OPTIONS

Options are a type of derivative, which simply means that their value depends on the value of an underlying investment. In most cases, the underlying investment is a stock, but it can also be an index, a currency, a commodity, or any number of other securities.

A stock option is a contract that guarantees the investor who has purchased it the right, but not the obligation, to buy or sell 100 shares of the underlying stock at a fixed price prior to a certain date. Each option has a buyer, called the holder, and a seller, known as the writer. If the option contract is exercised, the writer is responsible for fulfilling the terms of the contract by delivering the shares to the appropriate party. In the case of a security that cannot be delivered such as an index, the contract is settled in cash.

There are two basic forms of options. A call option provides the holder with the right to buy 100 shares of the underlying stock at the strike price, and a put option provides the holder with the right to sell 100 shares of the underlying stock at the strike price. If the price of a stock is going to rise, a call option allows the holder to buy stock at the price before the increase occurs. Similarly, if the price of a stock is falling, a put option allows the holder to sell at the earlier, higher price.

For the holder, the potential loss is limited to the price paid to acquire the option. When an option is not exercised, it expires. No shares change hands and the money spent to purchase the option is lost. The upside, however, is unlimited. Options, like stocks, are therefore said to have an asymmetrical payoff pattern. For the writer, the potential loss is unlimited unless the contract is covered, meaning that the writer already owns the security underlying the option.

Options are most frequently used by individual investors as either leverage or insurance. As leverage, options allow the holder to control equity in a limited capacity without paying the full price of buying shares up front. The difference can be invested elsewhere until the option is exercised. As insurance, options can protect against price fluctuations in the near term because they provide the right acquire the underlying stock at a fixed price for a limited time.

It is important to remember that options can be an extremely risky investment, and they are certainly not appropriate for beginning investors. Only the most experienced investors should include options in their investment strategy, and even the most knowledgeable investors should prepare for the possibility of substantial losses.

Advantages and Disadvantages of Options

Advantages:

- An investor can gain leverage in a stock without committing to a trade.
- Option premiums are significantly cheaper on a per-share basis than the full price of the underlying stock.
- Risk is limited to the option premium (except when writing options for a security that is not already owned).
- Options allow investors to protect their positions against price fluctuations.

Disadvantages:

- The costs of trading options (including both commissions and the bid/ask spread) is significantly higher on a percentage basis than trading the underlying stock, and these costs can drastically eat into any profits.
- Options are very complex and require a great deal of observation and maintenance.
- The time-sensitive nature of options leads to the result that most options expire worthless. Making money by trading options is extremely difficult, and the average investor will fail.
- Some option positions, such as writing uncovered options, are accompanied by unlimited risk.

10.2 VOCABULARY NOTES AND COMMENTARIES

underlying investment основна, базисна інвестиція

option опціон

call option опціон “колл”

covered call покритий опціон

put option опціон “пут”

option holder власник опціону

option writer продавець опціону

to exercise використовувати право виконання опціону

strike price ціна виконання опціону

premium ціна опціону