

Webinar Presentation

Introduction to Options Part I of III: The Basics



Presented by:
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Disclosures

- Options' trading entails significant risk and is not appropriate for all investors. Certain complex options strategies carry additional risk. Before trading options, please read [Characteristics and Risks of Standardized Options](#), and call 800-544- 5115 to be approved for options trading. Supporting documentation for any claims, if applicable, will be furnished upon request.
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- Profit probability shows how likely a particular option trade (or combination of trades) will be profitable, based on a calculation that takes into account the price of the trade and the expected distribution of stock prices based on the 90-day historical volatility.

Goal of this webinar Series:

The goal of this series is to introduce options to those who are new option traders. We will primarily cover the fundamentals of options. To do this, we will cover topics such as; what are options, what kinds of options are there, key terms and concepts option traders need to be familiar with.



Topics that will be covered in **Part I**:

- **What are options?**
- **How are they quoted and where?**
- **What is Exercise versus Assignment?**
- **What are In the money, At the money, and Out of the money?**
- **What is Intrinsic versus Extrinsic value?**

What is an Option?



An option is simply a contractual agreement between two parties, the buyer and the seller.

The contract stipulates:

- Expiration date (Usually the third Friday of the month)
- Strike price
- Underlying (can be stock, ETF, or index) that the contract will be based upon
 - A standard option represents 100 shares of the underlying
- When the holder can exercise the option (convert to the underlying)
 - Anytime before expiration (American style)
 - Only at expiration (European Style)

Why do people trade options?

People trade options for many different reasons. Since we are focusing on options basics today, we will focus on the most common reasons.

1. **Leverage:** As stated on the last slide, one option contract controls 100 shares of the underlying's stock
2. **Capital outlay:** You can purchase an option for significantly less than purchasing the underlying stock outright.

What's the trade-off?

1. **Time:** Options have a finite expiration date. They are a “wasting” asset. They will either expire worthless or be turned into long/short shares of the underlying.
2. **Leverage:** Leverage goes both ways, it can hurt you as much as it helps you. We will show an example shortly.

Call or Put?



There are two types of options, Calls and Puts

- **Call**

- Call option is a contract that allows the option **holder** (buyer) to **buy** 100 shares (typically) at the strike price up to the defined expiration date. Said to be **LONG** the call. **Bullish**
- Call options **oblige** the **seller** (writer) to **sell** 100 shares (typically) of the underlying at the strike price up to the defined expiration date. Said to be **SHORT** the call. **Bearish**

- **Put**

- Put option is a contract that allows the option **holder** to **sell** 100 shares (typically) at the strike price up to the defined expiration date. Said to be **LONG** the put. **Bearish**
- Put options **oblige** the **seller** to **buy** 100 shares (typically) of the underlying at the strike price up to the defined expiration date. Said to be **SHORT** the put. **Bullish**

Call or Put?

In the last example we said “typically,” why?

When we talk of options we generally talk of standardized options where one contract represent 100 shares of the underlying. But what happens when something like a stock split occurs in the underlying, or a company takeover/merger?

Options can be **adjusted** in a number of ways to account for corporate events. These are called Adjusted options. Lets look at what happens when there is a stock split:

You own 1 contract for XYZ stock with a strike price of \$75.00, the company announces a 3 for 2 stock split. How is the option contract adjusted?

