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Preface

This program teaches you about options principles and trading strategies in a concise, easy-to-follow format. It also encourages you to participate through the quizzes at the end of each day, as well as tracking your own options paper trades (which you select at the end of day 1; don't worry, we will walk you through the selection process step-by-step). The paper trades will teach you some concepts based on market activity that occurs in the 10 days following your selections, and you should follow these positions daily in order to get a feel for how options can move in "real time." The benefit in this simulation is that you can learn as you go without the market exacting its own brand of "tuition" in the form of trading losses. The tuition you spent to purchase this program should save you many times the real-world potential cost in learning the hard way.

Interest in options trading continues to grow at record levels. Just as stock trading was once thought of as the realm of the select few (only to become such a mainstream investment alternative), trading options seems to be the next likely wave. A new breed of traders and investors has clearly developed, with more of a do-it-yourself mentality. Obviously, if you're going to do it yourself, it's important to be knowledgeable about what you're doing.

How to Use This Program

You are about to receive the benefits of many years of option trading experience, without the risk of a tuition paid to the school of "hard knocks," all in a period of just 10 days. We have structured the lessons into a 10-day curriculum and suggest that you stick with this pace. Key concepts and terms are strategically repeated throughout the course, as repetition in learning often pays off with better recall. You will notice this by some often-

confusing terms being presented with their definitions several times over several days (and of course, you can always refer to the glossary for any option jargon). You will also be exposed to challenging concepts in multiple formats (audio, video, and Internet). Our goal is to succeed in teaching you as much of this information as possible in just 10 days.

There are two items that you will focus on daily for each of the 10 days:

- **Today's Objectives** - At the beginning of each day's session, you should review the day's to-do items, learning objectives, and trader jargon. This list will brief you on the important areas that you will cover for the day. Review the objectives list not only before starting that day's chapter, but also after finishing the chapter in order to ensure that key concepts are mastered.
- **Daily Paper Trades** - During Day 1, we walk you through a simple process to help you select three options to paper trade while you move through this program. The beauty of paper trading is that you get to test your ideas without risking real dollars. Learn from your mistakes at no cost. At the same time, follow these paper trades as if your real hard-earned dollars were at risk (which should teach you how to monitor open positions). There's an emotional and psychological element to trading that causes human beings to react differently when we feel something important (money) is on the line, versus how we trade when we feel no such pressures. Please take the simulation seriously, as it is a core element in the flow of this program.

*Our goal is to
succeed in
teaching you as
much of this
information as
possible in just
10 days.*

Tools

There are a number of tools that accompany this program, and each adds to the overall educational experience. Learning through alternative sources often yields better recall, and we encourage you to use each element as directed in the program. These tools are:

- **SchaeffersResearch.com** – Throughout this program, we encourage you to take advantage of SchaeffersResearch.com. Get daily stock and option information for your paper trades, look through the free tools, and read the extensive free commentaries posted throughout each trading day.

- **DVD** – Bernie Schaeffer shares a selection of valuable concepts that directly address the ultimate success of every options trader. Bernie talks about basic options principles and discusses his unique Expectational Analysis® methodology. You will also gain important information about several sentiment indicators, some of which were developed at Schaeffer's Investment Research.
- **Glossary** - We encourage you to use the comprehensive glossary at the end of this workbook. It may be beneficial to consult the glossary for definitions of "trader jargon" terms you don't know before actually getting into the day's lesson. While most of the terms are defined as you go, the glossary adds another layer of repetition to the learning process.
- **Quizzes** - We encourage you to read and reread key passages to give the concepts time to sink in. Take the quiz as you complete each chapter. With options likely being a foreign concept to many readers, it's important to retain every single bit of beneficial information this program has to offer. Make the effort to check your answers and reread relevant sections on those you might miss. Nothing would make us happier than to hear how much you learned as a result of this program.
- **CD-Rom** – For those who prefer to "travel light," the entire workbook, including a searchable index and glossary, is supplied on disc. Also included are two presentations by Bernie on option concepts and maximizing trading profits, along with other valuable audio and video features.

One More Thing...

While we're sure that you're ready to get started with Day 1, we suggest that you don't do more than what is covered on each day. This will facilitate a steady buildup of knowledge (much as a foundation is laid brick by brick) and allow for greater retention of material each day. We truly hope you enjoy *10 Days to Successful Options Trading* and find it enriching - both in your trading profits and in your trading knowledge.

On behalf of Bernie and the entire Schaeffer's team, good luck with the program! We wish you much success.

Introduction

By Bernie Schaeffer, Chairman and CEO
Schaeffer's Investment Research, Inc.

Bernie Schaeffer is a renowned options analyst and the developer of Expectational Analysis® as well as the author of *The Option Advisor: Wealth-Building Techniques Using Equity & Index Options*. He also contributed a chapter on sentiment analysis to the Bloomberg Press book, *New Thinking in Technical Analysis: Trading Models from the Masters*. In 2003, Bernie penned a chapter on technical and sentiment trading for the Bloomberg Press book, *Investing Under Fire: Winning Strategies from the Masters for the Bulls, Bears, and the Bewildered*.

Since its inception in 1981, Bernie has served as senior editor for *Bernie Schaeffer's Option Advisor* newsletter. Today it is the nation's leading options newsletter.

Bernie often contributes option columns and market commentaries to various magazines and websites such as MarketWatch.com. He is a CNBC Market Maven and regularly appears on CNN, The Nightly Business Report, Bloomberg Television, Fox News Channel and has also been interviewed on *Wall Street Week with Fortune* and ABC's *World News Now*. His views on the stock market and the economy are regularly quoted in *The Wall Street Journal*, *The New York Times*, *BusinessWeek*, *Investor's Business Daily*, and *USA Today*. Additionally, he has been the subject of "Q&A" interviews in *Barron's* and *The New York Times*.

Bernie is widely recognized as an expert on equity and index options, investor sentiment, and market timing. *Timer Digest*, an industry publication, has been monitoring Bernie since 1984 and ranks him as the #2 Gold Timer for the last 10 years. Furthermore, he is rated as the #5



Bernie Schaeffer,
Chairman and CEO

**Bernie
Schaeffer's
Option Advisor
is the nation's
leading options
newsletter.**

Bond Timer and the #9 Intermediate Market Timer for the last decade among more than 100 of the nation's top market timers. According to *Timer Digest*, in 1987 "he called the exact market TOP in August, remained SHORT through the Crash, moved to NEUTRAL at the exact bottom and gave a BUY recommendation the next day."

