Options Trading 101 MARKETCLUB OPTIONS

by: Trader Travis exclusively for MarketClub Options

Chapter 1: Stock Options; The Tool Used By Sophisticated Investors To Build Wealth Quickly

I'm not sure what your particular financial situation is, but maybe you're one of the millions of people out there who are afraid you won't be financially independent at some point in your life. Or, maybe you're afraid of losing money in the stock market and would like to know how to guarantee you won't lose money.

If so, would you like to learn how to create true financial freedom and an income source you control?

I hope so, because trading options empowers investors who are tired of losing money in the stock market to earn 2 - 5% each month (without being glued to the computer all day).

And right about now you may be saying, "Yeah right ... "

And I have to admit, it does sound too good to be true. But, 1) It is true, and 2) I completely understand how you feel.

I'm skeptical by nature so even I thought it sounded farfetched, but my mentor showed me how little I knew about investing.

Essentially, trading options is just another way to invest in the stock market.

You can invest in bonds. You can invest in stocks or commodities. Options trading is just another component of stock market investing.

The great thing about trading options is a 1% gain in the stock market can often produce a 10% gain on your option contract. You get to benefit from a rise or fall in the stock price without actually owning the stock (more on this later).

Also, stock options allow you to make money when the stock market is going up, down, or sideways. Said another way, stock options are how investors make money when stock prices are going down or just remaining the same.

Now let me take a moment to teach you a little bit about stock options...

WARNING: I'm about to hit you with some technical jargon, but then I'll simplify it a little later on.

The primary vehicle behind options trading is something called a stock option contract.

For the sake of simplicity, I'm going to refer to options on stocks only, even though options can be traded on commodities and other securities as well.

What is a stock option?

There are four components that make up a stock option contract:

- > An underlying security or stock
- The right, not an obligation, to buy or sell a stock
- > A specified price for the stock
- > And a fixed time period for which the option is valid

Stock Option: If you buy or own a stock option contract it gives you the "right, but not the obligation", to buy or sell shares of a stock at a "set price" on or before a "given date" (time period).

Strike Price: The fixed price at which the owner of an option can buy or sell the stock when the option is exercised.

Example: An IBM May 50 call option has an exercise price of \$50 a share. When the option is exercised the owner of the option will "buy" 100 shares of IBM stock for \$50 a share.

Options trading is very involved and can be quite complex, but I will try to make things as simple as possible.

For now, don't stress about getting a full understanding; that will come with time. Just read for comprehension, not a full understanding.

Expiration Date

A stock option contract grants you the right to buy or sell a specific stock, but you can only do so within a certain time period as <u>option contracts eventually expire</u>.

Unlike stocks, option contracts have an expiration date and after this date your contract expires and your option ceases to exist. Translation: it goes bye bye and disappears from the inventory of contracts available to trade.

This is why stock options are often called <u>wasting assets</u>. They are called this because they have expiration dates.

Stock option contracts are like most contracts, they are only valid for a set period of time.

Technically speaking, option contracts expire the 3rd Saturday of the month of expiration.

However, stock option contracts cannot be traded on Saturday so for trading and practical purpose we say that stock option contracts expire on the 3rd Friday of the month of expiration.

For example if I bought a June option, it will cease to exist (expire worthless) after the 3rd Saturday in June.

So if it's February and you buy a June option, that option is only good for four more months.

The contract will expire or cease to exist in June, and when it expires so do all the rights the contract granted you.

Analogy: I have a contract with a local gym here. It gives me the right, but not the obligation, to go to the gym whenever I want.

They don't make me go, but if I don't exercise my right to go to the gym then I lose the money I paid for this right.

After a year my gym contract ends and I no longer have the right to workout at that gym.

Unfortunately this seems to be the case. It's quite silly how my wife and I keep a gym membership even though we don't go ha ha...anyway, back to the lesson...

Right vs Obligation

If you buy or own a stock option contract, it gives you the "right, but not the obligation", to buy or sell shares of a stock at a "set price" on or before a "given date" (time period).

You don't have to buy or sell the stock if you don't want to. If you don't exercise the rights of your contract then you simply lose the money paid for the contracts.