Old option contract $100 \times \$75 = \$7,500$

New option contract $150 \times \$50 = \$7,500$

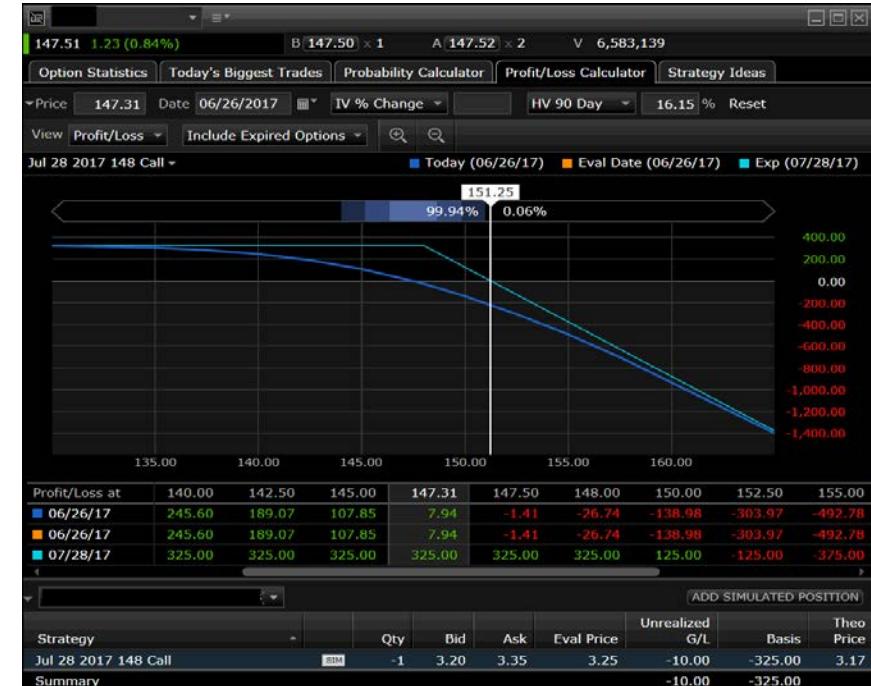
The adjustment keeps the **notional value the same**, the number of shares and the strike price are adjusted to maintain the notional value of the contract post split.

*Other adjustments may occur from corporate actions. Terms can be found in the option chain or check with the Options Clearing Corp to find out the new terms of an adjusted option.

Call Profit and Loss Graphs



Long Call (Buyer)
Bullish



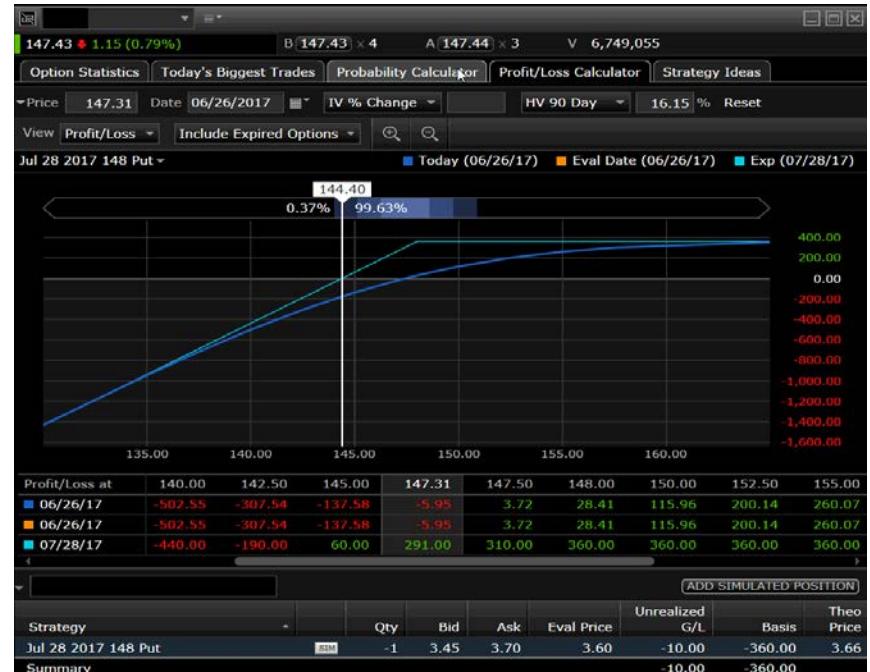
Short Call (Seller)
Bearish

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Put Profit and Loss Graphs



Long Put (Buyer)
Bearish



Short Put (Seller)
Bullish

Buyer or Seller?

With options, you can either be a buyer or seller

- **Buyer**

- Have a right to Exercise and buy or sell 100 shares of the underlying
 - **Also called a call/put holder (long the option)**

- **Seller**

- Have obligation to buy/sell at Assignment 100 shares of the underlying
 - **Also called a call/put writer (short the option)**

Many option novices are confused by the terms Buy to Open and Sell to Open versus Buy to Close and Sell to Close.