Bernie was the recipient of the 2004 Traders' Library Trader's Hall of Fame Award for his numerous contributions to the field of trading. In 2003, Aaron Task of *TheStreet.com* selected Bernie as the Market "Guru of the Year." *USA Today* selected Bernie as one of their five esteemed panelists for the "2004 Investment Roundtable," based on his 2003 forecast, which according to *USA Today* was a "Bulls-Eye!" Bernie also made the ONLY successful bearish stock pick in the *Forbes* Annual "Love Only One" stock-picking contest, and is a three-time winner of *The Wall Street Journal's* Stock-Picking Contest. Since 1999, Bernie has been one of the top 50 market forecasters polled in the annual *BusinessWeek* Market Forecast Survey. In 2002, he was recognized as having most accurately forecast year-end levels for the major indices. In addition, Bernie received the "Best of the Best" Award from the Market Technician's Association for his contributions to Sentiment/Psychological Analysis.



From the Desk of Bernie Schaeffer

"If a man didn't make mistakes he'd own the world in a month. But if he didn't profit by his mistakes, he wouldn't own a blessed thing."

These remarks appeared in Edwin LeFèvre's book *Reminiscences of a Stock Operator*. They have been attributed to Jesse Livermore, the famous turn-of-the-century stock speculator. As a teenager growing up in New York in the 1960s, fascinated by the world of Wall Street, I didn't realize that I was soon to discover for myself the wisdom of Livermore's view of mistakes.

My dad would often take me to visit the New York Stock Exchange and the American Stock Exchange, where I'd get caught up in the noise, excitement, and activity of the exchanges' trading floors. I'd also accompany him at every opportunity on his visits to our local brokerage firm. At that time, all of the transactions on the stock exchanges were actually printed on a long,

narrow roll of paper called ticker tape, and this tape was then projected onto a screen so that brokers and their customers could conveniently view the latest prices. I'd watch this stock ticker for hours, nearly hypnotized by the continuous ebb and flow of stock prices.

Enticing Profit Potential of Options

As I began studying the financial section of the newspaper, I noticed some fascinating little advertisements offering "put and call options" on big name stocks for as little as \$112.50. While I had no idea what options actually were, the idea of being able to participate in the stock market for \$112.50 was a very powerful attraction to a middle-class teenager, particularly when the rewards for successfully investing that \$112.50 could be thousands of dollars!

My fascination with the profit potential of options trading combined with my degree in mathematics helped me learn the principles of options at breakneck speed. I very quickly understood that call options gave me the right to buy a stock at a specified price for a specified period of time, and that put options gave me the right to sell rather than to buy a stock.

I also learned that if I were very *bullish* on a particular stock, I wanted to buy a call option, because if I was correct and the stock rose significantly in price, my call option would allow me to buy that stock well below the market price. I could thus buy low (by exercising the terms of my call option and buying the stock at the specified price) and then sell high (by selling the stock that had rallied). And relative to my small initial investment, my profits could be huge. Of course, all of this favorable stock movement needed to occur before the option expired, and if the necessary rally in the stock did not occur by the expiration date I would lose the entire sum I paid for the option.

At the other end of the spectrum, if I were very *bearish* on a stock, I learned that I wanted to buy a put option, because if I was correct and the stock declined significantly in price, my put option would allow me to sell that stock well above the market price. Again, I would be buying low (by buying the stock that had declined) and selling high (by exercising the terms of my put option and selling the stock at the specified price).

The idea of being able to participate in the stock market for \$112.50 was a very powerful attraction.

My fascination with the ads offering various call and put options grew, but there was a significant stumbling block for me: While I had the \$100 or \$200 required to purchase many of these options, the process of actually exercising the options (should the stock move as I had expected) was far beyond my reach as a teenager. At that time, the only way to realize the value of a purchased call option was to buy the stock from the options dealer and then sell the shares on the exchange. While I had enough capital to buy the option, I was far short of the capital I would need to exercise it.

So, options remained an enticing but unrealized dream for me until 1973 when the Chicago Board Options Exchange (CBOE), the first exchange devoted exclusively to trading equity options, began operation. On the CBOE, options transactions occurred on a trading floor in a manner similar to how stocks traded on stock exchanges. Options investors enjoyed exchange and regulatory protections similar to that afforded stock investors. And most important for me, options could be purchased and sold on the exchange at any time (the technical term is full *fungibility*), so that I, as an options buyer, needed no additional capital beyond that required to purchase the option. I was in business.

***Don't repeat my
early mistakes—
I ignored the
principles of
money
management
and the simple
fact that
options expire.***

Or so I thought. I spent most of the remaining part of the 1970s making every mistake possible by a beginning options trader. To add insult to injury, I repeated some mistakes with numbing regularity. Many of these mistakes involved ignoring sound *money management* principles. Too much of my total investment capital was tied up in my options trading, and too much of what I was investing in the options market was in just one or two situations. My other mistake was in trading options in the exact same manner as I would trade stock, thereby ignoring the two most important words in options investing: "Options Expire."

By the end of the 1970s, I had put together some extensive notes on what I had learned from my options trading experiences. I began to approach options trading in a much more serious, intelligent, and intense manner. At the time, I was vice-president and actuary for a major Midwestern insurance company and a career change appeared to be in order.

Like most investors of that era, I had subscribed to a number of market letters. These newsletters published the investment advice of entrepreneurs

whose work was generally steeped in technical analysis (the analysis of stock price and volume patterns). While there were hundreds of these market letters, and many were very valuable sources of advice for stock traders, I was amazed to discover that there was little available in these publications for the options investor.

Though it was possible for the options investor to gain some value from these stock-oriented market letters, I was already well aware of the pitfalls of trying to adapt a stock trading approach to the options market. It became clear to me that the needs of the options investor were not being served by the investment-newsletter industry. I realized that I was at a juncture in life where I could fill that void for the options investor.

What were my qualifications for this role of market letter writer for the options trader? I had a thorough understanding of the stock market and the mathematics and practicalities of the options market. I had spent the better part of a decade learning from the mistakes most investors make in trading options. And, finally, I had good communications skills. Plus, I was plain fascinated with options - their profit potential, their low capital requirement, and the excitement of trading them. I wanted to share my enthusiasm with other investors and show them how to benefit from my experiences so that they could trade options intelligently and, thus, profitably.

Searching for an Edge

But I needed more than a solid foundation and enthusiasm about options. Trading options successfully is ultimately about successful timing - of the market, of industry sectors, and of individual stocks. To be successful at timing in the stock market, I learned that an investor needs an edge - a set of indicators or a methodology that is both unique and effective.

