The Rookie's Guide to Options

The Beginner's Handbook of Trading Equity Options

BY MARK D. WOLFINGER

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By Mark D. Wolfinger

Introductory e-book version

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“Finally! A well done and thorough book covering what one must know to trade and why. Kudos, Kudos, Kudos!!! No B.S. and hype to sift through. Just serious guidance. I am very thankful you wrote it” Don, Georgia

“I am thoroughly enjoying reading your new Rookies Guide To Options. I really like how you articulate the terms contained within it. You are very clear.” Norman

“I got your book last week and it is great. So far I'm in chapter 6 and it's better than any other book about the subject. Most of the others are either too vague in explaining options and make it sound like you cannot lose money and promise too much.” JP

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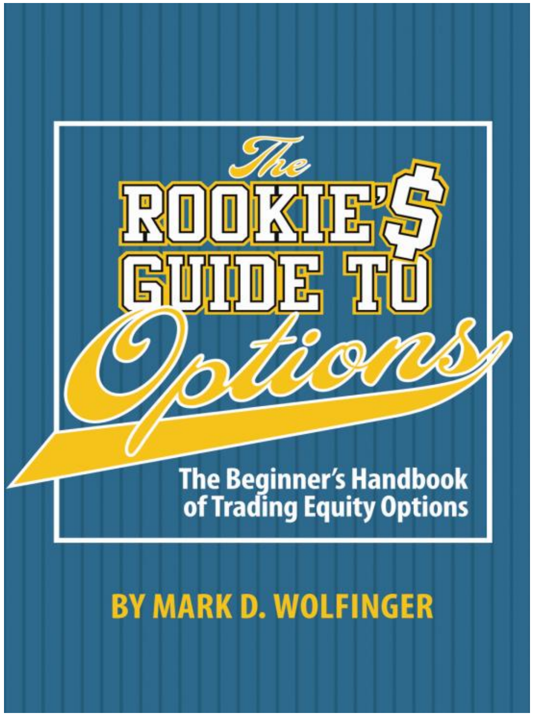

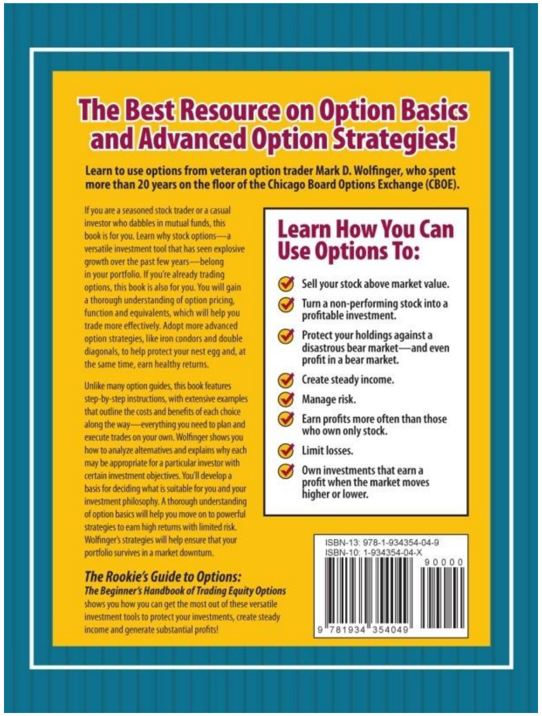

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Introduction

You are about to enter the world of options. My goal is to make your learning experience enjoyable. That means being certain you come away with a clear understanding of options - how they work and how you can make money by incorporating option strategies into your investment methods. You will learn to make money and reduce investment risk. In keeping with the goal of making this a fun learning experience, nothing more complicated than simple arithmetic is used.

In the sports world, a rookie is someone in his or her first year of professional play. The term also refers to someone who is new to a profession. This book was written for newcomers to the world of options - not necessarily investment rookies, but option rookies. It contains substantial background information on options and detailed descriptions of six options strategies. These are not the only option strategies available, but they were chosen because they make it easy for you to enter the world of options. And these strategies were not chosen at random - I use *only* these strategies for my personal trading.