- Any time you are **creating a new position** in your account, you are **OPENING** and you are either buying or selling the option to Open that new position.
- Anytime you are **removing a position** from your account, you are **CLOSING** it out and either buying or selling it to Close.

Anatomy of an Options Symbol



-SPY170818C244	
SPY AUG 18 2017 244.0000 CALL	
3.14 ↓	B 3.14 x 69
0.11(3.63%)	A 3.15 x 10
	V 1,162
Open	3.44
Day Range	3.14 - 3.69
Close	3.03 (06/23/2017)
Contract Hi	4.20 (06/19/2017)
Contract Lo	1.64 (05/18/2017)
Last Trade Size	12
Last Trade Exch	N/A
Open Interest	123,175
Delta	0.5100
Gamma	0.0498
Theta	-0.0299
Vega	0.3714
Rho	0.1766
Implied Volatility	0.0856

What does all that mean?

-SPY is the symbol of the underlying
17 is the year of the expiration
08 is the month of the expiration
18 is the day of the expiration
C indicates that this is a Call option (as opposed to a **P** for a Put option)
244 is the Strike Price

This means that a holder (buyer) of this call has the right to BUY 100 shares of SPY at \$244 per share at any time until August 18, 2017

Bid, Ask, Volume?

Bid: The highest price that a buyer is willing to pay for the option. Similar to a Bid on stock (options are typically quoted in \$0.01 or \$0.05 increments)

Ask: The lowest price that a seller is willing to sell the option at. Also, similar to an Ask on a stock

Volume: The total number of that particular contract that has traded on that trading day. Once again, similar to stock



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The Option Chain

Where can you find options quotes and information?



AAPL

146.28 0.00 (0.00%) V 15,951,941 HV30 21.81 IV30 18.95 C/P Ratio: BULLISH BEARISH

Calls 10 Strikes All Volume & Open Int (W) Adj

Jun 30 (W) Jul 07 (W) Jul 14 (W) Jul 21 E Jul 28 (W) Aug 04 (W) Aug 18 Aug 15 Sep 15 Oct 20

Strike	Symbol	Last	% Chg	Chg	Bid	Ask	Volume	Open Int	IV Mid	Delta	Gamma	Theta	Vega
Aug 18 (53 days)													
125	-AAPL170818C125	23.10			21.75	22.10	5	11,233	27.87 %	0.9454	0.0075	-0.0158	0.063
130	-AAPL170818C130	17.21	0.00	0.00	17.05	17.35	0	2,009	25.35 %	0.9081	0.0122	-0.0219	0.0942
135	-AAPL170818C135	12.75	0.00	0.00	12.70	12.70	106	2,785	23.96 %	0.8346	0.0193	-0.0318	0.1408
140	-AAPL170818C140	8.50	-2.86	-	8.75	8.75	284	9,053	22.42 %	0.7239	0.0276	-0.0402	0.1873
145	-AAPL170818C145	5.57	1.46	0.00	5.55	5.55	1,028	15,606	21.65 %	0.5691	0.0334	-0.0457	0.2174
150	-AAPL170818C150	3.18	0.95	0.03	3.15	3.20	4,767	36,006	21.35 %	0.4009	0.0332	-0.0441	0.2144
155	-AAPL170818C155	1.65	0.00	0.00	1.52	1.52	1,454	26,294	20.92 %	0.2506	0.0277	-0.0353	0.1771
160	-AAPL170818C160	0.81	1.25	0.01	0.78	0.78	1,056	29,839	21.02 %	0.1424	0.0194	-0.0249	0.1269
165	-AAPL170818C165	0.40	-4.76	-0.02	0.40	0.41	362	17,155	21.67 %	0.0793	0.0123	-0.0166	0.0844
170	-AAPL170818C170	0.22	-4.35	-0.01	0.22	0.23	104	6,344	22.77 %	0.0462	0.0076	-0.0113	0.0565

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The Option Chain

What is Open Interest?



- Open interest is the number of **ALL** outstanding contracts.
- It is not static! The number is updated daily based on the previous day's trading activity.

