

Picking a Strategy: Long Calls and Long Puts

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Presentation Outline

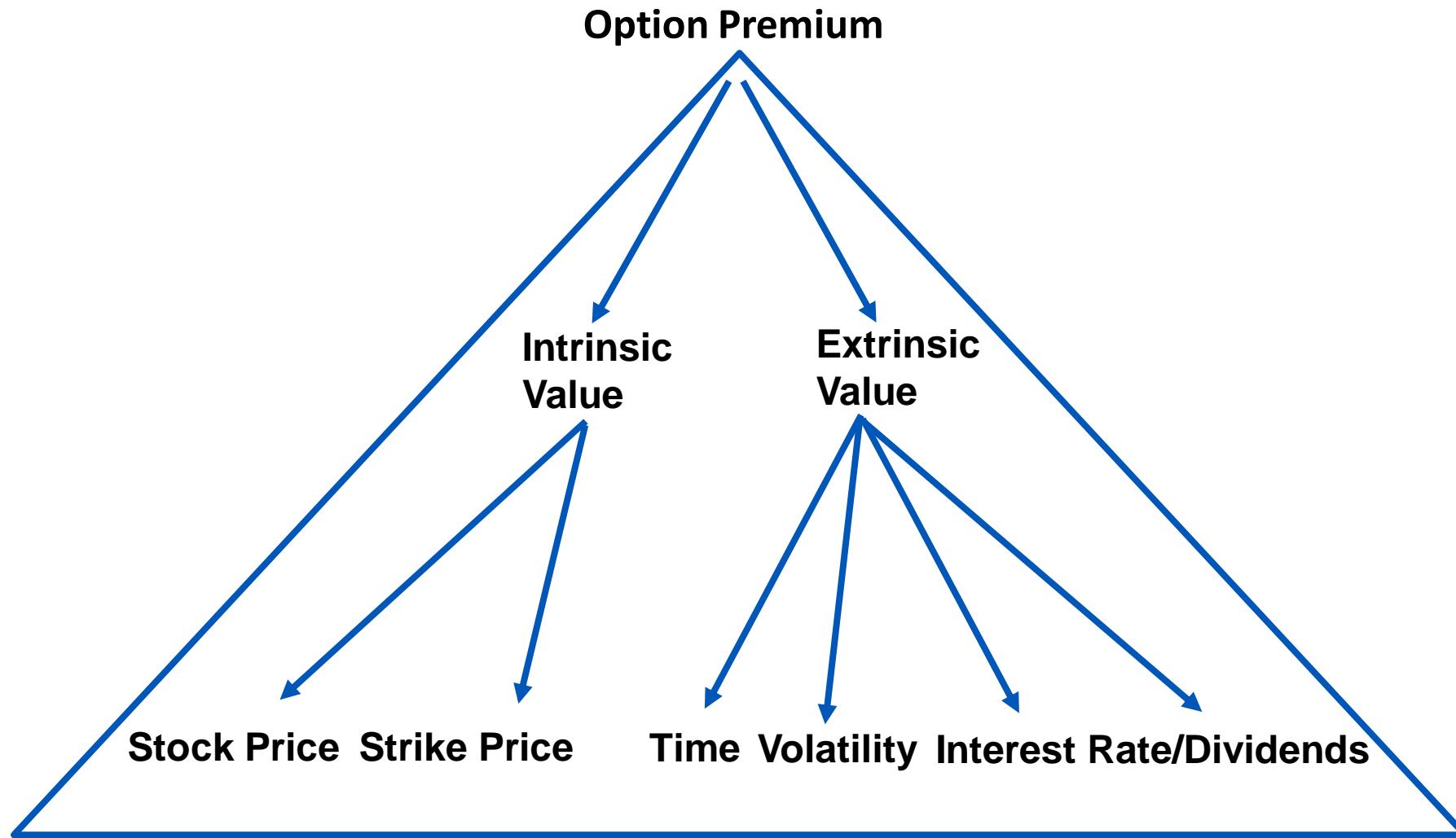
- Options Time Decay
- Long Calls
 - Motivation
 - Selecting Strike
 - Managing Position
- Long Puts
 - Motivation
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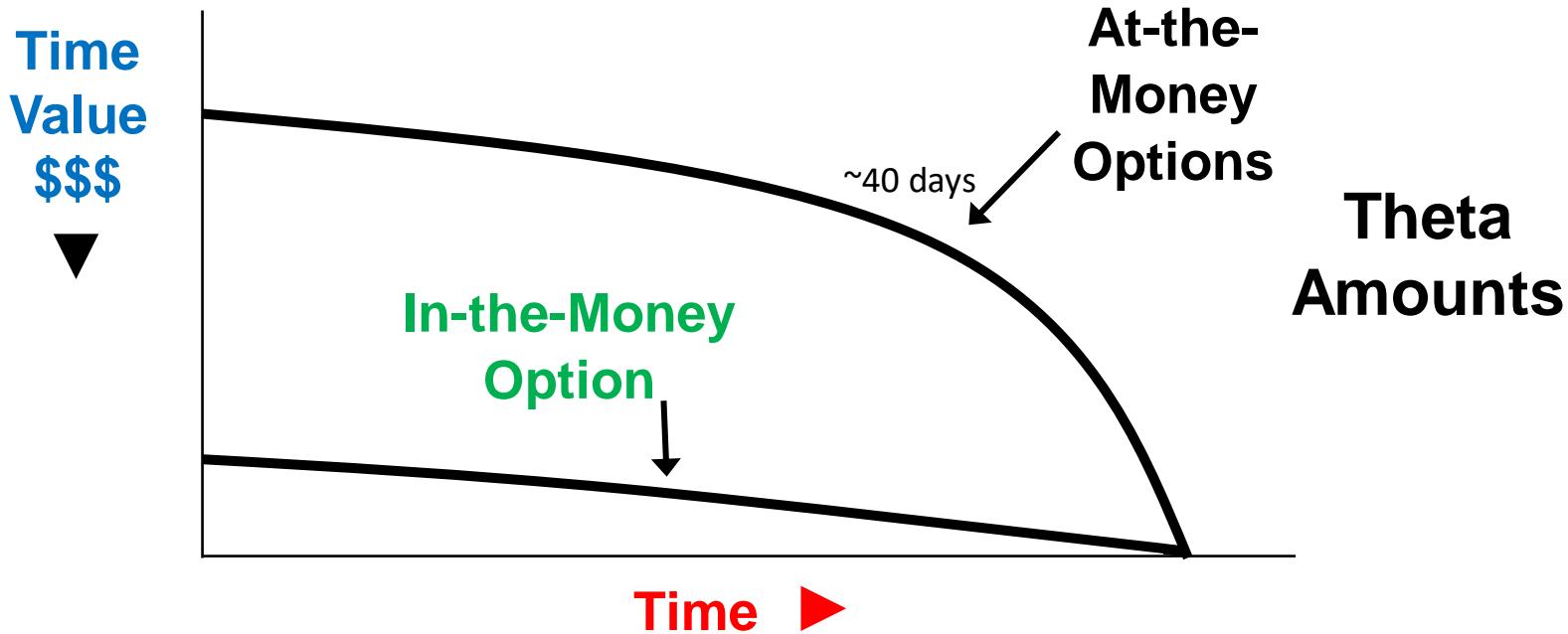
Time Decay