Many stock market indicators have proven effective over the years, but they share a common shortcoming - they lose their effectiveness as they gain in popularity. Too many market participants begin to use these indicators in their trading decisions. And then the "Heisenberg Uncertainty Principle" comes into play, which, simply put, tells us that any indicator that becomes too popular will, by definition, lose its effectiveness.

Trading options successfully is ultimately about successful timing - of the market, of industry sectors, and of individual stocks

The difficulty is compounded by the fact that the unique indicators that avoid the consequences of the Heisenberg Uncertainty Principle are almost uniformly afflicted with the malady of ineffectiveness.

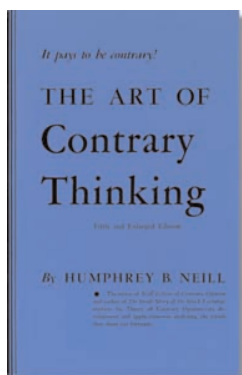
It also became obvious to me that following the "conventional wisdom" on Wall Street was a sure recipe for investment mediocrity. Time and again I would listen to the "experts" who were quoted in the pages of the leading financial publications, only to be led down the path to investment losses. But, like the fly that continually bumps into the windowpane in its logical attempt to get outdoors, I just couldn't seem to stop heeding all the expert advice, despite the losses I had sustained. How could the best minds on Wall Street be so consistently wrong when they were in agreement?

Fortunately, I took heed of the wisdom of those around me. I learned from reading the wry wit of Alan Abelson's weekly column in *Barron's* that research churned out by Wall Street firms was as often a subject for ridicule as it was an object of reverence. Joe Granville stimulated my skepticism even further with his simple yet profound trademark phrase: "The obvious is obviously wrong."

But I still needed a logical explanation for why skepticism was the proper approach to the investment world. My breakthrough came when I read John Kamin's pioneering iconoclastic newsletter, *The Forecaster*, which boldly stated on its masthead that "The Theory of Contrary Opinion Has Never Been Disproved." John's opinions tended to diverge significantly from the conventional wisdom that had so often disappointed me, and I became intrigued with what this contrary opinion theory, which Kamin attributed to one Humphrey Neill, was all about. I then read Neill's masterpiece, *The Art of Contrary Thinking*, (available on SchaeffersResearch.com) full of revelations that completely changed my approach to investing forever.

In this outstanding book, Neill revealed the reasons why the conventional wisdom on Wall Street was constantly letting me down. I began to understand that when market participants develop a strong consensus opinion, an atmosphere of vulnerability is created, rather than the atmosphere of safety that I first envisioned.

For example, a widespread bullish consensus on a stock indicates that most of the buying power to propel this stock higher has already been used to



purchase the shares. The stock price then becomes vulnerable to selling based upon disappointing developments or from simple profit taking, as there are few buyers remaining to step up when sellers wish to get out. I began to refer to such stocks as high-expectation stocks, which, by definition, are stocks to avoid or to consider for shorting or, better yet, for put buying.

Low-expectation stocks, on the other hand, are ripe for big gains on any positive developments, as there are very few buyers who have committed to these shares. These stocks should therefore form the core of my *call buying* list.

I was very excited about this expectational approach, but I still didn't have my edge. I recalled very vividly Neill's warning, "We need accurate sentiment measures, otherwise we will conclude that the consensus is what we wish it to be." In other words, if I wanted to know which stocks were truly high-expectation or low-expectation situations, I needed to have an objective way of measuring the sentiment on those stocks.

Once again, the options market provided my inspiration. I recalled that in the old days, prior to widespread options trading, it was the odd-lot traders (those who traded stocks in lots of less than 100 shares) who constituted the small speculators who were considered to be almost always incorrect when they agreed in large numbers. These were unsophisticated investors who tended to trade on rumors or on old news, and who thus were almost always buying late into trends or chasing ill-fated hot tips.

But once listed options trading became popular, the odd-lotters gave way to options speculators, who had the same propensity to be wrong. And the beauty of analyzing data from the options market was that it was available separately for puts and for calls, by expiration date and striking price. I could see at a glance which stocks the speculators were enthusiastic about through heavy call buying (my high-expectation stocks) and which stocks they were pessimistic about through heavy put buying (my low-expectation stocks).

I now had an effective methodology (Expectational Analysis) and unique and objective indicators (option trader activity) and I was prepared to begin publishing my options newsletter. The first issue of *The Option Advisor* newsletter was published in December 1981.

Stocks with low expectations are often ripe for big gains, while high-expectation stocks are often vulnerable.

Options Growth is Exploding

Over the course of the ensuing 24 years, equity options trading has continued to grow by leaps and bounds, with only a brief pause in the aftermath of the 1987 stock market crash. This growth accelerated during the 1990s, fueled by increasing participation of individual investors. And just last year (2004), equity options volume topped the one-billion mark for the first time.

Option trading volume topped the one-billion mark for the first time in 2004.

I believe that two major factors have helped drive this explosive growth in options trading. Today's investor is increasingly aware of the benefits of adding an options trading component to their investment arsenal. Most investors are attracted to options because they can be used as a cheap, leveraged vehicle to profit handsomely from the movement in an equity. But options can also be used to protect a portfolio from a major decrease in value or to provide additional income, and these more conservative uses are attracting more and more attention in an increasingly nervous investment environment.

Second, the equity options industry has moved out of the back rooms and into the investment mainstream. It wasn't too long ago that equity options transactions were performed for investors by a small group of obscure firms without the benefit of an options exchange. As a result, options tended to be very expensive. Compounding this problem was the fact that the options buyer could not take immediate advantage of changes in the value of their contract, as its terms could not be exercised until the day the option expired. It is not surprising that the tiny options industry sported something of an outlaw reputation.

Today options are traded on six exchanges (the CBOE, AMEX, Philadelphia Stock Exchange, Pacific Stock Exchange, International Securities Exchange, and Boston Options Exchange) in virtually the same manner that stocks are traded on stock exchanges. Plus, options investors have protections analogous to those traditionally enjoyed by stock investors. And options are now *fully fungible*, which simply means that an option buyer can turn around and sell his or her contract on the options exchange at any time up to and including the date that it expires.

25 Years...

When I look back over my 25 years of providing advice and analysis to investors, there are a number of accomplishments of which I am particularly proud.