A screenshot of the Fidelity Active Trader Pro software interface showing the Option Chain for AAPL. The top header displays current price (146.28), volume (V 15,951,941), and various volatility metrics (HV30 21.81, IV30 18.95). The C/P Ratio is listed as BULLISH. The interface includes dropdown menus for Calls, Strikes (set to 10), and sorting by All Volume & Open Int. Below this, a timeline shows options expiring from Jun 30 to Oct 20. The main table lists call options for Aug 18, with 53 days remaining. The columns include Strike, Symbol, Last, % Chg, Chg, Bid, Ask, Volume, Open Int, IV Mid, Delta, Gamma, Theta, and Vega. A blue arrow points from the text 'Open Interest' to the 'Open Int' column in the Calls section of the table. A green rounded rectangle highlights the 'Open Int' column.

Strike	Symbol	Last	% Chg	Chg	Bid	Ask	Volume	Open Int	IV Mid	Delta	Gamma	Theta	Vega
▼ Aug 18 (53 days)													
125	-AAPL170818C125	23.10	2.67	0.60	21.75	22.10	5	11,233	27.87 %	0.9454	0.0075	-0.0158	0.063
130	-AAPL170818C130	17.21	0.00	0.00	17.05	17.35	0	2,009	25.35 %	0.9081	0.0122	-0.0219	0.0942
135	-AAPL170818C135	12.75	0.00	0.00	12.60	12.70	106	2,785	23.96 %	0.8346	0.0193	-0.0318	0.1408
140	-AAPL170818C140	8.50	-2.86	-0.25	8.70	8.75	284	9,053	22.42 %	0.7239	0.0276	-0.0402	0.1873
145	-AAPL170818C145	5.57	1.46	0.00				15,606	21.65 %	0.5691	0.0334	-0.0457	0.2174
150	-AAPL170818C150	3.18	0.95	0.00				4,767	21.35 %	0.4009	0.0332	-0.0441	0.2144
155	-AAPL170818C155	1.65	0.00	0.00	1.62	1.64	1,454	26,294	20.92 %	0.2506	0.0277	-0.0353	0.1771
160	-AAPL170818C160	0.81	1.25	0.01	0.79	0.80	1,056	29,839	21.02 %	0.1424	0.0194	-0.0249	0.1269
165	-AAPL170818C165	0.40	-4.76	-0.02	0.40	0.41	362	17,155	21.67 %	0.0793	0.0123	-0.0166	0.0844
170	-AAPL170818C170	0.22	-4.35	-0.01	0.22	0.23	104	6,344	22.77 %	0.0462	0.0076	-0.0113	0.0565

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What is Premium?

Premium is the amount that you pay for the option contract, or the proceeds that you receive from the sale of a contract.

- Example: You buy the AAPL July 2017 146 Call shown below. The premium you would pay is \$2.85 (the A next to the price stands for ASK, which is the price someone is willing to sell the contract for)



*Apple trading at \$146.06 at the time

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Remember! The option contract represents 100 shares, so you would actually pay $\$2.85 \times 100$ or $\$285.00$

If you were the seller of the call in this example, you would have received the premium of $\$285.00$

What is Breakeven?



Breakeven point is the market price that the underlying security must reach for an option buyer to avoid a loss if they exercise the option. Example: You buy the AAPL July 2017 146 Call shown below. The premium you pay is \$2.85. Your breakeven on this trade would be \$148.85. Why?

- Because you have the right to buy AAPL at \$146, but you paid \$2.85 for the right.

*Apple trading at \$146.06 at the time



Strike price +/- the premium paid or received = breakeven
 $146 + 2.85 = 148.85$

Remember, most options are actually closed out prior to expiration!

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Exercise and Assignment



Long options get exercised, Short options get assigned.

What is Exercise?

- Exercising a call is when the option holder opts to buy the underlying at the strike price (Typically 100 shares)
- Exercising a put is when the option holder opts to sell the underlying at the strike price (Typically 100 shares)
- If the option has intrinsic value of at least \$0.01 at expiration, it will be automatically exercised.

If your account cannot support the position that will be created by auto exercise, you should close the option position!

Exercise and Assignment



What is Assignment?