Intrinsic Value vs. Extrinsic (Time) Value



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

Long Calls



Motivation for Long Calls

- After analyzing the chart on ticker XYZ (stock or ETF), you determine that shares have reached a strong support level and might be due for a rally
- If support does not hold, shares could collapse
- Due to this downside risk, purchasing a call option might be an alternative to buying shares:
 - **Risk:** Loss of entire option premium; with consideration to time decay, profitability will generally require the market thesis to be correct on direction, magnitude, and timing

Strike selection

An equity call **buyer**:

- Owns the **right to buy** underlying stock/ETF
- Bullish on underlying
- Needs stock movement > time decay

Option buyers

- ITM call options cost more but have greater sensitivity to stock price movements (greater potential for \$\$\$ gain)
- OTM call 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

Long Calls

- Stock higher
 - Hold for further gains or close position (or scale down)
 - Roll up to a higher strike price
 - Exercise if willing to buy shares (or capture dividend)
 - **Important:** An ITM long call is subject to Auto-exercise at expiration which could result in the risk of owning shares
- Stock consolidates (position suffers 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



Motivation for Long Puts

- An investor has determined that the share price of XYZ (stock or ETF) has become extended and might be due for a pullback
- Absent the use of options, an investor has limited choices including selling short or doing nothing
- Buying a put can provide downside exposure to capitalize on a share price decline:
 - **Risk:** Loss of entire option premium; with consideration to time decay, profitability will generally require the market thesis to be correct on direction, magnitude, and timing

Strike selection

An equity put **buyer**:

- Owns the right to sell underlying stock/ETF
- Bearish on underlying
- Needs stock movement > time decay

Option buyers

- ITM put options cost more but have greater sensitivity to stock price movements (greater potential for \$\$\$ gain)
- OTM put 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

Long Puts

- Stock higher (consider risk tolerance)
 - Hold in anticipation of share price decline
 - Close position before experiencing total loss
- Stock consolidates (position suffers time decay)
 - Close position to avoid further losses
 - Hold position and risk further losses
- Stock lower
 - Hold for further gains or close position (or scale down)
 - Roll down to a lower strike price
 - Exercise unlikely as it would yield short stock position
 - **Important:** An ITM long put is subject to Auto-exercise at expiration which could result in the risk of a short stock position



What to Think About

- Market outlook
- Market timing
- Know the underlying (e.g. earnings)
- Magnitude of anticipated move
- **Generally, motivation for buying options is speculating on directional move of underlying**
- Movement in share price needs to have greater effect on option price than effect of time decay



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