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This book is unlike any other you may have read. I don't just tell you about a strategy and then leave you to your own devices. I show you how to analyze alternatives and explain why each may be appropriate for a specific investor with specific investment objectives. I teach you to think for yourselves. When you face a choice, you'll have a basis for making a decision that's suitable for you and your investment philosophy. It's important that you find trades that place you within your comfort zone - and that means being satisfied with both the risk and potential reward of your investments.

Options offer substantial rewards, but not without risk. It's true that you will have less risk that the traditional buy and hold investor who owns stocks and mutual funds, but there's no reason why risk should not be reduced further. One major goal of this book is to make you aware of the importance of managing risk.

Although this book is intended for option rookies, there's enough material for the investor who already has option trading experience. When you re-read these pages to reinforce your options education, you will discover that some of this material is easier to understand the second time around. This book will be useful for many years to come.

To learn to use the option markets to make money, we must begin at the beginning. That requires an explanation of what an option is and how an option works - both in our everyday lives and in the stock market.

Chapter One (excerpt)
Option Basics

Our discussion is limited to options involving stock market investments. Those include options on individual stocks, stock indexes and some exchange traded funds (ETFs). Many other options exist, such as options on commodities and currencies. Once you understand how stock options work, you'll also understand the principles concerning other types of options.

The stock options discussed here should not be confused with employee stock options. Those are given to the employees of some companies as part of their compensation packages. Employee stock options are similar to the stock options under discussion—but are more limited because they are not traded on an exchange and cannot be bought and sold.

What is an option?

How does an option work?

What can you do with an option?

Chapter Two
Exchange-Traded Options

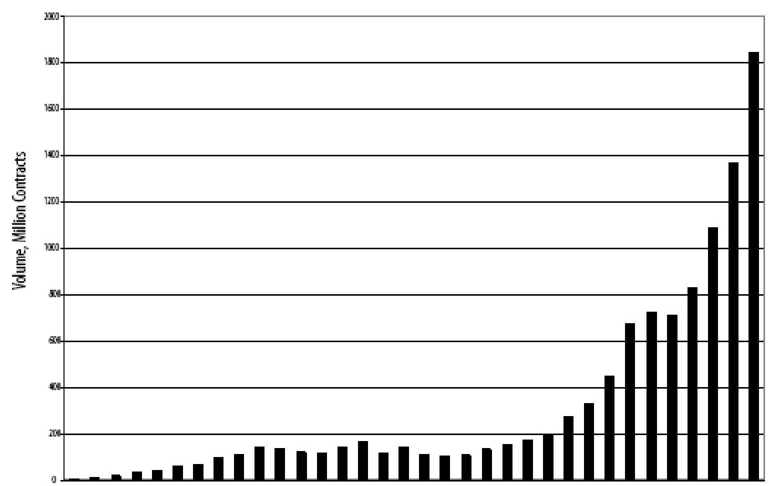
Once you recognize that you have been comfortably using common options for years, you understand that options are neither difficult to understand nor dangerous. What is dangerous is people buying and selling options without a clear understanding of what they are trying to accomplish. Too many investors buy calls, see their stocks rise in price and, bewildered, discover that they lose money. I don’t want that to happen to you. The better you understand what you are doing when working with options, the better your chances of being a successful investor and trader.

In this chapter we’ll take a closer look at options that trade on exchanges.

Chapter Three
Buying and Selling Options

Options are currently listed for trading on six different options exchanges in the U.S., plus many others around the world. Options are becoming more and more popular, as trading volume sets new records year after year (Figure 3.1). Trading volume is not just creeping higher, it's exploding. Although not on the chart below, volume increase by more than 40% (to 2.8 billion contracts) in 2007.

FIG 3.1 - Annual volume in equity issues, 1973-2006



Options are exploding in popularity—especially over the last five years.

