Introduction to Options

I placed my options trade! Now what?

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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. *Supporting documentation for any claims, if applicable, will be furnished upon request.*
- ✓ Examples in this presentation do not include transaction costs (commissions, margin interest, fees) or tax implications, but they should be considered prior to entering into any transactions.
- ✓ The information in this presentation, including examples using actual securities and price data, is strictly for illustrative and educational purposes only and is not to be construed as an endorsement, recommendation.

Goal of this webinar Series

The goal of this series is to introduce options to those who are option novices. Prior sessions covered some of the basics of options and Fidelity's options tools. We will continue this process by reviewing some aspects of managing an options trade.

Topics that will be covered in Part III

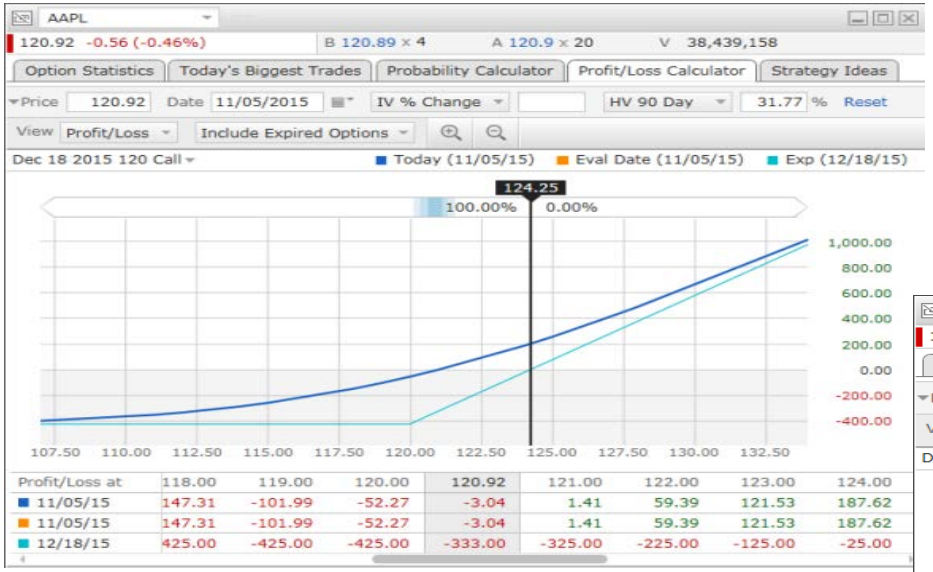
- Review of some options basics
- Managing options trades prior to expiration
- Managing options trades at expiration
- Tips, tricks, and things to consider

REVIEW - Calls and Puts Defined

There are two types of options, Calls and Puts

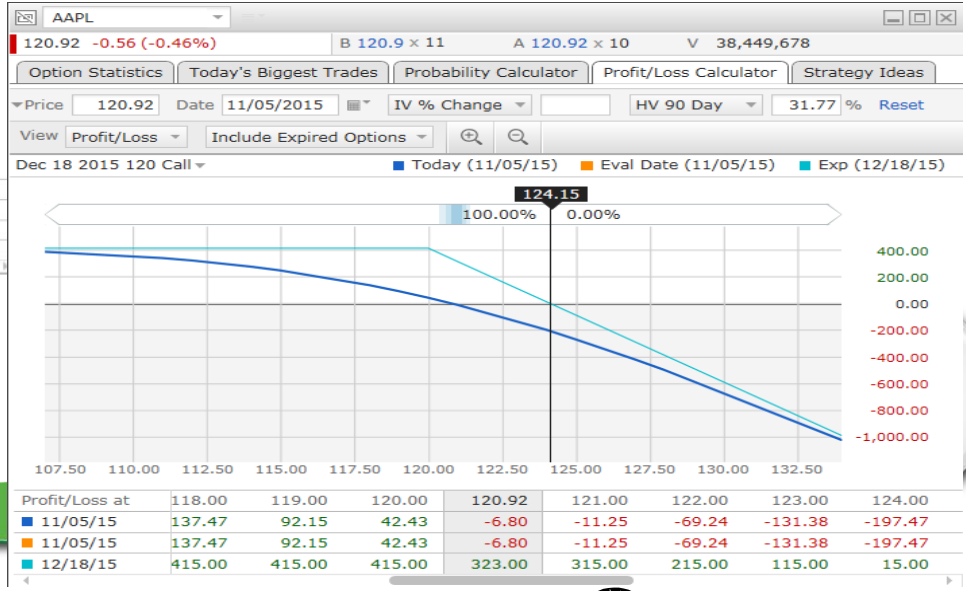
- Call
  - *Call option is a contract that **allows** the option **holder** (buyer) to **buy** 100 shares at the strike price up to the defined expiration date. Said to be **LONG** the call. Bullish*
  - *Call options **obligate** the **seller** (writer) to **sell** 100 shares of the underlying at the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