- Assignment of a call is the option writer fulfilling their obligation to sell the shares at the strike price. (Typically 100 shares). A short option can be assigned at any time!
- Assignment of a put is the option writer fulfilling their obligation to buy the shares at the strike price. (Typically 100 shares)
- As an option seller, you do not choose if/when assignment will occur. The option buyer controls the action, assignment occurs when they choose to exercise their option.

Remember! A short (sold) option can be assigned at any time!

Even if it has no intrinsic value.

Exercise and Assignment Value Examples

If we use the previous AAPL example what would Exercise of a call look like?

- If you exercised your long AAPL call, you would purchase 100 shares of AAPL at 146.
 $100 \times \$146 = \$14,600$

Remember, many people use options for leverage, if you had 10 of those contracts and exercised them, it would be $10 \times 100 \times \$146 = \$146,000!$

Each contract controls 100 shares of stock. If you only want to buy 100 shares of the underlying, only buy 1 call contract.

If we use the same example, what would Assignment look like?

- If you were assigned on the one call, you would need to deliver 100 shares of AAPL and you would receive \$146 per share, $100 \times \$146 = \$14,600$. But what if you didn't already own the shares? You would have to buy them at whatever price they were trading post assignment, which would likely be higher than \$146 per share!

Example, what if AAPL was now trading at \$155?

- It would now be $100 \times \$155 = \$15,500$



Exercise and Assignment Value Examples

This time lets substitute an AAPL 146 put for the call. Now what would Exercise of the put look like?

- If you exercised your long AAPL put, you would sell 100 shares of AAPL at 146. You would receive proceeds of $100 \times \$146 = \$14,600$

If we use the same example, what would Assignment look like?

- If you were assigned on the one put, you would need to buy 100 shares of AAPL and you would pay \$146 per share, $100 \times \$146 = \$14,600$.
- Once again remember leverage, if you sold 10 of the puts it would be $10 \times 100 \times \$146 = \$146,000$ you would be paying for 1000 shares of AAPL stock!

Exercise and Assignment Value Example

Cash Settled Index Options:

The previous examples were based on options with Stock or ETF's as their underlying. Index options are slightly different.

- Index options often are “European style”, meaning they can only be exercised at expiration, as opposed to “American style” which can be exercised at any time.
- Additionally, because index options are based on an index (which cannot be delivered) they are settled in cash!

Let's look at an example on .SPX (S&P 500 Index):

- You are Long (Own) 1 SPX call with a strike of 2440. If your one SPX call were exercised because SPX closed at 2441 on expiration, you would receive **\$100 CASH** in your account.
- Your option has **\$1 of intrinsic value** X the multiplier for SPX which is \$100 = \$100

What is ITM, ATM and OTM?



1. ITM stands for In the Money

- In the money options are those options that have intrinsic value
- Calls with strikes below where the underlying is currently trading
- Puts with strikes above where the underlying is currently trading

2. ATM stands for At the Money

- At the money options are options that have a strike price closest to where the underlying is currently trading

3. OTM stands for Out of the Money

- Out of the money options are those which have no intrinsic value
- Calls with strikes above where the underlying is currently trading
- Puts with strikes below where the underlying is currently trading

What is intrinsic value?

Intrinsic versus Time Value



There are 2 components to an options price: Intrinsic value and Time value

Calls		Jul 21 (25 days)										PUTS					
Last	Chg	Bid	Ask	Volum	Open Int	Intrinsic Value	Time Value	Strike	▲	Last	Chg	Bid	Ask	Volum	Open Int	Intrinsic Value	Time Value
6.15	-0.25	6.25	6.35	89	326	5.215	1.085	141		0.89	0.00	0.87	0.89	77	935	0.00	0.88
5.60	-0.28	5.45	5.50	179	214	4.215	1.26	142		1.10	0.03	1.08	1.09	359	2,947	0.00	1.09
4.80	-0.05	4.70	4.80	63	679	3.215	1.535	143		1.34	0.01	1.33	1.35	247	615	0.00	1.345
4.17	-0.03	4.05	4.10	209	1,136	2.205	1.845	144		1.69	0.05	1.65	1.66	687	735	0.00	1.66
3.48	-0.07	3.40	3.45	6,417	32,191	1.215	2.21	145		2.01	0.01	2.01	2.03	7,486	37,666	0.00	2.03
2.85	-0.11	2.84	2.87	1,273	1,657	0.195	2.655	146		2.46	0.05	2.44	2.46	1,384	2,514	0.00	2.45
2.32	-0.13	2.35	2.36	2,132	2,343	0.00	2.34	147		2.96	0.08	2.94	2.96	3,312	949	0.805	2.155
1.90	-0.11	1.90	1.91	1,639	2,010	0.00	1.90	148		3.55	0.10	3.45	3.55	506	2,060	1.79	1.735
1.55	-0.04	1.51	1.53	3,007	2,178	0.00	1.51	149		4.10	0.17	4.10	4.15	297	780	2.805	1.345
1.21	-0.06	1.20	1.21	9,130	67,601	0.00	1.20	150		4.82	0.24	4.75	4.85	855	31,518	3.805	1.02