Also, when you are looking to buy an option contract you might see a small price quoted such as \$1.50.

This price has to be multiplied by 100 because 1 stock option contract represents 100 shares of a company's stock.

So when you buy 1 contract you are buying the right, but not the obligation to buy or sell 100 shares of that stock.

Option Valuation / Pricing

Buying an option contract and selling it later down the road seems pretty simple in theory. However, what makes this task hard is that there are several factors that influence the option's price.

To the dismay of new traders, the option's price does not always move in conjunction with the price of the underlying stock; there are six other factors involved.

The following are the six factors that determine what the price/cost of the option will be:

- > The current market price of the stock
- The strike price of the option (particularly in relation to the current market price of the stock)
- > The remaining life of the option (time left until expiration)
- > Volatility
- Interest Rates
- Stock Dividends

Chapter 2: The Big Reason Why Traders Are Able To Double Their Money In A Few Days

There are two parallel camps or approaches to trading options. You can be an options "buyer" or an options "seller."

When you sell options, your profit is often capped or limited. Selling options would take a book in and of itself. So, in this ebook, I will only cover buying stock options.

When you buy an option, your profit is usually unlimited and you can often make a 50 - 100% return on your money in a matter of weeks, if not days.

Now I am aware of how completely unbelievable that sounds, but stick with me and you'll see just how true it is...

Financial Leverage

The reason a person can make so much money with options trading is because of something called financial leverage.

On the surface, that makes no sense to someone new to options and certainly doesn't show you how to make money.

So let me walk you through an example that will show you leverage in action and I'm going to do it with a real trade I made.

Example: On 11/6/09 I invested about \$600 on an options trade; stock symbol STEC. Roughly, six days later I looked into my account and that trade was then worth about \$3,000.

Since I'm no fool, I took my profits and ran with them. After paying fees, I walked away with about a **\$2,700 profit in only six day's time**.

The quick accelerated profits I made on that trade are precisely why people are so eager to learn how to trade options!

Deep down inside, everyone dreams of getting rich quick (even if we know it's not possible).

Again, what makes options trading so powerful and why you can have these type of returns in such a short amount of time, \$600 to \$2,700 is because of financial leverage.

Financial Leverage: taking a small amount of money and multiplying it into a larger sum.

Got it? Good. Because now, we can talk about the difference between stock "options" and stock "shares."

Stock Options vs Stock Shares

A stock option is not a physical thing, like owning shares in a company. Instead, it's a contract between two parties and these contracts are attached to a specific stock.

The option contract price and the stock price move in unison, but the <u>option contract moves at</u> <u>a magnified rate.</u>

Said another way, the value or price of that contract will move at an accelerated rate compared to whatever percentage move the stock has. When the stock has a 1% move in price, the option contract can have a 10% move in price (both up and down).

When you own stock or shares of a company, you actually own a small piece of the company. You are an owner.

And when that company's value goes up in price, so does your shares. Then, you have the opportunity to sell your stock back into the open market at a higher price.

However, a stock option is just an agreement or contract where one party agrees to deliver something, in this case stock shares, to another person within a specific time period for a specific price.

Essentially, options trading boils down to the buying and selling of contracts, stock option contracts.

This usually doesn't make sense to new traders and honestly it won't make complete sense until you've actually traded and seen how it all works in real life.

But what I want you to do is think on a surface level, okay?

A lot of people make the mistake of trying to comprehend options trading in one sitting. It's not possible, give up.

Forget about trying to understand how you can make money with contracts. Just understand this...options trading is nothing but the buying and selling of contracts.

Understand that on a surface level and then everything you learn after this will build upon that.

Example Of A Contract

Let's say I was a real estate investor and I found a house that was appraised for \$50,000. I wrote up a contract to buy it within the next 3 years.

In most real estate contracts, you have to put some money down; they usually call it earnest money. So let's say I put down \$2,000.

For exaggeration purposes, let's also say they built a golf course near that home and the value of the home increased to \$100,000.

Remember, I have a contract that allows me to buy that home for \$50,000.

So now I have a contract that says I can buy a \$100,000 house for \$50,000, and I put \$2,000 down as a good faith deposit.

