What Is Options Trading?

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Options Trading - Introduction

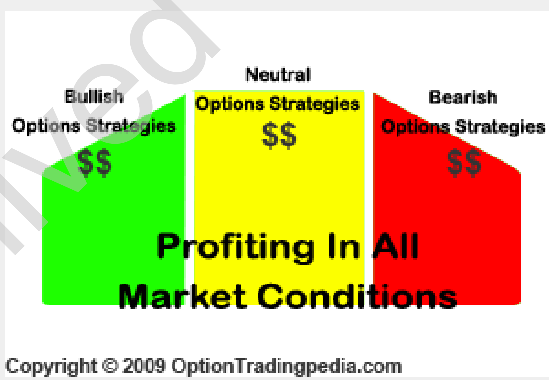
Option Trading, or options trading, is the trading of stock options over an exchange. As options trading is most commonly conducted through online option trading brokers, it is also commonly known as **Online Options Trading** or even **Online Optiontrading**.

There are many people who confuse options trading with futures trading. Futures and options are two distinctly different derivative instruments with their own characteristics.

Learn the Differences Between Futures and Options.

Options trading means trading options that are offered on stocks (or any other assets such as forex) instead of the stocks themselves. That's right, you do not need to own the underlying stock in order to trade options.

There are 2 classes of options, CALL OPTIONs and PUT OPTIONs. Creative use of both classes leads to an almost unlimited combination of possible option strategies. Options trading strategies are capable of performing wonders such as profiting from BOTH an up or down move, or profiting even when the underlying stock stays stagnant!



Options Trading Profits In All Market Conditions

Optiontradingpedia Explorer

Options Trading

Options Strategies

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2. Bull Call Spread (no change)
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4. Butterfly Spread (-1)
5. Deep ITM Covered Call (-1)

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Why Options Trading?

Successful Investors like Robert Kiyosaki and Robert G Allen have popularised options trading through the use of options strategies as part of an overall strategy to financial freedom. They preach that options trading is the investment of the rich. So, what makes options trading so powerful?

Options Trading Grants Unprecedented LEVERAGE!

Yes, options trading is LEVERAGE! Trading options allows you to potentially make over 10 times more profit on the same move in the underlying stock than if you bought the stock itself! The leverage power of options trading is perhaps the main reason why traders with small funds choose to trade options. Even though options was initially designed to be a hedging tool instead of a leverage tool, options trading is still a great way to profit while risking only very little money.

In fact, the power of leverage in options trading is unique in the sense that it is not a fixed amount of leverage but a variable amount of leverage that you can use by choosing different strike prices and/or expiration months! It is also this variability of leverage that makes options trading suitable for traders of any risk tolerance when used correctly. You can be as aggressive or as conservative as you wish in options trading by choosing options with the correct strike price and expiration.

The Leverage effect of option trading also allows investors to participate in the move of high priced stocks using only a small capital outlay. This is because stock options cost only a fraction of the price of its underlying stock. For instance, Apple (AAPL) is trading at $93.65 today while it's call options cost only $1.70. Investors can participate in the gains on 100 Apple shares through buying its call options for only $170 exactly rather then spend $9365 buying the stock itself. That's another benefit of option trading.

Options Trading For Leverage

Options Trading Grants Unprecedented PROTECTION!

Options trading not only grants you leverage, but it also grants you PROTECTION! When a stock moves AGAINST you, an options trader could potentially make a lesser loss than the stock trader. Why? Because your maximum loss is limited to the price you paid for the option which could be just 10% of the price of the stock, or lesser! Taking our Apple example from above, the stock trader's maximum risk is $9365 while the option

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(Jul 26, 2012)
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trader's maximum risk is $170 for controlling the same number of Apple stocks! Indeed, options trading need not be risky!

You can also protect your stocks from dropping in value through options trading by buying the same number of put options as the number of shares that you own. In this case, those put options act as an insurance policy, protecting your shares from dropping in value. This is what we call a Protective Put.

Options Trading Grants Unprecedented FLEXIBILITY!

Options Trading allows you to profit from every possible move in the underlying asset! Up, Down or Stagnant, there is an option strategy that allows you to profit from that exact move. In Options trading, an options trader can easily participate in a downwards move on a stock through buying a put option without having to risk margin calls by going short the underlying stock or futures.

Yes, there are even times when stock trading is riskier than option trading! Read about How Stocks Can Be Riskier Than Options. This is also why I wrote this options trading tutorials site to teach the world about this wonderful trading instrument.

How To Start Options Trading?

The easiest way to start options trading is by opening an online options trading account with a broker which offers online options trading and then practise buying call options for stocks which you think will go up and buying put options for stocks that you think will go down. After you are completely familar with trading call options and put options, you can then move on to the more complex option strategies. Make sure you follow the essential Steps in Trading Options. There are currently (Dec 2010) seven exchanges in the United States that list standardized stock options for options trading -- The Philadelphia Stock Exchange (PHLX), American Stock Exchange (AMEX) and NYSE Arca in New York City, and the Chicago Board Options Exchange (CBOE) which are all open-outcry marketplaces, and the International Securities Exchange (ISE), Nasdaq Options Market (NASDAQOMX) and Boston Options Exchange (BOX) are electronic marketplaces. Anyone can trade options in any of these options trading exchanges through any options trading brokers.

Learn More About Options Trading from our Options Trading Basics Tutorial!

