Fresh Invest: Your options on options
Season 2, Episode 10 Transcript

Alex Lieberman, Co-founder and Executive Chairman of Morning Brew Hey, there. I'm Alex Lieberman, co-founder and executive chairman of Morning Brew. This is season two of Fresh Invest, the investing podcast sponsored by Fidelity Investments and powered by Morning Brew. Last week, I chatted with Greg Stevens about the basic ideas behind one of the most commonly talked about investing tools: options. This time, we'll dig into how you can put options to work for you.

Alex Call me a finance nerd—and you wouldn't be the first—but options are just cool. In case you missed our overview last week, options are essentially a contract that can be purchased and give whoever buys it the right, but not the obligation, to buy or sell an underlying asset. I think that's cool because they allow you to play the prognosticator a bit and hedge your risk. If you buy a call option on your favorite stock and it doesn't quite reach where you want it to, all you lose is your premium. And if that stock really soars, you can take home a nice chunk of change.

Alex Then again, options can be risky. If you're dealing with options for a large quantity of shares, the premium loss can be significant, so you want to be careful. Here to guide us through how to embrace the cool aspects of options while staying careful is Greg Stevens.

Alex Greg, great to have you back.

Greg Stevens, Fidelity Hey, great to be back, Alex.

Alex So, let's just start from scratch. For those who missed last episode, could you introduce yourself and explain what you do at Fidelity?

Greg Sure. I'm Greg Stevens, and I've been with Fidelity over 15 years and in the industry, well, hard to say again, but for over 25. And, you know, prior to Fidelity, I spent some time at the CBOE, or the Chicago Board Options Exchange located in Chicago. And then, at Fidelity, I work within the Independent Investing Group as a team or squad leader for the options experience.

Alex Love it. So you have obviously a ton of knowledge around options. I want to talk about individual investors thinking about getting some exposure in their portfolio to options. What is the biggest potential benefit of options versus buying or selling outright a stock?

Greg Yeah. For me, it's cost and then flexibility. In the previous episode, we discussed stock versus option. With stocks, there are only a few things you can do. You could buy it, sell it, or sell short. Selling short the stock, for the listeners, involves borrowing the shares and selling them in hopes to buy them back at a lower price, and you get to keep the difference. Not many investors do this.

Greg But with options, there are a lot of choices. So the first for me is flexibility. You know, the flexibility to use options to design a strategy based upon your stock sentiment—bullish, bearish, or neutral. You can use them to help generate income, speculate, or to hedge.

Greg And then finally, the second piece of that is cost. Options typically have a lower cost to implement a strategy than stock. We used this example in the previous episode, but let's go over it one more time. If you wanted to buy 100 shares of XYZ stock at 100, it would cost you around $10,000. With options, you could buy a call option, which typically represents 100 shares for a fraction of the cost. For example, you could buy one XYZ 90-day call at $5, which would cost you around $500, versus the $10,000 for the stock.

Greg But—and as we know, there's always a but—there are trade-offs. You know, one is the option expiring after 90 days, and two is the underlying must be above your breakeven at expiration to be profitable. So, if you understand these trade-offs, to me, cost and flexibility can be the biggest potential benefits.

Alex So, obviously, we've talked about these benefits, which are large benefits. It is a really nice thing to not have to buy XYZ stock for $10,000, but instead have an option to buy that stock in the future. And also just the flexibility that an option strategy can offer you versus buying an outright asset. But let's talk for a second about this idea of expiry and why it is or can be such a significant drawback in engaging with option contracts. How should amateur investors be thinking about this before getting involved?

Greg Yeah. To me, the fact that options expire can be the biggest drawback. It can also be a benefit. But we discussed this a bit in the last show. An investor must have a three-part forecast: one for price, one for time, and then one for volatility.

Greg But to me, the most significant drawback is that time. For example, you could forecast that a stock, currently trading at $50, is going to 75. So you decided to buy, say, a call option expiring in 30 days. However, the stock didn't rise to 75 until 60 days later. So the call option you bought may have expired worthless. And what I mean by that is you lose your initial investment.

Greg So in the previous example, where we said it was $5, maybe you lost the entire $500 in your investment. So it could have expired worthless or, at a minimum, you were not able to capture the stock price rise up to 75. So that's why you must have a forecast for time. When is something going to happen? And after saying all that, even though you may have a forecast for time, but you might have still been wrong. So trading, as they say, is an art, definitely not a science. So if wrong, you also need to have a plan for mitigating losses and when right, when to take profits.

Alex Yeah. And I love this idea of, like, you can be right directionally, but still not make money on your options contract if you're not right about the time. Like, you could be bullish on XYZ stock, but if the stock doesn't move in the way you want it to within the period of time prior to an option's expiration, it doesn't matter. So I think that's a really important point that you point out.

Alex Let's talk about just kind of, like, the fluctuation in popularity of options trading. Why do you think it is that options go in and out of favor at different points in time? Is it a market-related thing? What's the reason for this?