REVIEW - Call Profit and Loss Graphs

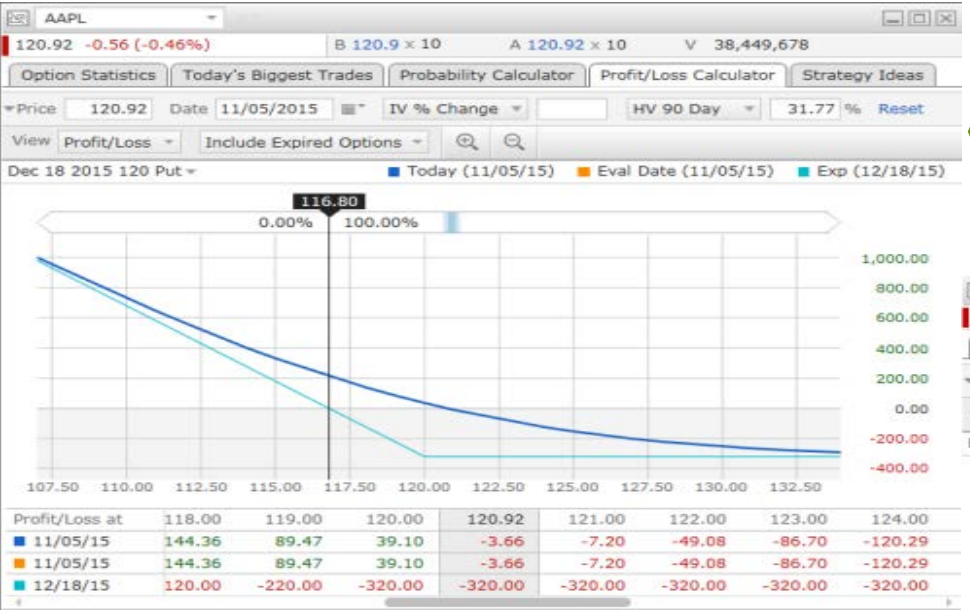


Long Call (Buyer)
Bullish

Short Call (Seller)
Bearish

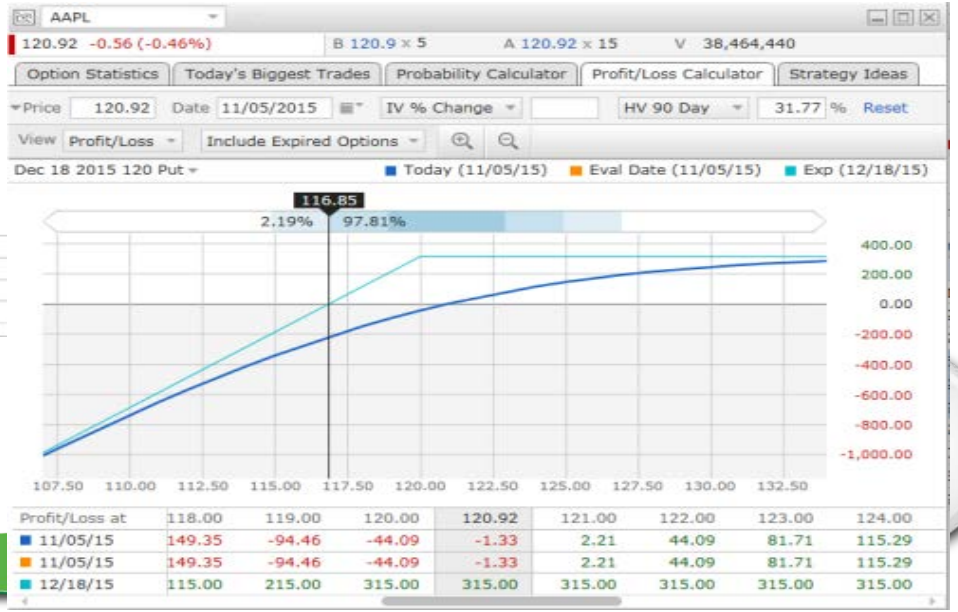


REVIEW - Put Profit and Loss Graphs



Long Put (Buyer)
Bearish

Short Put (Seller)
Bullish

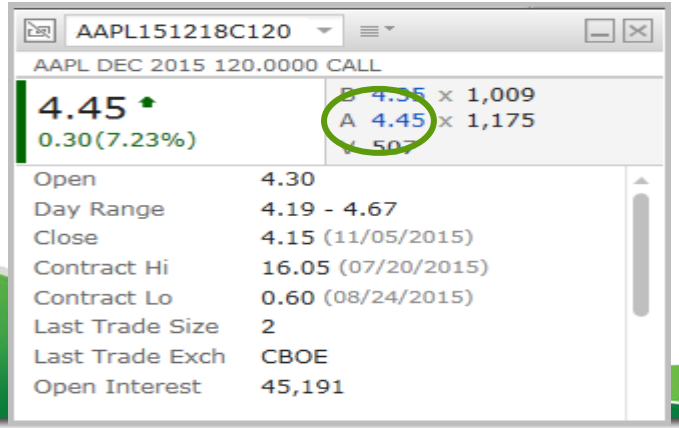


REVIEW – Calculating Breakeven Points

Breakeven is the price the underlying needs to be trading at expiration for your trade to "breakeven", that is, to not gain or lose any money.

