The Options Industry Council

Options Strategies

QUICK GUIDE

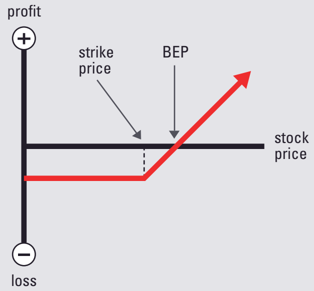
ABOUT OIC

The Options Industry Council (OIC) was created to educate the investing public and brokers about the benefits and risks of exchange-traded options. In an effort to demystify this versatile but complex product, OIC conducts seminars, distributes educational software and brochures, and maintains a Web site focused on options education. OIC was formed in 1992. Today, its sponsors include BATS, BOX, C2 Options Exchange, Chicago Board Options Exchange, International Securities Exchange, NASDAQ OMX, NASDAQ OMX PHLX, NYSE Amex, NYSE Arca and OCC. These participants have one goal in mind for the options investing public: to provide a financially sound and efficient marketplace where investors can hedge investment risk and find new opportunities for profiting from market participation. Education is one of many factors that assist in accomplishing that goal.

OIC The Options Industry Council

1-888-OPTIONS (678-4667)
www.OptionsEducation.org

HOW TO USE THIS BOOK



Each strategy has an accompanying graph showing profit and loss at expiration.

- The vertical axis shows the profit/loss scale.
- When the strategy line is below the horizontal axis, it assumes you paid for the position or had a loss. When it is above the horizontal axis, it assumes you received a credit for the position or had a profit.
- The dotted line indicates the strike price.
- The intersection of the strategy line and the horizontal axis is the break-even point (BEP) not including transaction costs, commissions, or margin (borrowing) costs.
- These graphs are not drawn to any specific scale and are meant only for illustrative and educational purposes.
- The risks/rewards described are generalizations and may be lesser or greater than indicated.

TERMS AND DEFINITIONS

Break-Even Point (BEP): The stock price(s) at which an option strategy results in neither a profit nor loss.

Call: An option contract that gives the holder the right to buy the underlying security at a specified price for a certain, fixed period of time.

In-the-money: A call option is in-the-money if the strike price is less than the market price of the underlying security. A put option is in-the-money if the strike price is greater than the market price of the underlying security.

Long position: A position wherein an investor is a net holder in a particular options series.

Out-of-the-money: A call option is out-of-the-money if the strike price is greater than the market price of the underlying security. A put option is out-of-the-money if the strike price is less than the market price of the underlying security.

Premium: The price a put or call buyer must pay to a put or call seller (writer) for an option contract. Market supply and demand forces determine the premium.

Put: An option contract that gives the holder the right to sell the underlying security at a specified price for a certain, fixed period of time.

Ratio Spread: A multi-leg option trade of either all calls or all puts whereby the number of long options to short options is something other than 1:1. Typically, to manage risk, the number of short options is lower than the number of long options (i.e. 1 short call: 2 long calls).

Short position: A position wherein the investor is a net writer (seller) of a particular options series.

Strike price or exercise price: The stated price per share for which the underlying security may be purchased (in the case of a call) or sold (in the case of a put) by the option holder upon exercise of the option contract.

Synthetic position: A strategy involving two or more instruments that has the same risk/reward profile as a strategy involving only one instrument.

Time decay or erosion: A term used to describe how the time value of an option can “decay” or reduce with the passage of time.

Volatility: A measure of the fluctuation in the market price of the underlying security. Mathematically, volatility is the annualized standard deviation of returns.