Think on a surface level here. I have a contract that allows me to buy something at a significant discount.

If you can understand that, then you can understand options trading, at least the buying side of options.

A fact that needs to be taken into account is that if I was to buy the house (exercise the terms of the contract), I would need \$50,000 and only then could I sell it for \$100,000, thus realizing the profit.

Or, I have another option. <u>I could take the approach of an options trader</u>. I could take my purchase contract and sell it to someone else.

The contract I have is more valuable because the underlying asset increased in value.

If I were to sell the contract to someone else, I wouldn't need \$50,000 to realize a profit (that fact alone is why I'm an options trader).

Do you think I can find somebody else who might want this contract?

Maybe I can find another investor and say "Hey, I'll sell you the rights of this contract for \$5,000."

I paid \$2,000 and then I sell it for \$5,000. The \$3,000 profit equals a 150% return on my money.

By the way, this happens all the time in real estate investing. I know, I "used to be" a real estate investor. Notice I said "used to be."

That's a long story filled with drama and failure. I'll have to save that story for another day. I don't feel like reliving that agony right now, haha.

Anyway, back to my example...

So essentially, it's not the house that makes the contract so valuable. The "rights" the contract gives you is what makes it so valuable.

This is also what I meant by "leverage." You take a small amount of money and use it to make a large amount of money.

The small amount of money allows you to get in the game so to speak.

Paying \$50,000 for a house and then selling it for \$100,000 is the equivalent of investing in stocks. You need more money to get ahead.

However with options trading, the financial investment needed is much smaller.

So that's just a short example of how you can make money by buying and selling a contract.

You will essentially do the same thing as an options trader, but the underlying asset will be a stock, not a house.

Real estate investors - buy and sell homes Stock investors - buy and sell shares of stock Option traders - buy and sell contracts

Option traders make money when the option contract they buy goes up in price. When that happens, they sell their contract back into the open market at a higher price than what they paid.

Option traders buy and resell stock option contracts all the time. This is because minor fluctuations in the stock price can have a major impact on the price of an option.

So if the value of an option increases sufficiently, it often makes sense to sell it for a quick profit.

NOTE: You can also use option "buying" to protect your assets from a decline in price. There are ways to structure a trade that essentially guarantees you can't lose money within a specific period of time. You'll see how a little later in this ebook.

In the next portion of this ebook, we will cover the two types of options: Put options and Call options (also called Puts and Calls).

Chapter 3: How To Build Wealth And Protect Your Assets At The Same Time

So what are puts and calls?

Generally speaking, put options are used to both protect the value of your assets as well as make money when stocks fall in price.

And generally speaking, call options are how investors make ten times more money when stocks go up in price.

As an options buyer, it's not uncommon to earn (and lose) upwards of 40 - 50% return on your money.

But one of the inherent problems with options trading is that for new traders these returns just seem too good to be true.

Where else are you going to hear that you can make \$1,000 in three days, or a 40 - 50% return on your money in a matter of days?

It's not like they teach you this stuff in school.

And with any other form of stock market investing, you don't have these returns and in such a short period of time.

So it's natural if you are a little skeptical, that's okay...so was I.

The problem is that these kinds of returns are normal. They can happen on a consistent basis if you develop the skills.

So what people do is choose to allow their skepticism to rule and they keep this kind of information out of their life when it can actually help them.

I do hope the example in the previous chapter was enough to at least get you to see how leverage can help you earn super charged investment returns.

And yes, there is risk with trading options and you won't always make money, but the rewards are well worth the risk (at least in my opinion).

Stock options are precisely what the ultra-rich use for accelerated wealth creation!

But what about the common man? What about the person barely scraping by and all they have is the dream of becoming wealthy?

As my mentor Dave Ramsey says, "If you do what rich people do, you will become rich and if you do what poor people do, you will become poor."

And the wealthy people I know either trade or at least know about stock options. Call options and put options are the two tools they use for asset protection and accelerated wealth creation.

You can buy a "call option" and earn super charged returns on stocks that go up in value.

Or you can **sell** a "call option" and earn additional income on your stock holdings (this is done through a strategy called covered calls).