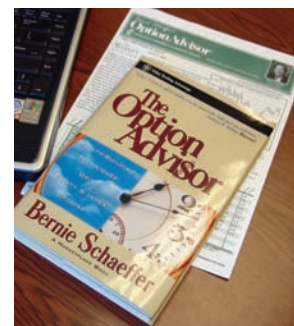
I'm proud of the fact that *The Option Advisor* has grown to become the nation's leading newsletter specializing in equity options recommendations. We've had the privilege of helping tens of thousands of investors understand the principles of an intelligent approach to options trading and avoid the common mistakes that have tripped up most options investors over the years.

I'm also proud that I've kept my subscribers on the right side of all of the major moves in the market. I was bullish until two months ahead of the 1987 crash, and then maintained a bearish posture until the day after the crash. And I remained bullish throughout most of what proved to be one of the greatest bull markets in history.

I'm convinced that my market-timing and stock-picking success has been the result of my ability to analyze investor sentiment and expectations and to combine this analysis with a sophisticated approach to technical and fundamental analysis.

I am very proud of this options education program, which uses a multimedia approach that will unquestionably maximize your ability to understand and retain new concepts. It is divided into daily bite-size chunks so you can concentrate on learning one major area at a time, with each day ending with a quiz to assure you that you've absorbed the important concepts. And it tackles the two most important disciplines that an options trader must master - options definitions and concepts and the keys to successful options trading.

If your relationship with Schaeffer's Investment Research should end with this program (and I certainly hope it won't), I am pleased that you have trusted us to provide you with a solid foundation for options trading success. Rest assured that we stand prepared to help you with a variety of



***10 Days to
Successful
Options Trading-
a solid
foundation
for options
trading success.***

additional educational offerings as well as trading tools and services that provide specific trading recommendations.

Good luck with this education program and with your trading!

A handwritten signature in black ink, reading "Bernie Schaeffer". The signature is fluid and cursive, with the first name "Bernie" and last name "Schaeffer" clearly distinguishable.

Bernie Schaeffer
Chairman and CEO
Schaeffer's Investment Research, Inc.
January 2007



DAY

1

Options definitions
Cracking the code
Truncated risk
Option pros and cons

1

**Option
Basics**



Schaeffer's Investment Research, Inc.

1-800-448-2080

www.SchaeffersResearch.com

Chapter 1

Option Basics

To do today:

- Pick three option paper trades
- Read today's market observations and commentaries, Schaeffer's Daily Market Blog, and *Schaeffer's Daily Contrarian* on SchaeffersResearch.com
- Take the quiz

Today you will learn:

Option basics

The concept of truncated risk

How to calculate breakeven on option trades

How to read option symbols

The differences between stock ownership and stock options

What's so important about the third Friday of the month

How to crack the option code

How to get option quotes from SchaeffersResearch.com

The pros and cons of options

Option facts and myths

Trader Jargon:

Option	At (or On) the Money	Short Position
Option Contract	In the Money	LEAPS
Call	Intrinsic Value	Volume
Put	Time Premium	Bid Price
Expiration Date	Premium	Ask Price
Strike or Exercise Price	Long Position	Open Interest
Out of the Money		

Welcome to the first of 10 days to learning about options. We're glad to have you with us. Today, we're going to start with the basics – the nuts and bolts, if you will – to lay the groundwork for later chapters on different strategies, money management, and how to pick the right underlying stock. As part of today's lesson, we'll get you started with paper trading (no money involved yet) to get your feet wet. You'll follow these trades throughout the 10 days to see how options behave in the market.

You're probably anxious to get going, so let's start with the most basic question of all...

What is an option?

An option is an instrument that allows you to buy or sell a set amount of an underlying security at a predetermined price and by a predetermined date.

It's more than just an offensive football play, as *Merriam-Webster's Collegiate Dictionary* likes to describe it. An option is an instrument that allows you to buy or sell a set amount of an underlying security at a predetermined price and by a predetermined date. Options trade on a variety of instruments, including stocks, equity indices, exchange-traded funds (ETFs), interest rates, and currency and commodity futures. Throughout this program, however, we will refer to a stock as the underlying security.

An option contract usually represents 100 shares of the underlying stock, even though they are commonly priced on a per-share basis. Thus, a stock option priced at \$2 will cost an investor \$200 per contract (\$2 X 100 shares = \$200). Thus, if you wanted to buy three option contracts, your cash outlay would be \$600 and you would control 300 shares of stock.

You can buy options only in one-contract increments. For example, if you wanted to put \$2,000 into an option trade acquiring the \$2 option, you could buy an even 10 contracts. If you wanted to put \$2,100 into the same option, you would still buy 10 contracts (i.e., you can't buy 10-1/2 contracts).

There are three critical components/concepts of an options contract to be aware of – strike price, expiration date, and exercise. These are defined in figure 1.1.

Option Contract

Strike (or exercise) Price

The price per share at which the holder can purchase (for call options) or sell (for put options) the underlying stock.

Expiration Date

The last day on which the option may be exercised. Listed stock options cease trading on the third Friday of each month and expire the next day.

Exercise

The procedure whereby the holder of an option notifies The Options Clearing Corporation (through his broker) that he wishes to purchase (for calls) or deliver (for puts) the underlying stock at the strike price.

Fig. 1.1
Components of an option contract

A call gives the buyer the right to buy a specified number of shares of a stock at a specified price by a specific date.

Calls

There are two types of options - calls and puts. A call purchase gives the buyer the right (but not the obligation) to *buy* 100 shares of a stock at a specified price (known as the strike price) up until a specified date (the expiration date). That is, the call buyer can exercise his right to buy the 100 shares of stock at the strike price at any time before the option expires.

A call buyer is bullish on the equity, believing that the price of the stock will exceed the strike price by the expiration date. For example, if you buy a 50-strike call option and the stock moves to 55 by the option's expiration date, you can exercise your option such that the option seller is obligated to sell you 100 shares of the stock at \$50 per share even though the prevailing market price is 55. As the call buyer, you essentially own any appreciation of the stock above 50. Of course, the cost of the option must be taken into account. If you purchased the option for \$2 (\$200 per contract), the breakeven for this trade is a stock price of 52 (the strike price plus the cost of the option). That is, the trade is profitable at expiration only when the stock price exceeds 52.

When the stock price is below the strike price, a call option is said to be *out of the money*, while an option with a strike price equal to the stock price is *at the money* (or *on the money*). A call option is *in the money* when the stock price is greater than the strike price. An in-the-money call option has intrinsic value - the amount the stock price exceeds the strike price. At-the-money and out-of-the-money calls have no intrinsic value; their entire price consists of time premium, whereas the price of an in-the-money option consists of both intrinsic value and time premium.