Chapter Four
The Mechanics of Trading

Most readers are familiar with the process by which an order is entered to buy or sell stocks. Options trade in similar fashion. This chapter features a brief description of the process by which you buy and sell options.

Chapter Five
The Options Clearing Corporation

In 1973 the Chicago Board Options Exchange (CBOE) became the first exchange to list options for trading. At the same time, the Options Clearing Corporation (OCC) came into being. The existence of a clearing firm is necessary because it's responsible for the matching of all buy and sell orders that occur in the marketplace.

Clearing provides smoother and more efficient markets. An option buyer never has to be concerned whether the option seller has the financial wherewithal to meet the obligations imposed by the contract. The OCC assumes responsibility and guarantees that all obligations are met.

Chapter Six
What Is an Option Worth?

The purchase and sale of options takes place in an open marketplace, and in many respects the process is identical with the trading of individual stocks. Most people understand, in general terms, how the price of a stock is determined. In theory, a person could learn everything there is to know about an individual stock. Taking that information into account, people (or brokers representing them) who want to buy the shares gather in the trading pit on the floor of the stock exchange and announce a price they are willing to pay for those shares. Those who want to sell announce a price at which they are willing to offer shares for sale. The auction market continues until buyers and sellers agree on a price and a transaction takes place. This is a continuous process and the price at which shares change hands is constantly moving higher and lower. The price at which trades occur is simply an agreement between buyers and sellers that the current price is acceptable for both, based on the available information

To a point, options also trade that way. But option trading involves much more.

Chapter Seven
Volatility

Volatility is the property of a stock that describes its tendency to undergo price changes. More volatile stocks undergo larger and more frequent price changes. Volatility, as it is used in the options universe, is a measure of the *absolute volatility* of each individual stock and is unrelated to the volatility of other stocks, or groups of stocks.

Outside the options world volatility is described by the term beta. Beta provides a very different measurement of volatility and beta is never used in the options universe.

Chapter Eight
The Importance of Risk Management

We have covered a lot of territory concerning options—far more material than most people who get involved with options ever bother to learn. That's to your advantage because understanding options and how they work puts you in a good position to begin using options successfully. It's not a guarantee of success, but it shifts the odds of success further in your favor.

There is one final topic that must be discussed before moving on to trading strategies: risk. Risk is a concept that most investors tend to ignore because they are unsure how to deal with it.

I will share my basic premise when trading options: It's easy to make money using options when you adopt conservative strategies, such as those described in this book. The difficult part is keeping that money. That's why risk management is so important.

Chapter Nine
The Basic Conservative Option Strategies

This section thoroughly explains three basic options strategies—not because they are the best possible ways to trade options (although they are good strategies), but because if you come away from Part II with a clear understanding of how these strategies work, then you are ready to grasp the concepts behind more advanced option strategies.

We begin from the perspective of an individual investor whose stock market experience has been limited to owning individual stocks or mutual funds.

These basic strategies are:

- Covered Call Writing
- Collars – the ultimate in portfolio insurance
- Selling naked Puts – when you have enough cash to buy the stock

Chapter Nine Addendum: Oct, 8, 2008. This page does not appear in the book.

The three basic strategies are just that – good methods for learning how to use options. But, two of them (covered call writing and naked put selling) are riskier than the other strategies described.

Over the years, these methods have proven to be successful as entry level methods. However, the current market environment (Oct, 2008) is far too volatile for these two strategies to be used as your *only* option play.

I encourage readers to absorb this basic material as an *education* and not as recommended strategies. Then learn methods that involve limited risk.

I buy iron condors for my personal account, and have adopted the methods described in Chapter 20. They worked far better than I anticipated. Ch 20 was not written for rookies, but if you understand the concept, practice using it before using it in your real account. One word of warning: Chapter 20 describes the purchase of options for insurance. The current high prices of all options (due to record high implied volatility) makes this method less attractive, but you may want to consider it.

Chapter Ten
Covered Call Writing: Preparing to Trade

Traditionally, the only way to invest in the stock market was to buy stocks or shares of mutual funds. Today, options provide an opportunity to participate in the ups and downs of the stock market without owning shares of anything.