Example: You buy the AAPL December 2015 120 Call shown below. The premium you pay is $4.45. Your breakeven on this trade would be $124.45. Why? Because you have the right to buy AAPL at $120, but you paid $4.45 for the right.

Apple trading at $121.35 at the time



Strike price +/- the premium paid or received = breakeven
120 + 4.45 = 124.45

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

Managing at Expiration

At expiration – 3 possibilities:

- Close the trade
- Exercise/Assignment
- Expire worthless

Remember! If your option is $0.01 in the money, it will automatically be exercised! Only allow options to be auto exercised if it is commensurate with the amount of shares you would want to own/sell. Example: if you only want to own 100 shares of XYZ, then you should only trade one contract.

Managing at Expiration - Exercise

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 is has intrinsic value (is in-the-money) of at least $0.01, it will be automatically exercised.*
- *If your account can not support the position that will be created by auto exercise, you should close the option position!*

Managing at Expiration - 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)*
- *Assignment of a put is the option writer fulfilling their obligation to buy the shares at the strike price. (Typically 100 shares)*

Important:

- ***A short option can be assigned at any time!***

Managing at expiration – Closing the trade

How do you Close a trade?

- Long option holders simply "sell-to-close." This sells your right to exercise the option.
- Short option writers simply "buy-to-close." This closes your obligation.

Important:

- Some option writers will let their contracts simply expire worthless rather than closing out their contracts. While this enables the trader to pick up additional profit, it's frequently referred to as "*picking up pennies in front of a steamroller,*" because if the trade suddenly moves against you, you could be flattened!

Managing the trade prior to expiration

A trader has 3 ways they can manage any strategy:

Option 1: Leave the strategy alone

- ***Makes Sense When:*** *I would put the same trade on today*
  - Allow exercise/assignment
  - Continue to stay in the trade

Option 2: Close the strategy

- ***Makes Sense When:*** *The strategy no longer aligns with the outlook*
  - Trade out of the strategy

Option 3: Adjust the strategy

- ***Makes Sense When:*** *The existing strategy can be altered to better align with the outlook*
  - Reducing position size
  - Rolling: up, down, or forward?

Trader's View:

- Be honest with yourself when re-evaluating an existing trade and manage accordingly. Don't fall into the trap of making adjustments without considering the end objective of the trade.

Managing the trade – your outlook

Do you still have the same outlook on the security? Has that outlook changed?

- *Were you bullish and are now neutral? Bearish?*
- *Has your time horizon changed?*

As we mentioned before***, be honest with yourself*** when re-evaluating an existing trade

What factors affect the premium?

1. **Money-ness of the option being sold (Strike Selection)**
   - Out of the money options offer lower premiums, lower probability
   - At the money option contracts have the most time value

2. **Time to expiration (Expiration Selection)**
   - Nearer term expirations offer the potential for the highest annualized return but a lower up front premium
   - Longer dated expirations decay at a slower rate, but have higher premiums

3. **Expected Movement from the Underlying (Implied Volatility)**
   - Higher implied volatility (expected price movement) results in higher premiums
   - Lower implied volatility results in lower premiums

Managing prior to expiration – early exercise/assignment

Early exercise

- ***Makes Sense When:*** *You can not sell the option in the open market for at least intrinsic (exercise) value.*
  - Typically the option is either very deep in-the-money, close to expiration, or both

Let's look at an example on ABC:

You are Long (Own) 1 ABC call expiring this Friday with a strike of 100. ABC is at 105.

Your ABC contract is currently trading at 4.50 x 5.50 and you wish to close the position.

If you sold your contract to the bid, you would only receive $4.50. But, if you exercise your option to buy ABC at $100 and then sell the stock on the open market for $105, you'd receive the $5.00 difference.

Managing prior to expiration – early exercise/assignment

Early assignment

- The less time until expiration (closer to expiration), the greater the risk
- The deeper in-the-money the option, the greater the risk
- Early assignment also frequently occurs around dividends, pay special attention!

Think about it from the perspective of the option holder: when it starts to make more sense to exercise instead of selling on the open market, your risk of assignment goes up!