You can buy a "put option" and earn super charged returns on stocks that go down in value.

Or you can **buy** a "protective put option" to ensure you don't lose money on a stock purchase.

On the selling side you can **sell** a "put option" and be paid to buy a stock at a lower price (this is done through a strategy called cash secured puts).

This is just a short summary to introduce you to the benefits of options trading.

The benefits of options trading are what will keep you motivated to learn this. There's a lot to cover so you will need all the motivation you can muster up.

And even though there is a lot to learn, just realize that everything boils down to two components: calls and puts.

That's it! Call options and put options are the only two types of stock options. Everything else is just a variation or combination of these two.

Calls and puts are the building blocks of all option trading strategies.

Call Option: gives its buyer the **right**, but not the obligation, to **buy** shares of a stock at a specified price on or before a given date.

Put Option: gives its buyer the **right**, but not the obligation, to **sell** shares of a stock at a specified price on or before a given date.

Please note: this is just an overview of calls and puts. We will go deeper into puts and calls in a little bit. For now just know that both calls and puts are used for asset protection and wealth creation and you can use them to make money in any market environment.

I repeat, you can use them to make money in ANY market environment.

Puts and calls are used to...

- > Make money when stocks go up in price
- Make money when stocks go nowhere in price
- And to really make money when stocks go down in price

It's truly an amazing thing to both see and experience, which is why I hope you one day decide to become a successful options trader.

WARNING: I know from experience that understanding stock options is hard. There is just so much information to take in. That is why I'm not teaching you any advanced strategies just yet.

My focus in this ebook is on the basics.

Recap

Buying a call option gives you the right to **buy** a stock Buying a put option gives you the right to **sell** a stock

4 Components Of An Option Contract

> Underlying Security

Options are based on an underlying security (stock). Each stock option is linked to a stock. A specific company's stock option is linked to that specific company's stock, and the price of the option will rise and fall with the price of the stock.

NOTE: Not all stocks have listed stock options

> Right, Not Obligation

Owning an option gives you the right, but not the obligation, to buy or sell the underlying security (the stock) at a specified price.

Specified Price (Strike Price)

Owning an option gives you the right to buy or sell a stock at a specified price. Listed options have been standardized to represent specific stock prices.

> Time

Your right to buy, or sell, the underlying stock expires on a given date. The period of time the option exists is also known as the life of the option. After that date the option ceases to exist, the stock does not go away but the option does.

Chapter 4: The Secret To Make Money When Stocks Go Down In Price

If you recall from the earlier chapter I told you that buying **put options** gives you the right, but not the obligation, to **sell** shares of a stock at a specified price on or before a given date.

A "put option" will **increase in value** when the underlying stock it's attached to **declines in price**, and it **decreases in value** when the stock goes **up in price**.

Read that sentence again. Really, do it.

Most of the people I teach have a hard time wrapping their head around the concept of making money when stocks fall in price.

But once I break down how calls and puts work it should be easier to understand the above concept.

Remember, put options give you the right to "sell" a stock at a specified price. When you are buying put options you are preparing for, expecting, or want the price of the stock to decline.

Imagine that, wanting a stock to fall so you can make money. It's so counterintuitive, but that's just how these contracts work.

Over time you will begin to like bear markets (market crashes) as you make your money much quicker because stocks fall faster than they rise.

Put Examples

If you bought a "May 120 put option" on stock XYZ, the option (contract) gives you the right to "sell" stock XYZ for a price of \$120 on or before the 3rd Friday in May.

If stock XYZ falls below \$120 before the 3rd Friday in May you have the right to sell the stock for more than its market value.

So let's say that stock XYZ falls in price to \$50. Everyone else who owns the stock has to sell it for \$50, but you own a contract that says you can sell it for \$120.

Can you now see why put option contracts go up in value as the underlying stock goes down in price?

The further the stock falls in price below your strike price (\$120) the more valuable the option becomes.

Essentially, you hold a contract that says you get to sell something for more than its market value.

Have you ever been in a losing stock trade and wished you could sell it for more? Or, have you ever lost money in an investment and hoped it went back up in value?

If you owned this stock and was facing the pressure of selling it for \$50 you would love to own a contract that says you could sell it for \$120.