Bull Strategies

bull strategy | LONG CALL

Example: Buy call

Market Outlook: Bullish

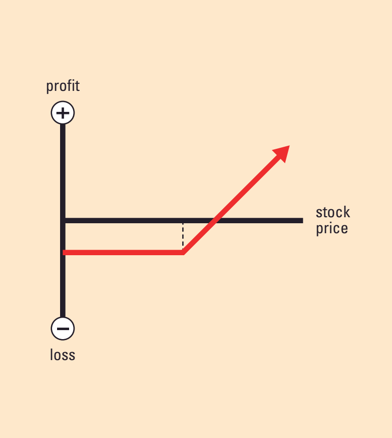
Risk: Limited

Reward: Unlimited

Increase in Volatility:
Helps position

Time Erosion: Hurts position

BEP: Strike price plus
premium paid



bull strategy | BULL CALL SPREAD

Example: Buy 1 call;
sell 1 call at higher strike

Market Outlook: Bullish

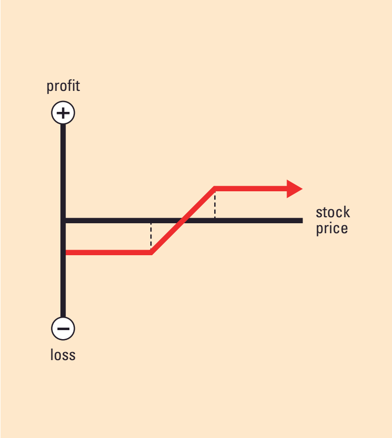
Risk: Limited

Reward: Limited

Increase in Volatility:
Helps or hurts depending
on strikes chosen

Time Erosion: Helps or hurts
depending on strikes chosen

BEP: Long call strike plus
net premium paid



bull strategy | **BULL PUT SPREAD**

Example: Sell 1 put;
buy 1 put at lower strike with same expiry

Market Outlook:
Neutral to bullish

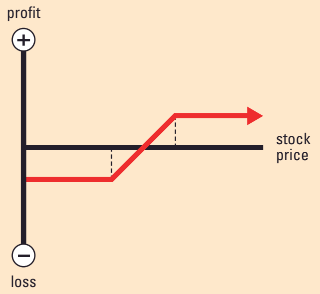
Risk: Limited

Reward: Limited

Increase in Volatility:
Typically hurts position slightly

Time Erosion: Helps position

BEP: Short put strike minus credit received



bull strategy | **COVERED CALL/BUY WRITE**

Example: Buy stock; sell calls on a share-for-share basis

Market Outlook: Neutral to slightly bullish

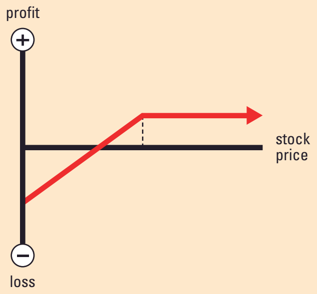
Risk: Limited, but substantial (risk is from a fall in stock price)

Reward: Limited

Increase in Volatility:
Hurts position

Time Erosion: Helps position

BEP: Starting stock price minus premium received



bull strategy | PROTECTIVE/MARRIED PUT

Example: Own 100 shares of stock; buy 1 put

Market Outlook: Cautiously bullish

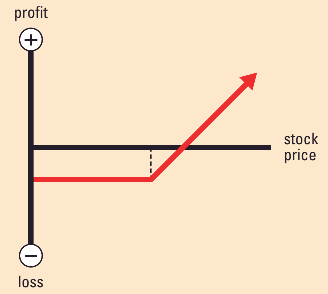
Risk: Limited

Reward: Unlimited

Increase in Volatility: Helps position

Time Erosion: Hurts position

BEP: Starting stock price plus premium paid



bull strategy | CASH-SECURED SHORT PUT

Example: Sell 1 put; hold cash equal to strike price x 100

Market Outlook: Neutral to slightly bullish

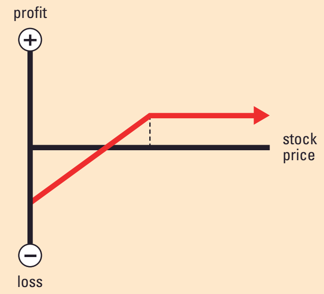
Risk: Limited, but substantial

Reward: Limited

Increase in Volatility: Hurts position

Time Erosion: Helps position

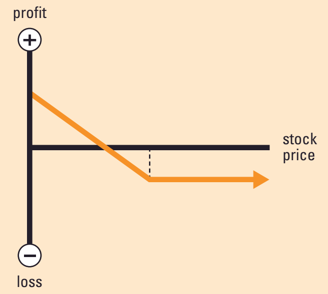
BEP: Strike price minus premium received



Bear Strategies

bear strategy | LONG PUT

Example: Buy put
Market Outlook: Bearish
Risk: Limited
Reward: Limited, but substantial
Increase in Volatility: Helps position
Time Erosion: Hurts position
BEP: Strike price minus premium paid



bear strategy | BEAR PUT SPREAD

Example: Sell 1 put;
buy 1 put at higher strike

Market Outlook: Bearish

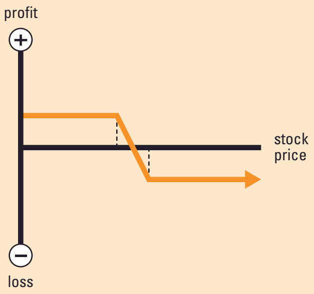
Risk: Limited

Reward: Limited

Increase in Volatility:
Helps or hurts depending on strikes chosen

Time Erosion: Helps or hurts depending on strikes chosen

BEP: Long put strike minus net premium paid



bear strategy | BEAR CALL SPREAD

Example: Sell 1 call;
buy 1 call at higher strike

Market Outlook:
Neutral to bearish

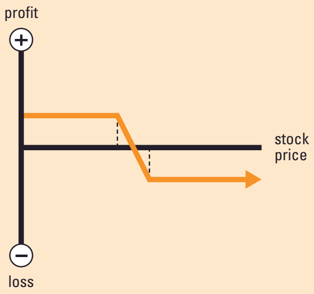
Risk: Limited

Reward: Limited

Increase in Volatility:
Typically hurts position slightly

Time Erosion: Helps position

BEP: Short call strike plus credit received



Neutral Strategies

neutral strategy | COLLAR

Example: Own stock, protect by purchasing 1 put and selling 1 call with a higher strike