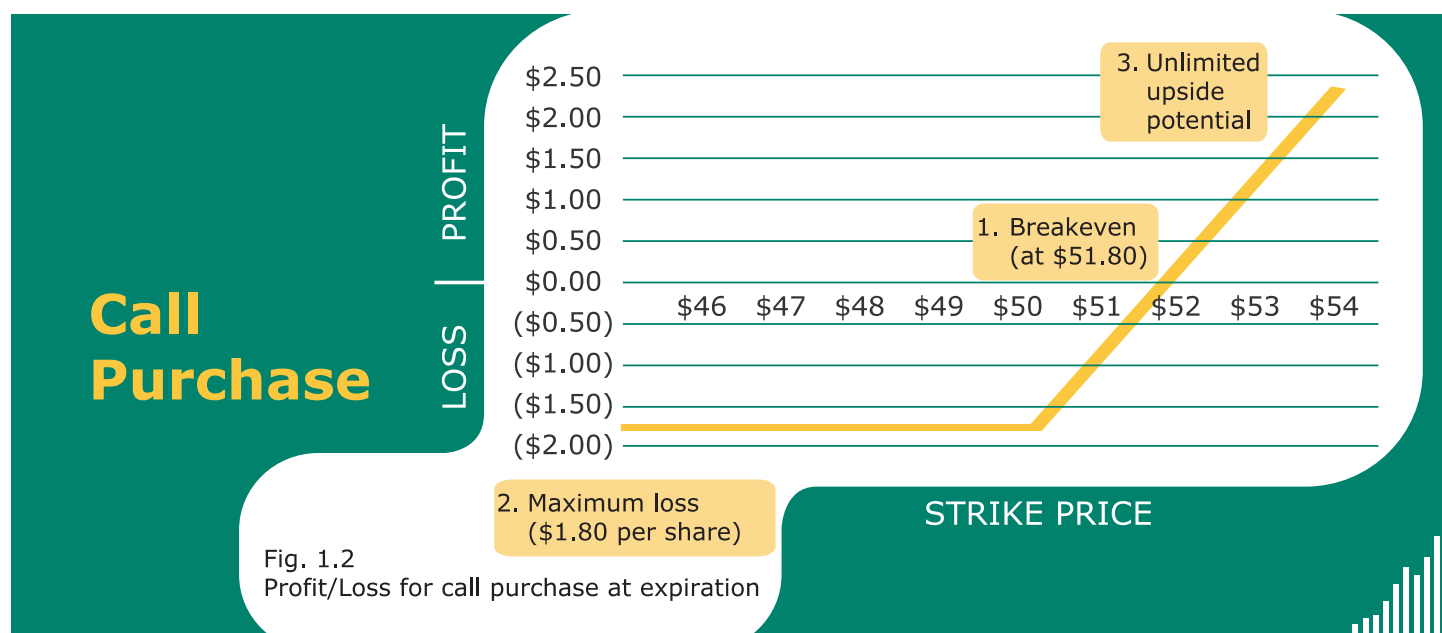
Time premium is one component of the option's price that is based on the time left until the option expires. The more time there is until expiration, the greater the time value of the option. For in-the-money options, the time premium is calculated by taking the difference between the total cost of the option and its intrinsic value (or the amount it is in the money). At expiration, call buyers will lose their entire investment if the stock price is equal to or below the strike price (there is no time value remaining at expiration and the intrinsic value is zero). If the stock price is above the strike price and below the break-even point (the strike price plus the premium paid for the option), the call buyer will lose part of his investment.

As the equity moves above the break-even level, the call buyer will profit on a point-for-point basis with each move higher in the stock. Keep in mind that the risk for a call buyer is truncated, as the maximum loss is limited to the premium paid, while the profit potential is theoretically unlimited.

The concept of truncated risk can be illustrated graphically using a profit-and-loss diagram. Figure 1.2 shows the profit or loss of a call purchase, or a long call strategy, over a range of stock prices at expiration. The horizontal axis represents various stock prices, and the vertical axis shows the range of profit or loss.

Note in particular how the maximum loss is limited while the profit is theoretically unlimited. For the example in Figure 1.2, assume that a 50-strike call is purchased for \$1.80 (\$180 per contract). The break-even point

The risk for a call buyer is truncated, as the maximum loss is limited to the premium paid, while the profit potential is theoretically unlimited.



for this trade is 51.80 at expiration (the strike price of 50 plus the premium of 1.80). Any stock price greater than 51.80 will result in a profit for the trade, while a stock price of 50 or less will result in a total loss for the trade. Between 50 and 51.80, the call buyer will incur a partial loss (for example, a price of 51 results in a loss of 0.80, or \$80 per contract).

The diagram points very clearly to three important observations about this long call position: (1) a break-even point of 51.80 (strike price plus the premium); (2) a maximum risk of \$1.80 (note that the profit/loss line is flat at a stock price of 50 or less); and (3) the profit is theoretically unlimited, as there is technically no upper limit to how high the stock price (and thus the value of the option) can rise.

Puts

A put gives the buyer the right to sell a specified number of shares of a stock at a specified price by a specific date.

A put purchaser owns the right (but not the obligation) to *sell* 100 shares of the underlying stock at the specified strike price by the expiration date. Put buyers are bearish on the underlying stock, believing that the stock price will decline below the strike price before expiration. For example, you may feel that a declining stock, currently at 52, will continue its current downtrend. To take advantage of this decline, you buy a 50-strike put, which gives you the right to sell the stock to the put writer (also known as put seller) at a price of \$50 per share, no matter how low the stock price declines. If the stock drops below 50 by expiration, your option is worth the difference between the strike price and the stock price (or the amount the put is in the money). If the stock falls to 45 at expiration, the put is worth \$5 per share. As with calls, the premium for the option must be included in your net profit calculation. For puts, the break-even point at expiration is determined by subtracting the premium you paid for the option from the strike price.

A put option is said to be *out of the money* when the stock price is greater than the strike price. As with call options, a put is *at the money* when the stock and strike prices are the same. A put is *in the money* when the stock price is below the strike price. The intrinsic value of a put equals the amount by which the strike price exceeds the stock price. As with a call, a put has value at expiration if the option is in the money.

To clarify, let's take a closer look at these terms dealing with the relationship between strike price and stock price:

	CALL	PUT
In the Money	strike price < stock price	strike price > stock price
At the Money	strike price = stock price	strike price = stock price
Out of the Money	strike price > stock price	strike price < stock price

The put buyer loses his entire investment if the stock price closes above the strike price at expiration and loses part of his investment if the stock price is in the money between the strike price and the break-even point. Put purchases begin to accumulate profits around expiration as the underlying stock drops below the break-even price.