But let's say you don't own the stock, but instead just bought the put option because you thought the stock might fall in price.

Do you think that contract has increased in value? Yes it has, and you can easily sell it into the options market for more than you paid for it.

Put Options: Will increase in value when the underlying stock it's attached to declines in price.

Now let's look at the situation in reverse...

Let's say stock XYZ was trading at \$300 a share. Who would want to buy a contract from you that gives them the right to sell stock XYZ for \$120 a share when they could easily sell it for \$300 on the open market?

No one, which is why put options decrease in value as the stock goes up in price.

TIP: Call options and put options function opposite of each other. So if you understand how one of them works it's the exact opposite for the other.

Now let's move on to call options...

Call Examples

Buying **call options** gives the buyer the right, but not the obligation, to **buy** shares of a stock at a specified price on or before a given date.

Call Options: Will increase in value when the underlying stock it's attached to goes up in price, and decrease in value when the stock goes down in price.

In the example above let's say you bought a "May 100 call option" instead. This option gives you the right to buy stock XYZ for \$100 on or before the 3rd Friday of May.

Now imagine that stock XYZ comes out with a new product and the stock goes up in price to \$150.

Per the terms of that contract (call option), you get to buy it for \$100.

You can purchase the stock at a \$50 discount or sales price when everyone else has to pay the full retail price of \$150.

So as the stock goes up in price, the May 100 Call option goes up in value.

And vice versa...

If stock XYZ falls in price to \$75 a share who wants to purchase a contract that gives them the right to purchase it at \$100 when it's selling for cheaper on the open market.

If you exercised the rights of the contract and bought the stock at \$100 you'd immediately be at a loss of \$25 since the stock is trading for \$75 on the open market.

That's the equivalent of someone trying to sell you a car for \$2,000 when the retail value of it is \$1,500. Thus why call options **decrease in value** when the stock goes **down in price**.

Quick Review

I want to personally thank you for your patience thus far. I used to be bored with options trading basics until I realized they were the key to succeeding.

I know we have covered a lot in this little ebook, but a sad fact is that all of that mumbo jumbo can be summarized with two sentences.

You "buy" a **Call option** when you think the price of the underlying stock might go **up** in price.

You "buy" a **Put option** when you think the price of the underlying stock might go **down** in price.

Of course there is much more to it and knowing it is a lot different than applying it, but for now just remember those two points.

Lastly, time is your most valuable asset so I thank you for spending it with me via the pages of this book. I pray I have done a good job of making options trading easy to understand.

Chapter 5: Strategy Preparation; How To Read An Option Chain

This chapter is here to assist you with the strategy you're about to learn.

Learning how to read an option chain is a vital component to options trading. Many traders lose money because they don't fully understand option chains.

An option chain is essentially a list of all the stock option contracts available for a given security (stock).

There are only two types of stock option contracts, puts and calls, so an option chain is essentially a list of all the puts and calls available for the particular stock you're looking at. Now that wasn't so hard to understand, was it? Well the confusing part comes when you actually pull up a stock option chain.

			Expire at close Fri, Dec 18, 200					
Strike	Symbol	Last	Chg	Bid	Ask	Vol	Open	
25.00	MVLLE X	14.00	0.00	14.00	14.20	5	18	
30.00	MVLLF.X	9.20	0.00	9.40	9.60	69	165	
35.00	MVLLG X	5.80	0.00	5.40	5.60	12	504	
40.00	MVLLH.X	2.25	0.00	2.45	2.55	12	431	
45.00	MVLLI.X	0.80	1 0.10	0.80	0.90	55	1,111	
50.00	MVLLJ.X	0.20	0.00	0.15	0.25	10	28	
PUT OPT	IONS			Expire	at close	Fri, Dec	18, 2009	
Strike	Symbol	Last	Chg	Bid	Ask	Vol	Open Int	
20.00	MVLXD.X	0.12	0.00	N/A	0.15	6	17	
25.00	MVLXE.X	0.32	0.00	0.10	0.25	10	49	
30.00	MVLXF.X	0.65	0.00	0.50	0.60	10	166	
35.00	MVLXG.X	1.65	0.00	1.45	1.55	7	6,121	
40.00	MVLXH.X	3.70	0.00	3.40	3.60	1	115	
45.00	MVLXLX	5.40	0.00	6.80	7.00	20	20	
45.00	MVLXJ.X	9.30	0.00	11.10	11,40	20	30	

All that easy-to-understand information suddenly gets lost in translation and you're left looking at a table full of numbers and symbols that make absolutely no sense at all.