Market Outlook: Neutral

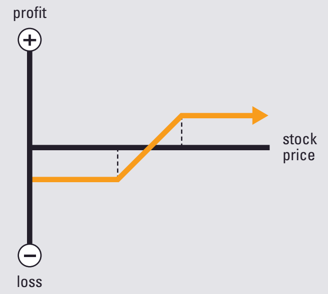
Risk: Limited

Reward: Limited

Increase in Volatility: Effect varies, none in most cases

Time Erosion: Effect varies

BEP: In principle, breaks even if, at expiration, the stock is above/(below) its initial level by the amount of the debit/(credit)



neutral strategy | SHORT STRADDLE

Example: Sell 1 call;
sell 1 put at same strike

Market Outlook: Neutral

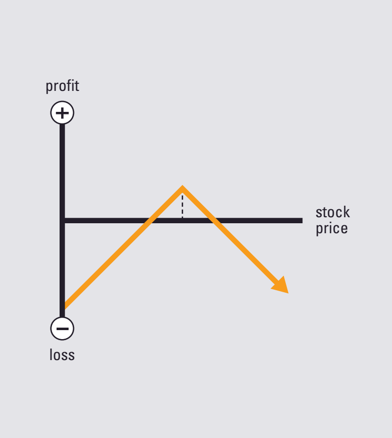
Risk: Unlimited

Reward: Limited

Increase in Volatility:
Hurts position

Time Erosion: Helps position

BEP: Two BEPs
1. Call strike plus premium received
2. Put strike minus premium received



neutral strategy | SHORT STRANGLE

Example: Sell 1 call with higher strike; sell 1 put with lower strike

Market Outlook: Neutral

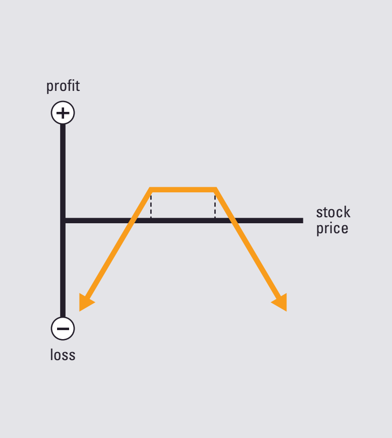
Risk: Unlimited

Reward: Limited

Increase in Volatility:
Hurts position

Time Erosion: Helps position

BEP: Two BEPs
1. Call strike plus premium received
2. Put strike minus premium received



neutral strategy | IRON CONDOR

Example: Sell 1 call; buy 1 call at higher strike; sell 1 put; buy 1 put at lower strike; all options have the same expiry. Underlying price typically between short call and short put strikes.

Market Outlook: Range bound or neutral

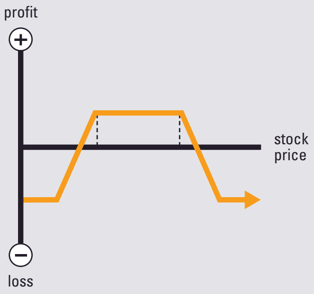
Risk: Limited

Reward: Limited

Increase in Volatility: Typically hurts position

Time Erosion: Helps position

BEP: Two BEPs
1. Short call strike plus credit received
2. Short put strike minus credit received



neutral strategy | CALENDAR SPREAD

Example: Sell 1 call; buy 1 call at same strike but longer expiration; also can be done with puts

Market Outlook: Near term neutral (if strikes = stock price); can be slanted bullish (with OTM call options) or bearish (with OTM put options)

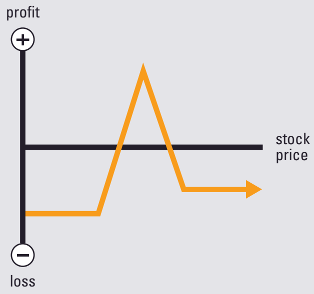
Risk: Limited

Reward: Limited; substantial after near term expiry

Increase in Volatility: Helps position

Time Erosion: Helps until near term option expiry

BEP: Varies; after near term expiry long call strike plus debit paid or (if done with puts) short put strike minus debit paid



neutral strategy | COVERED COMBINATION/COVERED STRANGLE

Example: Own stock; sell one call; sell one put; underlying price typically between short call and short put strikes