We'll begin with option strategies designed for investors who own, or are willing to own, stocks.

The first of the three basic conservative option strategies consists of owning stock and selling a call option that gives someone else the right to buy your stock. In option jargon, the strategy is known as covered call writing, or CCW

Chapter Eleven
Covered Call Writing: Making the Trade

Assume you own 500 shares of DOGS, the only publicly traded company that breeds animals for shows and state fairs. If you don’t already own the shares, you simply buy them and proceed as if you owned them earlier. This $19 stock is reasonably volatile, and that means the option premium looks attractive to sell.

To complete the strategy, you must write (sell) five call options. The main focus of this discussion is helping you decide which calls to write. Assume the nearest expiration is 30 days from today and the stock does not pay a dividend.

As can be seen in the discussion that follows, there are 16 different calls options from which to choose.

Chapter Twelve
Covered Call Writing: After the Trade

We’ve gone through the decision-making process and made our first trade. Now it’s time to consider what to do next.

Let’s assume time passes, nothing out of the ordinary happens (always a good situation for covered call writers), no adjustments are required and expiration arrives. There are three possibilities.

Chapter Thirteen
Collars: The Ultimate Portfolio Insurance Policy

If the idea of writing covered calls appeals to you, but you have some uneasiness about the possibility of losing substantial sums in the event of a sudden decline in the stock market, then the strategy of using options to "collar" the value of your investment is right up your alley. When you collar an investment, you establish a maximum value that your investment can achieve (identical to the covered call writing process), but you also lock in a minimum value by buying an insurance policy. That insurance policy is a put option.

Chapter Fourteen
Writing Cash-Secured Puts

Except for extremely bearish prognosticators, no one suggests that owning stock is anything but the most prudent of investment strategies. It's touted far and wide as sage advice that investors must invest in the stock market to maintain spending power and keep up with long-term inflation. Yet, writing naked put options is more conservative and less risky than buying stock and deserves consideration as an investment alternative by many investors. Many buy and hold investors would fare better if they incorporated put writing into their arsenal of investing methods.

Chapter Fifteen
Equivalent Positions

This chapter provides tools you can use to gain a trading edge by thoroughly understanding the details of each trade. There's nothing here that is absolutely essential to learning to trade options, but the material is very important for a better understanding of their versatility. There are two very practical reasons why this topic should be of interest:

- Trading equivalent positions occasionally provides an opportunity to make more profitable trades.

- Understanding this material allows you to trade more efficiently and reduce trading expenses by lowering commissions. That alone makes it worthwhile.

Chapter Sixteen
The Greeks

One way that option traders measure risk is by considering a set of mathematical parameters identified by Greek letters, and known collectively as “the Greeks.” When you quantify risk (exposure to loss), it’s easier to decide if a specific position, or your entire portfolio, is within your comfort zone—or if steps should be taken to reduce (or eliminate) that risk. No one is suggesting you trade without risk. But your profit potential is limited when you adopt the recommended methods, and you must not allow losses to overpower those gains.

Once again, no mathematical skills (beyond simple arithmetic) are required to use the Greeks.

Chapter Seventeen
European-Style Index Options

Trading European options differs from trading American options. Most of the high-volume index options traded in the U.S. are European style options, whereas all options on individual stocks are American options. The strategies discussed in this last part of the book are especially appropriate for index options, and unless you have a strong preference for trading options on individual stocks, many of you will ultimately trade European-style options.

Before you trade European-style options on a regular basis, be sure you understand the risks as well as the rewards associated with European style options.

Let’s discuss a few important differences between European and American-style options.

Chapter Eighteen
Credit Spreads

A credit spread is an option position consisting of two legs—either both calls or both puts. In addition, both options expire on the same day and have the same underlying asset. When initiating (opening) this position, you may trade one of the options first, then the other. But, it’s more efficient to enter your order as a spread. The discussion that follows defines a spread and includes specific instructions on how enter a spread order.