Part of the confusion in understanding option chains is that every option chain looks different. If you go to Yahoo, MSN, CBOE, or your brokerage account and pull up an option quote, you will notice that the layout of each of their option chains is completely different.

However, they all essentially have the same information displayed, but look completely different.

Let's use a snippet of the stock option chain listed above, which is a stock option chain of the stock symbol "MV":

CALL OPTIONS				Expire at close Fri, Dec 18, 2009				
Strike	Symbol	Last	Chg	Bid	Ask	Vol	Open Int	
25.00	MVLLE.X	14.00	0.00	14.00	14.30	5	18	
30.00	MVLLF.X	9.20	0.00	9.40	9.60	69	165	
35.00	MVLLG.X	5.80	0.00	5.40	5.60	12	504	
40.00	MVLLH.X	2.25	0.00	2.45	2.55	12	431	
45.00	MVLLI.X	0.80	1 0.10	0.80	0.90	55	1,111	

Expiration Months

As you can see from the picture, there are several different expiration months listed horizontally across the top of the option chain (Aug 09, Sep 09, Dec 09, etc.). For our example we are looking at all the call and put options that expire the 3rd week of December 2009.

Some traders want to stay in a trade 1 week, some want to stay in a trade 2 months, so your trading plan will dictate which month you look at.

Call Options & Put Options

Each stock option chain will list out all the call options and all the put options for the particular stock. Depending on which option chain you are looking at, the call options may be listed above the put options or sometimes the calls and puts are listed side-by-side.

<u>Strike</u>

The first column lists all of the different strike prices of the stock that you can trade. The strike/ exercise price of an option is the "price" at which the stock will be bought or sold when the option is exercised.

Symbol

The second column lists all of the different ticker/trading symbols for each stock option. "MVLLE.X" is the ticker symbol for the 09 December 25 call option. The symbol identifies 4 things: which stock this option belongs to, what the strike price is, what month it expires in, and if it is a call or a put option.

Last

The third column lists the last price at which an option was traded (was opened or closed). It's the price at which the transaction took place.

BE CAREFUL: This transaction could have been minutes, days, or weeks ago, and may not reflect the current market price.

Change (Chg)

The fourth column lists the change in the options price. It shows how much the option price has risen or fallen since the previous day's close.

Bid

The Bid price is the price that a <u>buyer is willing to pay</u> for that particular stock option. It's like buying a home at an auction, you bid (offer) what you are willing to pay for the home.

<u>Ask</u>

The Ask price is the price that a <u>seller is willing to accept</u> for that particular stock option (this is the price the seller is "asking" for).

BE CAREFUL: One stock option contract represents or controls 100 shares of stock. So whatever Bid/Ask price you see has to be multiplied by 100. This will be the actual cost of the contract.

Volume (Vol)

List how many stock option contracts were traded throughout the day.

Open Interest (Open Int)

This column lists the total number of option contracts still outstanding. These are contracts that have not been exercised, closed, or expired. The higher the open interests, the easier it will be to buy or sell the stock option because it means a greater deal of traders are trading this stock option.

CLOSING WORDS

Having all the knowledge is the world is great, but implementation is the best teacher. Even pros practice. Start a paper trading account, get down a dirty, and explore the power of options!

This MarketClub Options Strategy Blueprint is a great tool for new option traders and seasoned option traders alike. This provides a practical plan that will keep your emotions in check, while allowing you to explore the many benefits of options trading.

We are in this together! Chat with your fellow MarketClub Options Members. Learn from each other's successes and failures. Once you are successful, and with the right implementation and practice you will be, please share the power of MarketClub Options with others.

I'm excited to hear your success story.

Best,

Trader Travis & The MarketClub Team

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