Market Outlook: Range bound or neutral, moderately bullish; willing to buy more shares and sell existing shares

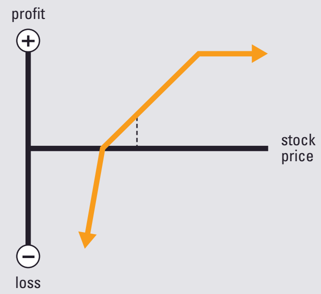
Risk: Limited, but substantial

Reward: Limited

Increase in Volatility: Typically hurts position

Time Erosion: Typically hurts position

BEP: Two BEPs
1. Short call strike plus total credit
2. Short put strike minus total credit



neutral strategy | LONG CALL BUTTERFLY

Example: Sell 2 calls;
buy 1 call at next lower strike;
buy 1 call at next higher strike
(the strikes are equidistant)

Market Outlook: Neutral around strike

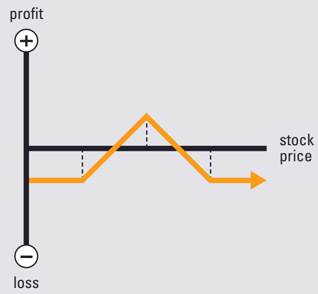
Risk: Limited

Reward: Limited

Increase in Volatility: Typically hurts position

Time Erosion: Typically helps position

BEP: Two BEPs
1. Lower long call strike plus net premium paid
2. Higher long call strike minus net premium paid



Volatility Strategies

volatility strategy | LONG STRADDLE

Example: Buy 1 call;
buy 1 put at same strike

Market Outlook: Large move
in either direction

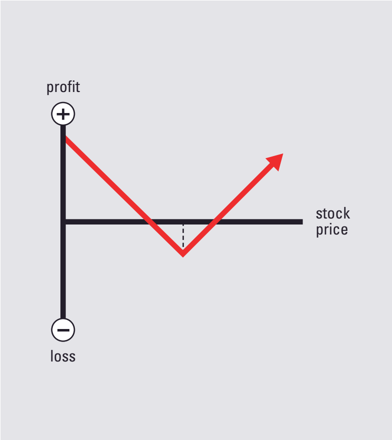
Risk: Limited

Reward: Unlimited

Increase in Volatility:
Helps position

Time Erosion: Hurts position

BEP: Two BEPs
1. Call strike plus premium paid
2. Put strike minus premium paid



volatility strategy | LONG STRANGLE

Example: Buy 1 call with higher strike; buy 1 put with lower strike

Market Outlook: Large move in either direction

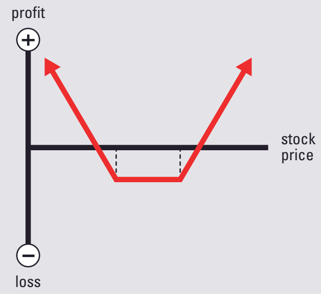
Risk: Limited

Reward: Unlimited

Increase in Volatility: Helps position

Time Erosion: Hurts position

BEP: Two BEPs
1. Call strike plus premium paid
2. Put strike minus premium paid



volatility strategy | CALL BACKSPREAD

Example: Sell 1 call; buy 2 calls at higher strike

Market Outlook: Bullish

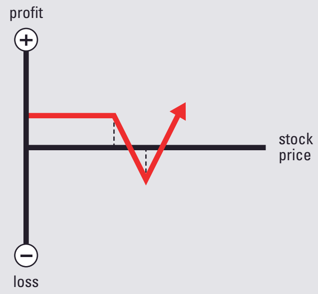
Risk: Limited

Reward: Unlimited

Increase in Volatility: Typically helps position

Time Erosion: Typically hurts position

BEP: Varies, depends if established for a credit or debit. If done for a credit, two BEP's with the lower BEP being the short strike plus the credit



volatility strategy | PUT BACKSPREAD

Example: Sell 1 put;
buy 2 puts at lower strike

Market Outlook: Bearish

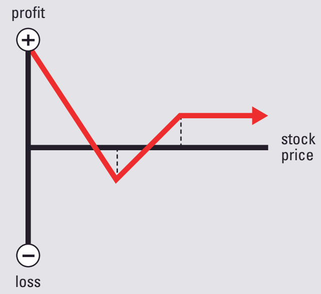
Risk: Limited

Reward: Limited, but substantial

Increase in Volatility: Typically helps position

Time Erosion: Typically hurts position

BEP: Varies, depends if established for a credit or debit. If done for a credit, two BEP's and the lower BEP is the short strike minus the credit



OIC The Options Industry Council

1-888-OPTIONS

www.OptionsEducation.org