When an underlying pays a dividend, calls in particular have a higher assignment risk. Why? The option may be at or slightly in the money and only trading for $0.20 of time premium when the underlying is paying a $0.50 dividend. If the customer was planning on owning the stock, it would make more sense for them to exercise the option just prior to the Ex-Dividend date so that they receive the $0.50 dividend.

Managing prior to expiration – "rolling"

What is "rolling?"

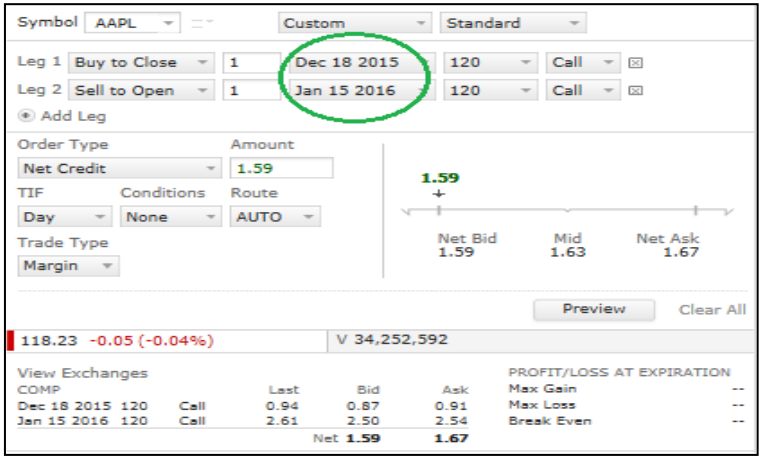
- Rolling is placing one trade to simultaneously close out a current position and open up a new one with either a different expiration date, strike price, or both.
- "***Rolling out***" is placing a trade to push the expiration to a further out date.
- "***Rolling up/down***" is placing a trade to either increase or decrease the strike price.

Trader's View:

- Its important to realize that by "rolling out" a trade, you are not "kicking the can down the road…" You are closing one trade and opening up a brand new one! *Be sure the new trade makes sense on its own merit!*

Managing prior to expiration – “rolling”

Example – “Rolling out”



You are simply closing the current trade and opening a new one with a later expiration date.

- Closing one call at $.91 and selling a new one for $2.50
- This is usually done at a ***credit***

An investor would consider rolling out a short option if their outlook has not changed and they want to take advantage of additional time

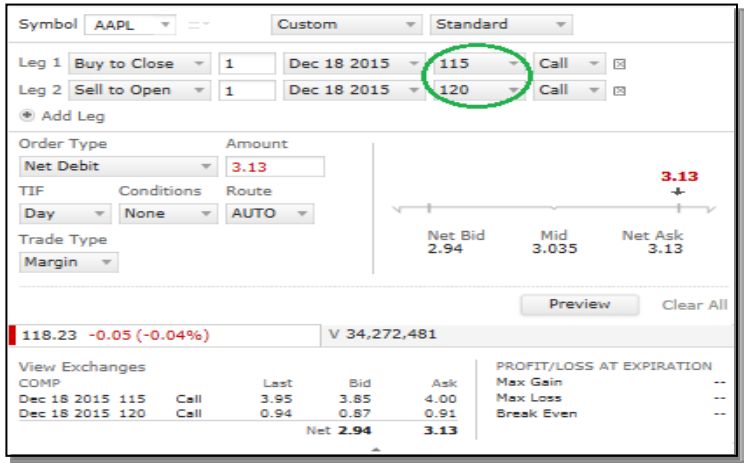
Managing prior to expiration – “rolling”

Example – “Rolling up”

You are simply closing the current trade and opening a new one with a different strike price.

- Closing one call at $4.00 and selling a new one for $.87
- This is frequently done at a ***debit***

An investor would consider rolling up a short option if their outlook has changed and they want to take advantage of additional stock price movement



Position Management

Position sizing:

- Reduce concentration in individual positions and sectors
- Keep it small and in proportion to your portfolio
- Go into each trade knowing what you can and are willing to lose
- If you can't sleep at night, your position is too large!

Minimize emotional decisions through risk and position size management!

Key Takeaways

- Security selection is critical – are you comfortable with the underlying security?
- Does your trade still match your outlook? The importance of the "honesty moment"
- Avoid costly mistakes by adopting a risk level you can live with
  - Diversify amongst market capitalization, sectors, geography and style
  - Watch out for concentrated positions (don't risk more than you are willing to lose)
  - ETF's may be a tool for increasing diversification
- If it appears too good to be true, then it probably is! - watch out for earnings announcements, dividends, or other events that could lead to significant moves
- Having an exit strategy at the time of trade entry gives a you a reference point when evaluating the trade down the road and reduces emotional decisions
- Use the resources at your disposal to seek out and analyze new opportunities

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Introduction to Options

This concludes today's presentation.

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