what the essential risk profiles look like and what they mean to you in terms of maximum risk and reward.

Profile	Description	Risk	Reward	Breakeven
	<b>Buy asset</b>	Purchase price	Unlimited	Purchase price
	<b>Sell asset</b>	Unlimited	Short sale price	Short sale price
	<b>Buy call</b>	Call premium	Unlimited	Strike Price plus call premium paid
	<b>Sell call</b>	Unlimited	Limited to the call premium received	Strike Price plus call premium paid
	<b>Buy put</b>	Put premium	Strike Price less put premium paid	Strike Price less put premium paid
	<b>Sell put</b>	Strike Price less put premium received	Limited to the put premium received	Strike Price less put premium paid

We can now progress to Chapter 2, “Into the Marketplace,” where we start to explore the reality of trading options with real numbers.