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What is a Stock Option?

Stock Options - What is it?
A stock option is a contract that gives the buyer the "right" or "power", but not the "obligation", to exercise the contract on or before a fixed future date (the exercise date or expiration) to trade the underlying stock at an agreed price.

Stock Options - In layman terms
When you buy a stock option, you are essentially buying the right to "buy or sell" a stock at a certain price, when you want to, IF you want to. There are no obligation to exercise the stock option at all. It should be clear from here that buying stock options is completely different from buying the stock itself. In options trading, you are essentially trading these stock options and not the stocks themselves.

Read about the Differences Between Stocks & Stock Options.

Types Of Stock Options
There are 2 types of stock options : Call option and Put option. Put options give the holder the right to sell a stock at a specified price, called the strike price. Call options give the holder the right to buy the stock at a specified price. When the holder of an option contract uses the rights conferred to him to buy or sell the underlying stock, it is known as to "Exercise" the option.

Styles Of Stock Options
There are 2 styles of stock options : American Style Options and European Style Options. American Style Options can be exercised at any time from the date of purchase up to and including the expiration date. Most exchange-traded options are American-style. European Style Options may be exercised only on the expiration date. To option traders buying and selling stock options, the styles make very little difference as rarely do options traders exercise their stock options.

note *There is still a widespread misunderstanding amongst option traders that stock options traded in the US Markets are American Style Options and that stock options traded in European markets are European Style Options. That is not true. Most stock options traded in European markets are American Style Options. Hence, American or European style are merely terminologies referring to the two different styles of stock options. More and more commonly around the world, European style options are being named as "Warrants" instead. However, Warrants and Options are really two distinctively different trading instruments. Read about the Differences Between Warrants and Options.*

Not All Stocks Offer Stock Options
However, not all stocks offer stock options for options trading over the exchanges. Stocks that do have stock options for options trading in the exchanges are known as "Optionable Stocks". A company must fulfill the following criteria before their stock options are allowed to be traded publicly:

1. The closing price must have a minimum per share price for a majority of trading days during the three prior calendar months.

2. The company must have equal to or more than 2,000 shareholders.

3. The company must have equal to or more than 7Million publicly held shares.

4. The stock must be listed on the NYSE, AMEX or Nasdaq.

Companies without publicly traded stock options may still have stock options circulating within the company and one common form are Employee Stock Options.

The above are only requirements generally required by all exchanges. Specific listing criteria change from time to time and from exchange to exchange. Some exchange even requires a qualitative check on the type of company and its potential before allowing their stock options to be publicly traded. *(This paragraph was included in response to a question by a reader.)*

Read The Full Tutorial On Stock Options Now!

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What is a Call Option?

In options trading, call options are simply known as "calls". The buyer of a call option has the right, **but not the obligation**, to buy an agreed quantity of the underlying stock from the seller of that call option before the call option contract expires at a certain time (the expiration date) for a predetermined, agreed price (the strike price).

In layman terms, when you buy a call option, you have the right to buy the stock at the agreed price anytime you want to no matter what price that stock is trading at prior to the expiry of that call option.

For example, if you buy a Call option on a stock with a strike price of $10 and an expiration date 2 months later, you have the right to exercise the right to buy that stock at $10 no matter what price the stock may be before the 2 months period is up. However, it is not necessary to exercise a call option in order to take profit on it. In fact, you can only exercise prior to expiration if it is an american style option. If it is an European style option you are trading, you can only exercise it upon maturity.

Profiting Using Call Options
Call options not only allows you to profit when the stock goes up but also when the stock goes down by shorting, or writing, call options. Call options can also be used defensively to protect the value of stocks or to enhance it through options trading strategies such as the Covered Call.

Read The Full Tutorial On Call Options.

As shorting or "writing" of call options without first owning the underlying stock requires a significant margin requirement, it is not usually a strategy that beginner option traders with very small funds can execute. There are options trading brokers who requires a cash reserve of about $100,000 before you are allowed to write a single call option. Therefore, for beginner option traders who wants to profit from a downwards move in the underlying stock through options trading, buying a put option would be a lot easier.

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What is a Put Option?

Put options behave opposite to call options and allow the buyer of the put option to profit from a downwards move in the underlying stock. In options trading, put options are simply known as "puts". The buyer of a put option has the right, but not the obligation, to sell an agreed quantity of the underlying asset to the seller of the put option before the contract expires at a certain time (the expiration date) for a predetermined, agreed price (the strike price).

In layman terms, Put Options allow you to sell a stock at a fixed price before the put option expires no matter how much the stock is at that time. However, it is not necessary to exercise a put option in order to take profit on it. In fact, you can only exercise prior to expiration if it is an american style option. If it is an European style option you are trading, you can only exercise it upon maturity.

Put options allow you to "buy" a drop in the price of a stock and profit when the underlying stock declines in price without the margin requirements of shorting the stock or its futures! Put options are therefore one of the most convenient financial instrument for use in profiting from a drop in the price of a stock.

Profiting Using Put Options
Put options not only allow you to profit when the stock goes down but also when the stock goes up when you short, or write, put options. The defensive ability of options trading is also epitomized by the use of put options. Put options can be used defensively in a number of ways to protect a portfolio of stocks. 2 very common ways are through the use of "Married Puts" and "Protective Puts".

Read The Full Tutorial On Put Options.

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