

Entry and Exit Strategy Considerations

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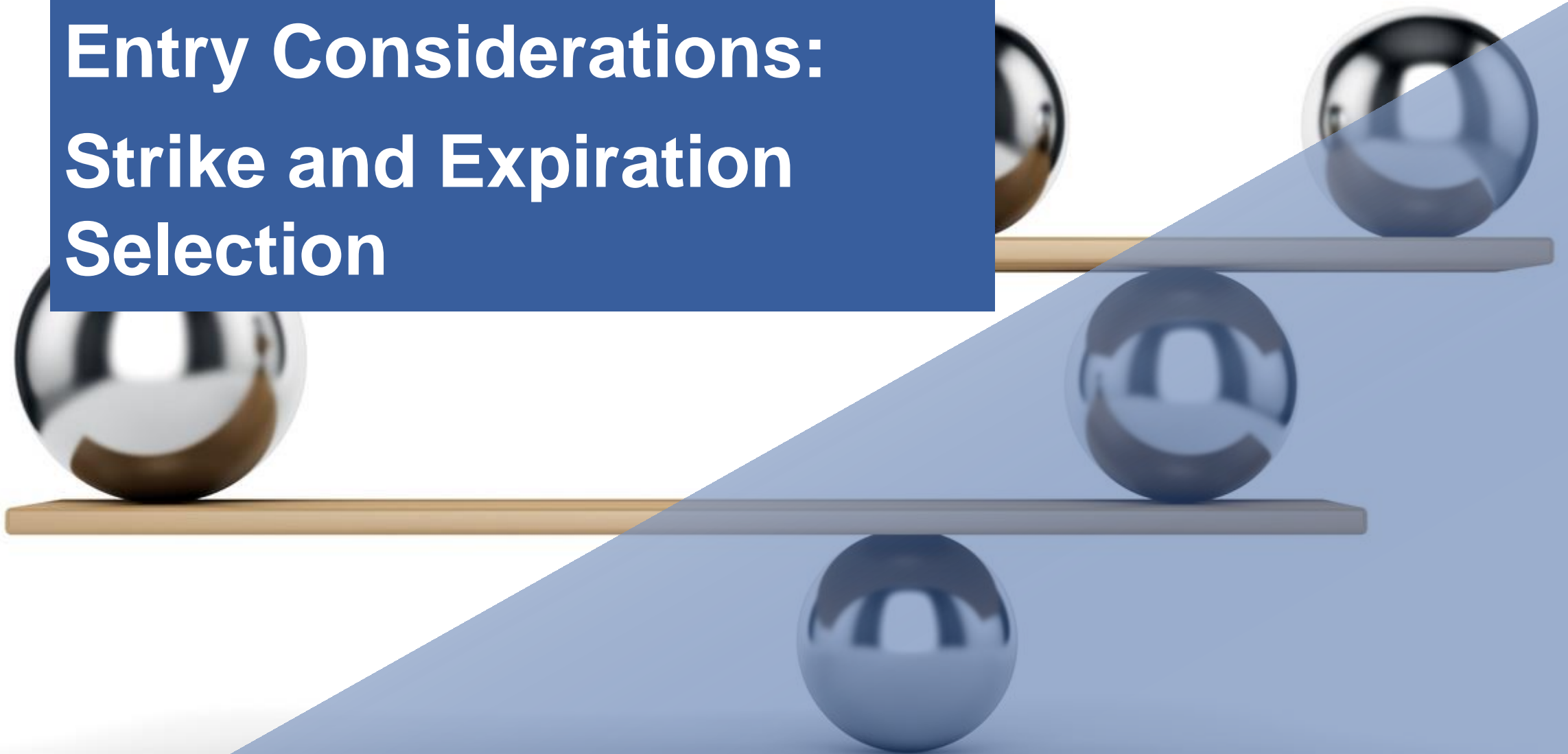
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Presentation Outline

- Entry Considerations
 - Strike selection
 - Expiration selection
- Exit Considerations
 - Option buyers
 - Option sellers



Entry Considerations: Strike and Expiration Selection



Moneyiness

Calls

- In-the-money (ITM) = strike price below stock price
- Out-of-the-money (OTM) = strike price above stock price

Puts

- In-the-money (ITM) = strike price above stock price
 - Out-of-the-money (OTM) = strike price below stock price
-
- ITM options have intrinsic value and time value
 - OTM options have time value ONLY
 - At-the-money (ATM) is when strike price = stock price

Strike selection

Option buyers

- ITM options cost more but have greater sensitivity to stock price movements (greater potential for \$\$\$ gain)
- OTM options cost less but require a larger stock price move to achieve profitability (greater potential for % gain)
- Market outlook and forecast might lead to target strike price

Option sellers

- ITM options generate more premium, but a portion of that premium is sensitive to stock price and will not decay
- OTM options generate less premium but offer room for the stock price to move before reaching the strike price
- Generally, sellers select the strike price at which they believe the stock price might reach but not break through