The profit-and-loss diagram for a put purchase (long put) is displayed in Figure 1.3. Assume that a put buyer is bearish on a stock currently at 50 and buys a 50-strike put for \$1.80 (\$180 per contract). The break-even point (profit of zero) for this trade is achieved if the stock falls to 48.20 at expiration (the strike price of 50 minus the premium of \$1.80). Any stock price below 48.20 will result in a profit for the trade, while a stock price of 50 or greater will result in a total loss. Between 48.20 and 50, the trader will incur a partial loss (for example, a price of 49 would result in a 0.80 loss).

From this, we conclude the following: (1) the break-even price point is 48.20 (strike price minus the premium); (2) a maximum risk of \$1.80 per share, or \$180 per contract (note that the profit/loss line is flat at a stock price of 50 or above); and (3) a theoretical maximum profit potential of \$48.20, which is achieved if the stock price hits zero (certainly unlikely but technically possible). Note this difference between calls and puts. Calls have no theoretical maximum profit, whereas put profits are technically capped because a stock cannot fall below zero.

Put Purchase

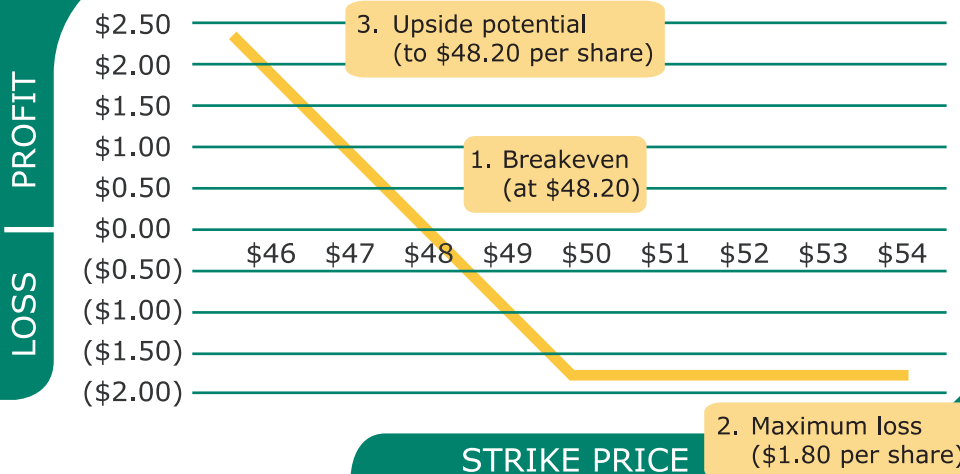


Fig. 1.3
Profit/Loss for put purchase at expiration

Equity options technically expire on the Saturday immediately following the third Friday of the expiration month, and cease trading on the third Friday of each month.

How to Read Option Symbols

When buying or selling options, it's very important to understand all the components of the trade. For example, say you wanted to buy the XYZ Company December 35 call. XYZ Company is the underlying stock, December is the expiration month of the option (equity options technically expire on the Saturday immediately following the third Friday of the expiration month, and cease trading on the third Friday of each month), and 35 is the strike price. The call is the type of option.

Name of the company	expiration month	strike price	call/put
XYZ Company	December	35	call

This option ceases trading on the third Friday in December. The strike price is 35 and this option buyer is betting bullishly on XYZ because it is a call. The buyer has the right to buy 100 XYZ shares at \$35 per share no matter how high the XYZ price increases.

Let's look at another...

Name of the company	expiration month	strike price	call/put
ABC Corp	March	50	put

The final day of trading for this put is the third Friday in March. The strike price is 50, meaning that the buyer can sell 100 ABC shares at \$50 each no matter the stock's market price. This option is owned by someone betting on a bearish move (because it is a put) in ABC shares before March expiration.

One more, just to be sure:

Name of the company	expiration month	strike price	call/put
MNO Healthcare	July	27.5	call

The call makes this a bullish play on MNO Healthcare. The call buyer wants to see the underlying stock significantly surpass \$27.50 (plus the cost of the option) on or before the third Friday in July.

Cracking the Option Code

Until 2010, the options industry utilized hard-to-decipher option codes, with only four or five letters used to represent an option's underlying stock, expiration month, and strike price. As veteran option traders know, these often enigmatic symbols, juxtaposed with the rapid industry growth and escalating complexity of options, presented several unavoidable speed bumps for the options market.

For starters, the old Options Price Reporting Authority (OPRA) code assumed a single expiration day, which clashed with some Long-term Equity Anticipation Securities (LEAPS), Flexible Exchange (FLEX) options, and short-dated options with multiple expiration dates. Plus, the three-character limit to identify the underlying stock symbol created inconsistencies with over-the-counter (OTC) securities, resulting in the use of often absurd identifiers. For instance, who would've guessed that "APV" and "MSQ" were the root symbols for Apple Inc. (AAPL) and Microsoft Corp. (MSFT) options?

The ultimate result of these industry issues was the Options Symbology Initiative (OSI), which transformed option symbols into today's lengthier, more easily discernible option codes. Under the OSI guidelines, option symbols are now displayed using the following four elements: **root symbol**, **specific expiration date**, **put/call indicator**, and **strike price**.

However, it's generally left to the various brokers, exchanges, and data vendors to determine in which order to exhibit these components, as there's no longer a uniform sequence enforced by the industry. In other words, some of the major market participants display varying symbols for the same option, though all of the post-OSI option symbols should include the aforementioned four primary ingredients.

The Four Elements of an Option Symbol

Typically, the **root symbol** of an option will reflect the underlying stock or index symbol. For example, Apple Inc.'s (AAPL) options will generally begin with "AAPL," while Microsoft Corp.'s (MSFT) options will usually start with "MSFT."

Meanwhile, each option code should display the **specific expiration date**, including the day, month and year the option expires. While there are some exceptions to the rule, most equity options expire on the third Saturday of the month, but cease trading on the prior Friday.

Furthermore, each option symbol must identify whether the option is a **put or call**. Again, this element isn't uniform across the board, so displaying this component can vary with each broker, exchange or data vendor. For example, Thomson Reuters – which provides data to a bevy of bigwigs in the industry – utilizes a unique alpha character to identify both the type of option and the month of expiration (i.e. - "J" for calls and "V" for puts expiring in October 2011).