If you sell the put (or call) spread, you collect cash. Hence, it’s referred to as a credit spread. If you buy the spread, you pay cash and it’s called a debit spread.

Chapter Nineteen
Iron Condors

Buying iron condors is an option strategy for investors who have a neutral opinion on the market, i.e., neither strongly bullish nor strongly bearish. It's also suitable for investors who seldom, if ever, have an opinion on market direction.

Iron condors represent an opportunity to earn money when the markets are treading water and are very popular among individual and professional traders. At least one major brokerage firm recommends this strategy to its clients. In addition, there are numerous advisory services who charge high fees to trade this strategy for clients.

An iron condor consists of two credit spreads— one call spread and one put spread—on the same underlying security. All four options expire on the same day. When buying* iron condors, the investor's objective is to profit as time passes and each spread decreases in value.

* Selling the call spread and selling the put spread = *buying* the iron condor.

Chapter Twenty
Advanced Risk Management

Although this book is primarily for option rookies, you won't always be a rookie, and when you return to these pages to further your options education, you will be in a better position to use more advanced trading and risk management methods. You may not be ready to adopt the methods described in this chapter now, but it's included to make your trading more successful down the road.

This sophisticated method for protecting your investment portfolio works like an insurance policy. When you buy insurance, most of the time the insurance is "wasted," and that's good news. (When you buy homeowner's insurance, aren't you pleased that your house doesn't burn and you don't collect on that insurance policy? But if a disaster strikes, that insurance is badly needed.)

Addendum, Oct 8, 2008. This strategy has been well worth any effort involved in understanding how it works.

Chapter Twenty-One
Double Diagonals

Under certain market conditions there are advantages to owning positions with options that expire in different months. Those spreads are referred to as diagonal spreads. In theory you can own the option that expires first or the option that expires later. For practical reasons, we'll only discuss diagonal spreads when you own the option that expires later. As with credit spreads, either calls or puts are used to create diagonal spreads. For the purposes of our discussion, we sell the diagonal spread. Thus, we sell the call with the lower strike price or the put with the higher strike price.

Afterword

I hope you felt welcome entering the options universe and that you've learned a fair amount about options along the way. The ideas presented here have been developed over the course of 30-plus years trading options. If you understand the principles behind options and know how they work, you are in a good position to make money adopting the strategies outlined in this book.

Every strategy described has been selected because of its compatibility with a generally conservative investing philosophy, including managing risk. In my experience, the major downfall of many new option investors is the tendency to trade more than your financial capacity (and trading experience) allows. Don't be in a hurry—you have the rest of your life to make money with options. Get familiar with options by paper trading, and then trade with real money. You now have the tools and knowledge that allows you to become a successful, long-term options trader.

Options are investment tools. Use them wisely. Options are versatile. Use them to reduce risk.

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E-mail: book@mdwoptions.com

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If you have comments or questions (I cannot offer specific investment advice), visit my blog and post your question: http://blog.mdwoptions.com/options_for_rookies/

About the Author

I began trading options for my own account in 1975 and two years later became an options professional as a market maker on the trading floor of the Chicago Board Options Exchange (CBOE).

Since mid-2000, I've been teaching individual investors how to adopt risk-reducing, profit-enhancing option strategies.

I've published three books and many magazine articles .

Born in Brooklyn, NY, I currently reside in the Chicago area. I earned a B.S. degree from Brooklyn College and a PhD from Northwestern University.

My latest book was released in February, 2008. **The Rookies Guide to Options: The Beginner's Handbook of Trading Equity Options**, provides a thorough introduction to options, helping readers *understand* how options are used to make money and reduce risk. The book allows the reader to follow along as a seasoned trader makes trading decisions. Six option strategies are described in detail.

If you always wanted to learn about options, this is the book for you.

I'm available for private consultation via e-mail or telephone. I also do group instruction on various aspects of options trading. More information is available:

http://www.mdwoptions.com/Author.html