Expiration selection

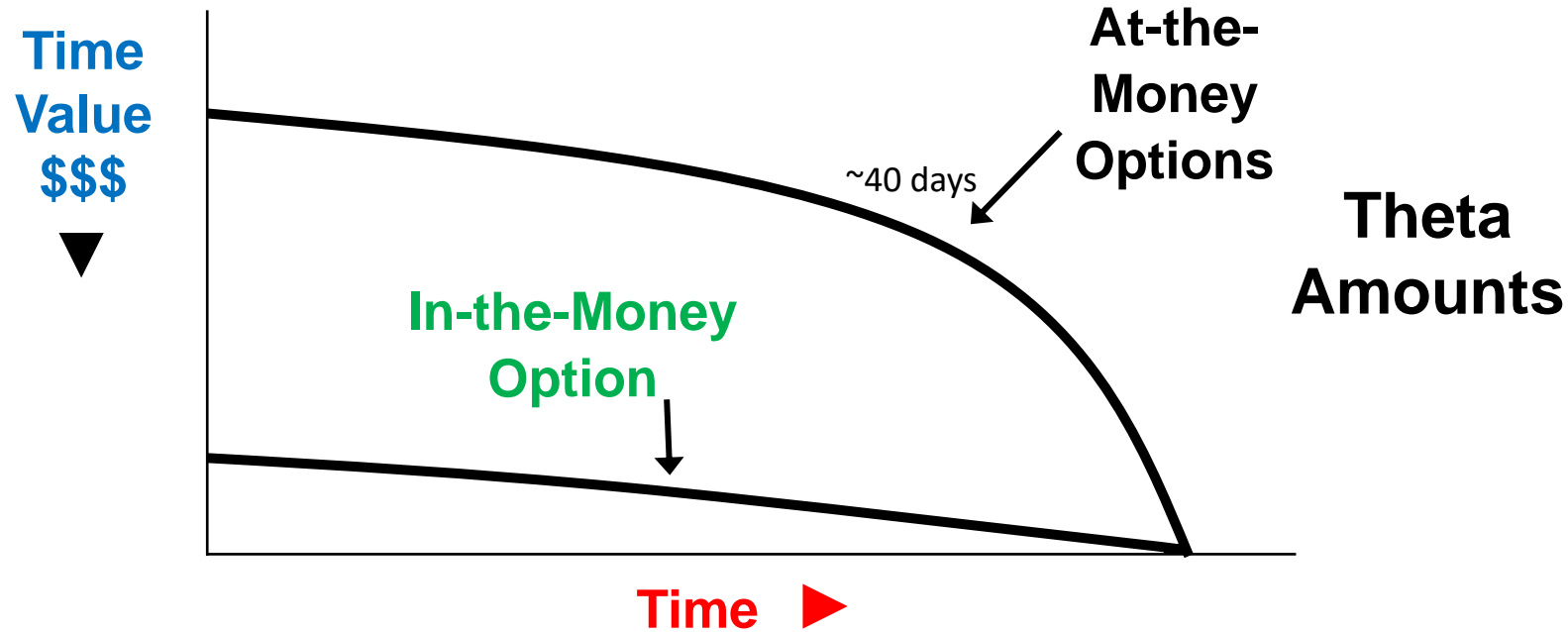
Option buyers

- Pay for time
- Technical analysis might provide a target time frame
- Fundamental analysis might necessitate longer expiration date selection

Option sellers

- Selling time
 - Might select a time frame during which the stock price is not expected to threaten the strike price
 - Need to evaluate whether the premium received (or held) is worth the obligation associated with being short the option
- ❖ Buyers and sellers should be familiar with the time decay curve....

Option Theta and Expiry



Overall rate of time decay is exponential (**accelerates** towards expiry)

ATM = decay exponential = volatility is key decay factor

ITM = decay linear = cost-to-carry is key decay factor

Exit Considerations: Option Buyers



Long Calls

- Stock higher
 - Hold for further gains
 - Close position (or scale down)
 - Roll up to a higher strike price
 - Exercise if willing to buy shares (or capture dividend)
- Stock consolidates
 - Position suffers from time decay
 - Close position to avoid further losses
 - Hold position and risk further losses
- Stock lower
 - Consider risk tolerance
 - Hold in anticipation of share price rally
 - Close position before experiencing total loss



Long Puts

- Stock higher
 - Consider risk tolerance
 - Hold in anticipation of share price decline
 - Close position before experiencing total loss
- Stock consolidates
 - Position suffers from time decay
 - Close position to avoid further losses
 - Hold position and risk further losses
- Stock lower
 - Hold for further gains
 - Close position (or scale down)
 - Roll down to a lower strike price
 - Exercise unlikely as it would yield short stock position



Exit Considerations: Option Sellers



Covered Calls

- Stock higher
 - Hold in attempt to maximize gain (assignment)
 - Close once maximum gain is almost reached
 - Roll up to a higher strike price
- Stock consolidates
 - Close position
 - Buy back short call and hold long stock
 - Roll down to lower strike and/or later expiration date
- Stock lower
 - Hold in anticipation of share price appreciation
 - Roll down to lower strike and/or later expiration
 - Close position and reallocate capital



Cash-Secured Puts

- Stock higher
 - Close when option premium nears zero
 - Hold in anticipation of option expiring worthless
- Stock consolidates
 - Close when option premium nears zero
 - Hold in anticipation of option expiring worthless
 - Roll up to a higher strike to capture more premium while being comfortable with purchasing shares at higher level
- Stock lower
 - Hold in anticipation of assignment
 - Roll down to a lower strike and/or later expiration
 - Close position and reallocate capital



Key Takeaways

- Buyers of options need price movement in their favor
- Sellers of options can benefit from stagnant price action
- Buyers and sellers are both monitoring:
 - The consistency of their position against their market outlook
 - The amount of time value remaining in the option