Finally, all option codes should advertise the underlying **strike price**, usually in dollars and decimals. However, for option strikes in whole dollar amounts, some industry constituents – like Thomson Reuters, for instance – may not display the zeros after the decimal point (i.e. – "115" instead of "115.00" for a 115-strike option), while others will.

Option Symbol Elements

ABCD Corp.

\$50 strike call option
expires March 19, 2010



To further demonstrate the four elements of an option symbol, as well as the sequence discrepancy between the dozens of industry heavyweights, try to identify the four primary ingredients of the various option symbols exhibited by a handful of some brokers, exchanges, and data providers, using the **Apple Inc. May 2010 200 call**, which expires May 22, 2010:

Apple Inc. (AAPL) May 2010 200 Call
Root Symbol: AAPL
Expiration: May 22, 2010
Option Type: Call
Strike Price: 200.00

Apple Inc. (AAPL) May 2010 200 Call
AAPL 1022E200
AAPL MAY 22 '10 \$200 Call
AAPL 05/22/2010 200.00 C
AAPL 100522C200
AAPL May 10 200 Call

Free Option Quotes from SchaeffersResearch.com

Accessing option quotes on the Internet is convenient, easy, and – most importantly – immediate. Let's go through an example of how to access a quote from SchaeffersResearch.com (Chapter 10 goes into a more thorough discussion of what SchaeffersResearch.com offers the option trader).

Let's say you are strongly bullish on Microsoft (MSFT) and are considering buying a call or selling a put on the stock. You can obtain quotes for MSFT options on SchaeffersResearch.com by following a couple of quick and easy steps. First, simply hover over the Quotes & Tools tab at the top of the home page, scrolling down to click "Option Quote." Once the page loads, enter the underlying stock symbol – MSFT, in this case – in the box and hit "Search." This will bring you to a page providing option-pricing data for both the stock's puts and calls.

	Strike	Expiration	High	Low	Previous Close	Change	Percent Change
MSFT	30	10-Jul	30.72	30.12	30.585	-0.46	1.49%
		Call	Put				
Bid		0.95	0.9				
Ask		0.96	0.91				
Open Interest		25348	25409				
Volume		1657	1150				

This information provides several pieces of information concerning pricing and trading activity (SchaeffersResearch.com quotes have a 20-minute delay), as well as basic information about the option itself (put or call, strike price, and expiration month):

- The **Last Bid** indicates the trading price of the option in the most recent transaction.
- The **Bid** is the highest price any potential buyer is willing to pay for a particular option.
- The **Ask** (also referred to as the “offer”) is the lowest price any potential seller is willing to accept for a particular option.
- The **High** and **Low** give the range of transaction prices for the day.
- The **Previous Close** is the final transaction price from the previous day.
- The **Change** and **Percent Change** show how much, in both absolute and percentage terms, the last sale differed from the previous day's closing price.
- **Open Interest** represents the number of outstanding (or open) contracts in the exchange market on the particular option. It is updated at the end of each trading day.
- **Volume** is the number of contracts that have been traded so far during the current day.

Picking Your Own Option Positions

Now that you understand the basic mechanics of options, it's time to select some of your first paper trades. Your goal is to select three option trades, as instructed in the Appendix, and check on them every day for the next 10 days (i.e., until you finish this course). You can check the SchaeffersResearch.com free option quotes to update the pricing information requested for each option. This exercise will show you how the prices may fluctuate even over the short period of time that you spend on this program.

Good luck!

Before we end this opening chapter, there are a few general items that add perspective to options trading. We've included these here to provide a deeper fundamental understanding of what options are as you move through the next nine days.

Distinguishing Stock Options From Stock Ownership

It's important to understand the distinction between buying equity options and owning the stock. Unlike stocks, options have a limited life. If an expected move does not immediately occur, a stock investor can say, "I'll give it another week" over and over, forever if they so choose. This is not true with options trading. Each option has a set expiration date. At expiration, an option is either worth the difference between its strike price and the current stock price, or it's worthless.

There's a key concept to keep in mind when dealing with the limited life of options - profiting from an options purchase depends on the ability to correctly predict both the direction and timing of a move in the price of the underlying stock. The first variable - direction - is easily understood. If the stock is expected to rise, but instead it declines, the investor loses money (of course a put buyer would profit if the expectation is that the underlying stock price will fall and the price does decline).

The second key variable in options trading is the timing of the move. For instance, the holder (buyer) of an XYZ May 35 call is guaranteed the right to buy 100 shares of the stock at \$35 per share at any time before the option's May expiration, even if the stock rallies to 40, 50, or even 70 or more. However, it costs more for a July 35 call than a May 35 call because of the additional time. This gives the stock a better chance of rallying above 35.

Be sure to understand the concepts of time and money with options. The more time the option provides for the expected move to occur, the higher the price (or premium) of the option. In the above example, the May expiration will typically be cheaper than the July option (which should be

cheaper than the September when the other factors affecting an option's price remain the same).

Sometimes new options traders will confuse other financial concepts with the above concept. For example, someone might suggest minimizing risk by buying a very cheap option. Everyone loves a bargain. But like a very cheap automobile, there is always a reason why it is so inexpensive. For an option buyer the typical reasons are simple:

- The option has little time left until expiration.
- The strike price and stock price are so far apart that it is highly unlikely that the option will be in the money before expiration day.
- Both of the above

If you choose to buy the cheapest options, you must be extremely precise in timing the move and calling the direction. In exchange for this precision, you reduce the amount of money you have to invest into the position, thereby enhancing the potential leverage you can achieve.

Focusing on only the cheapest options in this way often yields many losses and only occasional wins. If the potential volatility and thought of many sequential losses concerns you, then you may want to make it easier on yourself by paying for more time. Or you could buy an option that is already in the money. These concepts will be covered in more detail in a few days.

The Pros and Cons of Options Trading

The major benefits of options relative to trading stocks, ETFs, or mutual funds are:

1. Options require a limited amount of capital and thus have fewer total dollars at risk in the market. These extra dollars can be placed in safe investments such as a money market fund. Why buy stocks outright when you can lease them with options, especially when your market expectations are likely to change more frequently in a volatile market? Buy-and-hold investments still have a place for long-term investors, but you can also set aside a small portion of your portfolio to benefit from

the more frequent swings that can create even bigger profit opportunities for traders positioned to capitalize on these market swings.