Greg Yeah. To me, the question when we're talking about this, well, is the market up or down? And what I mean is, when the market's going up, people tend to have more money to invest than when it's going down. They tend to feel a little bit happier about what's going on. But when markets fall, people tend to panic, causing them to sell their positions, therefore pushing the market lower, which could cause more people to sell, and so on and so on. Kind of a self-fulfilling prophecy.

Greg So when investors are uncertain or there's uncertainty that persists in the market, investors tend to pull back on all trading. So I know that's a very simple answer, but I tend to believe that's one of the primary reasons when you see options trading volumes pull back. And why it takes them a little longer to recover is that investors want to feel confident in what they're doing. And when the markets are falling, they're a little bit uncertain.

Greg But I do believe, however, that education has mitigated some of this because buying call options isn't the only thing that you can do in order to take advantage of a market forecast. You could also buy puts to take advantage when markets are moving down, or there's other strategies that you could do for spreads and other typical types of strategies. But investors in options now better understand how to use options in all markets situations, whether it's going up or down. So I think we've mitigated some of that ebb and flow. But it still does exist.

Alex Yeah. So, you mentioned a second ago that when investors are uncertain or uncertainty persists, they tend to pull back on all trading, not necessarily just options trading, just trading volumes in general. But let's talk about for a second the idea of using options as a strategy for hedging when you don't feel super-confident in a position you're taking. Talk about the value of using options as a tool for hedging, and also what I'm just personally wondering about is, like, why should you be doing this? Why should you be even engaging in a position if you don't feel super-confident about the investment?

Greg Well, that's a very good question. Sometimes it's not initiating a new position, but whether to hold on to a current position. So hedging with options can help mitigate risk if you're nervous or not feeling confident in your current investment. So it can be a smart way to reduce risk going into an earnings announcement or product announcement, or if market volatility is creeping in.

Greg But before you hedge, you need to ask yourself, Are you nervous or are you bearish? If you're bullish on the stock longer term, but realize that an upcoming earnings announcement, if not well received, could drive the stock lower, then hedging might be the right thing to do. However, if you are bearish and believe the stock will move lower, hedging is likely not a good idea.

Greg So why would you hedge if you thought the stock was going to move lower and [indistinct] here. In this situation, selling the security may be the right thing to do. But overall, hedging can be a smart idea in the right situation.

Alex Yeah. So it seems like hedging, using options, makes sense when you're short-term uncertain about a stock's movement, but long-term, you still feel conviction about where it's going.

Greg That's exactly right.

Alex Love it. So we have one last question, and it's from a Fresh Invest listener. And they asked, "Are options riskier or less risky than stocks? What about gold or bonds?"

Greg Yeah, great question. Options, stocks, gold, and/or bonds. I don't believe that one of these is riskier than another. You can lose or make money in any investment. However, you must understand the asset before you can trade it. If I were to trade options or, say, bonds, and don't have a plan or even understand them, that's a risky investment.

Greg So I mentioned this before and worth mentioning again. You must understand the product you're trading, and there's no better way to lose money than making an uninformed investment decision. So you must also have a plan when investing to take profits and losses. What's your profit target? When do you cut losses? How much of my account am I willing to invest? Investing in a good education and understanding what you are trading and having a plan can help reduce the risk in any of these different products.

Alex I love it. I have one last question for you, and I think you just offer a valuable perspective, given how long you've spent in the world of options, is what is it about options as a financial instrument that really has attracted you to be in this space for so long? Like, what do you enjoy about it that has just made this such a fun and fruitful space within the financial markets to play for the last 25 years?

Greg Well, one of the original things that attracted me to it was the complexity—being able to do so much with options. And what I ended up finding out, Alex, is that they're not as complex. You mentioned this early on, that one plus one does equal two in the options market.

Greg It's a little bit different, and what I enjoy doing is helping others learn about the product. I think they offer a lot of flexibility, which I mentioned, for investors to take advantage of many different forecasts. But it's an interesting—the market has grown over these 25 years. I mean, it's hard to say just how much, you know, going from four options exchanges to well over 10, 12, 13, I think —

Alex Wow.

Greg Is what there are. And just, you know, the sheer volumes, like, the CBOE I'd mentioned. I mean, nine out of the 10 days, we've seen record volumes this year, so they continue to grow into someone's investing, you know, part of their investing strategy. And it's been great to help folks along during that path.

Alex Love it. Well, it's like you said, it's a really exciting time to be a part of and, you know, thinking about options as a market and as a strategy. And we're super-appreciative that you're taking the time to educate investors on the space. So really appreciate you for all the work you're doing and for joining the show.

Greg Yeah. Thanks, Alex, and great being here.

Alex Thanks for joining Fresh Invest today. I really enjoyed this one. Greg had so many interesting thoughts and ways of thinking about options. Like I said in the last episode, there's a really fruitful prism through which you can explore the idea of investing in finance more broadly. Take Greg's comments about the popularity of options trading and its relationship to both the VIX and the broader stock market. That alone is a great refresher class on markets and the patterns you can discern from them if you pay close attention.

Alex Thanks again for listening. Next up, on season two of Fresh Invest, I'm going to keep my finance nerd ball rolling. And we're going to talk about compound interest—how it could transform your time into money.

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