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= *In the Money*



= *At the Money*



= *Out of the Money*

Intrinsic versus Time Value

There are 2 components to an options price: Intrinsic value and Time value

AAPL		V 17,800,636		HV30 21.81		IV30 18.80		C/P Ratio: BULLISH		BEARISH						
Calls & Puts		10 Strikes		All Volume & Open Int		(W)		Adj								
		Jun 30 (W)	Jul 07 (W)	Jul 14 (W)	Jul 21	E	Jul 28 (W)	Aug 04 (W)	Aug 18	Sep 15	Oct 20	Nov 17	Dec 15			
Last	Chg	Bid	Ask	Volum	Open Int	Intrinsic Value	Time Value	Strike	Last	Chg	Bid	Ask	Volum	Open Int	Intrinsic Value	Time Value
CALLS																
6.15	-0.25	6.25	6.35	89	326	5.215	1.085	141	0.89	0.00	0.87	0.89	77	935	0.00	0.88
5.60	-0.28	5.45	5.50	179	214	4.215	1.26	142	1.10	0.03	1.08	1.09	359	2,947	0.00	1.09
4.80	-0.05	4.70	4.80	63	679	3.215	1.535	143	1.34	0.01	1.33	1.35	247	615	0.00	1.345
4.17	-0.03	4.05	4.10	209	1,136	2.205	1.845	144	1.69	0.05	1.65	1.66	687	735	0.00	1.66
3.48	-0.07	3.40	3.45	6,417	32,191	1.215	2.21	145	2.01	0.01	2.01	2.03	7,486	37,666	0.00	2.03
2.85	-0.11	2.84	2.87	1,273	1,657	0.195	2.655	146	2.46	0.05	2.44	2.46	1,384	2,514	0.00	2.45
2.32	-0.13	2.35	2.36	2,132	2,343	0.00	2.34	147	2.96	0.08	2.94	2.96	3,312	949	0.805	2.155
1.90	-0.11	1.90	1.91	1,639	2,010	0.00	1.90	148	3.55	0.10	3.45	3.55	506	2,060	1.79	1.735
1.55	-0.04	1.51	1.53	3,007	2,178	0.00	1.51	149	4.10	0.17	4.10	4.15	297	780	2.805	1.345
1.21	-0.06	1.20	1.21	9,130	67,601	0.00	1.20	150	4.82	0.24	4.75	4.85	855	31,518	3.805	1.02

- **Intrinsic value** is the measure of the true value of the “right” the option represents – it is the difference between the stock price and the strike price
- **Time value** is a measure of “uncertainty” – the potential that the option could hold more intrinsic value in the future
 - All else equal, the time value erodes as expiration nears – the uncertainty about the stock’s price movements between now and expiration gets lower and lower

