PhillipCapital
Your Partner In Finance

Introduction to Options

Introduction

Many people have heard of options, but have never really understood how to use options and therefore have avoided them altogether. Fortunately, everyone who has ever wanted to learn about options has had to start from that very same position.

By taking the time to understand options and with our help you can create an additional income to supplement your current income. Options can also help you profit from ANY view that you hold on the market - a feature that no other financial product offers.

Two types of options

Source: www.asx.com.au

The components of an option

Underlying security: Options derive their value from regular shares traded on the ASX. i.e. BHP will have options that can be bought or sold to take a position on the 'underlying stock'.

Contract size: One options contract is equal to 100 units of the underlying stock.

Expiry month: All options have a specified expiry date. Both the buyer and the seller can choose which month the position they take will expire.

Strike price: The strike price is the pre-determined buy or sell price for the underlying stock.

Premium: The term premium refers to the cost of the option. The buyer pays a 'premium' and the seller receives a premium.

Example of an options contract

The description of an options contract will look something like this: BHP $42.00 DEC11 CALL

BHP:	The underlying security
DEC11:	The expiry month
$42.00:	The strike price
CALL:	The option type
Premium:	$250

This contract gives the buyer the right to purchase 100 units of BHP at $42 anytime before the December expiry date. For this right the buyer pays a cost of $250. The value of the call will increase as the share price rises.

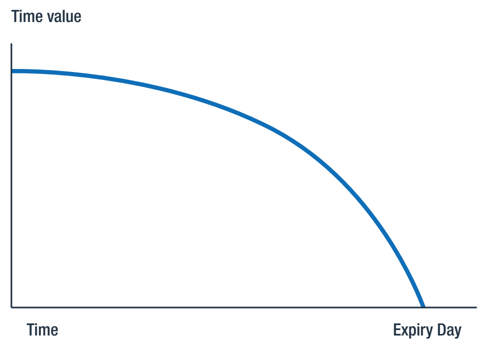
If this same position was taken with a put instead of a call. It would give the buyer of the option the right to sell 100 units of BHP at $42 anytime before the December expiry for a similar cost. The value of the put will increase as the share price falls.

Intrinsic value and time value

Intrinsic value: This is the difference between the strike price of the option and the market price of the underlying stock. The larger the intrinsic value, the smaller the time value component of the option.

Time value: The time value of an option is the cost for the possibility that the market might move in your favour during the life of an option.

As time draws closer to expiry, the rate of 'time decay' accelerates as per the chart below.



Positions that can be taken

There is a number of options positions that can be taken that will allow investors to hold a position that matches their view of an underlying security. All options strategies will need to comprise of one or more of the below:

Buy call: The buyer of a call has the right to purchase a stock at a predetermined price (the strike price) before a predetermined date (expiry date). The buyer pays a premium for this right. This position is generally taken if the buyer feels the stock will go up.

Sell call: The seller of a call receives a 'premium' or a credit for giving the buyer of the call option the right to buy the underlying security at the chosen strike price. In the BHP example above the seller of the call option can be told to sell BHP at $42 anytime before the expiry of that option despite where BHP is trading on the market. The seller of the option has the view that BHP will be trading below $42 at the expiry date—this will mean that the sold call would expire worthless and they will keep the premium received.

Buy put: The buyer of a put has the right to sell the underlying stock at any time before the expiry date of the option at the chosen strike price. If the investor purchased a $42.00 Put over BHP, the buyer of the put will be able to sell BHP at $42 despite where BHP is trading on the market. This position is usually taken if the buyer feels the underlying stock might fall.

Sell put: The seller of a put receives a 'premium' or a credit for giving the buyer of the put option the right to sell the underlying security at the chosen strike price. If the investor sold a $42.00 put on BHP, the seller of the put would have the view that BHP will be trading above $42 at the expiry date - this will mean that the sold put would expire worthless and they will keep the premium received.

Understanding the risks

Just like holding normal shares, should the price of the underlying stock move against the position that you are holding, the holder of an options position will be exposed to a loss. The difference is that options are leveraged products, in other words, a large position exposure can be taken using a small amount of capital. When the taken view is correct, it can produce healthy returns however, when the incorrect position is taken, losses are also accelerated. Fortunately, the flexibility of options allows users to adjust their positions to manage their risk. Your PhillipCapital adviser can help you reduce the associated risks with effective risk management.

Options often receive an inaccurate reputation as being risky and this perception is generally by people who don't understand how to use options properly. In fact, there are a number of ways that options can be used to reduce the risk of an equity portfolio. For more information about options as a risk reduction tool, please contact your PhillipCapital adviser for an information pamphlet on 'portfolio protection' and 'covered calls'. Portfolio protection refers to buying a put to protect against losses on an existing portfolio. Covered calls is a strategy which helps create a monthly income for clients and has been proven to reduce the overall volatility in portfolio returns.

Margins

The seller of an option needs to pay 'margins' when selling either a put or a call option.

Margins are best explained through the example below:

If the seller of a put is 'exercised' on the sold option, they will be required to buy the stock at the nominated strike price, they can then choose to sell the stock at any time on the market and will therefore be liable for the difference between the market price and the strike price. To ensure that the seller of the put is able to cover this potential shortfall (a shortfall is referred to as a 'margins'), the client needs to ensure that there are adequate funds available to cover the shortfall while their sold options position is open. These margins are held by ASX Clear. The sold put position is open and can be covered by cash held in a nominated bank account or, alternatively, investors can choose to lodge existing shares they hold with ASX Clear to cover their margin requirements. When choosing to lodge shares with ASX Clear to cover margin requirements, clients can continue to generate a monthly income without having to put extra funds to work in the market. Similarly, margins are also required for a sold call position.

A lot to take in?

Most people who are new to options feel this way. Fortunately, PhillipCapital has fully accredited ASX derivatives advisers who can help you structure options trades that take advantage from your view of the market.

Your next step

To start profiting from the flexibility of options contact us at either of our PhillipCapital offices below:

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