2. Options offer profit potential not just when the market rallies, but also when it drops. If you are bearish on the stock market, cash is usually your only alternative. Why should you be correct in your assessment of a down market but not be able to profit from this correct view? With options, you can use both calls and puts to your advantage, with your maximum risk being only what you paid for the option.
3. Options offer far greater leverage than stocks or funds. For investors who are pleased to have called a 10-20 percent move in a stock, they often could have made 100 percent or more buying an option on that stock. The concept of leverage is what allows one to put limited dollars at risk but still experience healthy absolute profits.
4. Put options are usually a better choice than selling a stock short. Unlike shorting a stock, option purchases do not require a margin account. In addition, a short stock position has theoretically unlimited loss potential (the higher the stock goes, the more you lose as a short seller), whereas a put option purchase's maximum loss is capped at the cost you paid to buy the option. In addition, short sellers can only short stocks after upticks (a higher price than the last traded price), whereas put buyers can buy puts as stock prices are falling.
5. Options can hedge stock or fund portfolios without losing the long-term holding designation for tax purposes, which allows long-term stock to obtain a lower tax basis. This improves after-tax returns on stock holdings, while still allowing you to protect those stocks during market turbulence.
6. Other option strategies can be created to profit from any market view. For example, if the market is flat over the next month, you can profit by selling option premium. This concept will be explored further in Chapter 5.

The negative aspect to options is primarily related to a general lack of understanding by the investing public. Options are not stocks. They have their own characteristics, peculiarities, and quirks that make them very different from stocks. The pricing of options can be very complex and

difficult to understand. The biggest difference (and the one that is hardest for the novice to comprehend) is that options are time-dependent. They will expire within a given time frame. This adds a whole layer of complexity onto the option-trading decision process because time can work for you or against you, depending on your strategy. A successful options trader must not only be knowledgeable about the underlying stock, but must also know and understand the dynamics of the option and time frame they are trading.

Options Facts and Myths

Despite the explosion of options trading over the past few years, misconceptions about how options work abound. Many of these myths are holdovers from the “cottage industry” days when the options market was much less organized than it is today. Myths about options fall into two very distinct categories. The first stems from an overly optimistic view of options as an investment that gives one a “license to print money.” These types of myths stem from the hyperbole offered for why options are great. The danger of these myths is that they can provide an options investor with a false sense of security, causing him/her to be less cognizant of the very real risks associated with options trading. These facts include the following:

1. The most that can be lost in an options trade is your original investment.

This is a true statement when buying an option (buying premium) as we previously discussed. However, this is not the case when you sell (write) options to open an option position. There is more on selling options in Chapter 5. And, as you’ll see later, this statement is not entirely true if you are selling option premium to open trades.

2. Uncovered (naked) option selling allows you to be like the “house” at a casino because you can profit from nearly every trade.

Selling premium, whether puts or calls, can be a very risky strategy because losses can be considerable. A prime example is the October 1987 crash, in which naked put selling easily accounted for the most devastating trader losses. This happened because put sellers were riding a wave of euphoria that the market would continue higher and thus failed to hedge their positions. The market crash put them in a position of having to buy back their puts at losses far surpassing the premium

they collected. When done prudently, option selling can be a wise strategy. Done recklessly, it is a recipe for disaster.

3. *If you concentrate on low-priced, out-of-the-money options, profits from big winners will exceed the losses from the more frequent trades that expire worthless.*

Such options do provide the most leverage and those types of options will generate “grand slam” returns. However, some trades will result in total losses and the winning percentage will be low. If a trader places a significant portion of his trading capital into those types of trades, the risk of ruin will increase. One should place smaller amounts of capital in these types of speculative trades.

The following option myths have to do with the feeling that options are a “shell game” that’s impossible to win. This type of thinking scares many away from the potential benefits of trading options. Many try to “stick a toe in the water” to try options out, lose money, and vow to never try again. The primary way to combat such attitudes, and the primary reason for this program, is education. Only when investors are fully knowledgeable of how options work, how to trade, and how to practice sound money management discipline will the stigma of options as a loser’s game be eradicated. The following myths are included in this category:

1. *90 percent of options expire worthless.*

Logically, it is impossible for 90 percent of options to expire worthless. If a stock declines, call positions will most certainly lose value and many may expire worthless. However, put positions will increase in value with the same decline in the underlying stock. The opposite would of course hold when a stock price increases. Another thing to keep in mind is that most options that have any value are closed out before they expire. Thus, most of the options that make it to expiration are worthless simply because the others have already been closed out. The statement that 90 percent of options expire worthless is grossly misleading, if not outright untrue.

2. 90 percent of options traders lose money.

While it is probably true that the majority of options traders lose money, the figure of 90 percent is an extreme that is highly unlikely. While there are no statistics to either support or refute this myth, there are a number of mistakes that options traders commonly commit that lead to an overall losing options experience. For example, they may take profits too early, thereby reducing the potential leverage options offer in order to "book a winning trade."

The primary purpose of this program is to help investors new to the options game avoid mistakes. Consider that there are at least two people in each option trade - the option buyer and the option writer (or seller). If the buyer loses (because the option expires worthless), the writer wins. Both participants are considered "options traders."

3. Options trading is much riskier than stock trading.

There is no doubt that options trading can be riskier than trading stocks. Most often, this increased risk results when the options trader over-commits capital to a particular trade, fails to diversify options positions, or engages in riskier trading strategies (buying far-out-of-the-money options in search of the huge winner). However, there are a number of relatively low-risk strategies (covered writes, spreads, LEAPS, hedging, etc.) that refute the myth that options trading is riskier than stocks. In fact, options can make stock trading less risky.

4. Brokerage commissions for trading options are too high.

Commissions for options trades used to be relatively high, especially when compared to stock trading. However, with the explosion of discount and deep-discount brokers and the advent of Internet brokers, commissions have been drastically reduced. Also, committing enough capital to each position can minimize the commission percentage for each trade. There is no doubt that the potential return from trading only one contract will likely be more heavily impacted by commissions. Proper money management will minimize the effect commissions can have on your trading results.

**Be sure to use
Schaeffers
Research.com
for all your option
trading needs.**

5. *Options trading is only for investment professionals.*

Education is the key to successful options trading. Anyone who understands the rewards and risks of trading options and who understands how to approach the options market can profit from options. A goal of this program is to arm you with that understanding so that you too can trade with an educated edge.

Having completed the Option Basics chapter, you've accomplished a great deal. You know what calls and puts are, you know the option coding system, and how to get quotes. Hopefully, you've used SchaeffersResearch.com and realized that it contains a variety of additional educational content. You've selected some paper trades to do a short simulation of option trading (if you haven't, see the Appendix to get started). To insure that all this information "took," we encourage you to take the following quiz...