Importance of Time Value



SPX		HV30 7.77		IV30 7.72		C/P Ratio: BULLISH		BEARISH			
Calls & Puts		10 Strikes		All Volume & Open Int		(W)	Adj				
	Jun 26 (W)	Jun 28 (W)	Jun 30 (Q)	Jul 03 (W)	Jul 05 (W)	Jul 07 (W)	Jul 10 (W)	Jul 12 (W)	Jul 14 (W)	Jul 17 (W)	Jul 19 (W)
Last	Chg	Bid	Ask	Volum	Open Int	Intrinsic Value	Time Value	Strike	Last	Chg	Bid
CALLS											
24.40	2.70	23.20	23.60	230	1,071	20.7	2.69	2420	2.70	-1.76	2.50
19.00	1.00	18.90	19.30	188	20,299	15.7	3.38	2425	3.35	-2.15	3.20
15.25	1.15	14.80	15.10	1,072	15,731	10.6	4.17	2430	4.10	-2.49	4.00
11.40	0.90	11.00	11.30	573	3,781	5.7	5.47	2435	5.30	-3.04	5.20
7.75	0.55	7.70	8.00	1,396	13,418	0.7	7.05	2440	7.20	-1.95	6.90
5.02	0.61	4.90	5.20	1,416	3,863	0.0	5.05	2445	8.65	-4.05	9.10
2.97	0.30	2.85	3.10	4,892	19,444	0.0	2.975	2450	11.40	-3.20	12.10
1.60	0.14	1.55	1.65	1,729	4,693	0.0	1.575	2455	14.80	-5.80	15.60
0.85	0.05	0.85	0.90	7,090	19,949	0.0	0.85	2460	20.40	-0.90	19.80
0.45	-0.04	0.40	0.50	2,623	13,833	0.0	0.45	2465	23.15	-8.40	23.70
PUTS											
2420	2.70	2.50	2.65	2,202	5,053	0.00	2.60	2425	3.35	3.20	3.40
2425	3.35	3.20	3.40	6,954	18,650	0.00	3.25	2430	4.10	4.00	4.20
2430	4.10	4.00	4.20	4,113	5,608	0.00	4.15	2435	5.30	5.20	5.50
2435	5.30	5.20	5.50	1,849	3,435	0.00	5.30	2440	7.20	6.90	7.10
2440	7.20	6.90	7.10	6,191	3,943	0.00	7.05	2445	8.65	9.10	9.40
2445	8.65	9.10	9.40	439	1,284	4.35	4.90	2450	11.40	12.10	12.30
2450	11.40	12.10	12.30	2,631	3,962	9.39	2.76	2455	14.80	15.60	16.00
2455	14.80	15.60	16.00	79	503	14.32	1.53	2460	20.40	19.80	20.20
2460	20.40	19.80	20.20	96	958	19.31	0.74	2465	23.15	23.70	25.30
2465	23.15	23.70	25.30	90	229	24.22	0.33				

- The Time Value of the calls and puts at each strike price is nearly equivalent
- A covered call and a cash secured put of the same strike price have almost identical risk (max loss, breakeven) and reward (max gain) profiles
- The only difference to the trader is the probability that the trade will result in the acquisition or sale of the underlying security
- ATM contracts have the most time value, but may not always be the best choice

What factors affect the premium?

- **Money-ness of the option being sold (Strike Selection)**
 - Out of the money options offer lower premiums
 - At the money option contracts have the most time value
 - In the money options offer higher premiums
- **Time to expiration (Expiration Selection)**
 - Nearer term expirations offer the potential for the highest annualized return but offer a lower up front premium
 - Longer dated expirations decay at a slower rate, but offer the advantage of more upfront premium (income certainty)
- **Expected Movement from the Underlying (Implied Volatility)**
 - Higher implied volatility (expected price movement) results in higher premiums
 - When selling options, if that expected volatility becomes realized volatility, it can result in substantial losses



Key Takeaways

- An option is a **contract between two parties**, the buyer and the seller, that stipulates the rights and obligations of each party.
- **Exercise & Assignment** are the processes whereby option contracts are converted into shares of the underlying or cash (Index options)
- **Option prices have 2 components:**
 - **Intrinsic value**, the measure of the true value the “right” that the option represents
 - It is the difference between the stock price and the strike price
 - **Time value (Extrinsic value)**
 - The potential that the option could hold more intrinsic value in the future
- **Option States:**
 - In-the-money: options with intrinsic value
 - At-the-money: options whose strike price is closest to the current price of the underlying
 - Out-the-money: options with no intrinsic value
- **Option premiums are impacted by: money-ness, time to expiration, and implied volatility levels**

Introduction to Options – The Basics

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