

# Inner Circle Options Starter Kit: A Step-by-Step Guide to Options Trading



*ChangeWave*  
**Inner Circle**

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# Contents Page

<a href="#"><u>Options Starter Kit: A Step-by-Step Guide to Options Trading</u></a> .....	3
<a href="#"><u>7 Reasons Why You Want to make Options-Trading Part of Your Portfolio</u></a> .....	4
<a href="#"><u>Options Basics</u></a> .....	5
<a href="#"><u>Risk</u></a> .....	5
<a href="#"><u>Options in Action</u></a> .....	6
<a href="#"><u>Types of Options</u></a> .....	6
<a href="#"><u>Call Options</u></a> .....	6
<a href="#"><u>Put Options</u></a> .....	7
<a href="#"><u>Premium</u></a> .....	7
<a href="#"><u>Strike Price</u></a> .....	7
<a href="#"><u>Expiration Dates</u></a> .....	8
<a href="#"><u>Bid/Ask Prices</u></a> .....	8
<a href="#"><u>At-the-Money, In-the-Money, Out-of-the-Money</u></a> .....	8
<a href="#"><u>Factors Affecting the Option Price</u></a> .....	9
<a href="#"><u>Stock Price</u></a> .....	9
<a href="#"><u>Time</u></a> .....	9
<a href="#"><u>Volatility</u></a> .....	9
<a href="#"><u>5 Options-Trading Strategies That Can Change Your Portfolio for Life</u></a> .....	10
<a href="#"><u>Strategy #1 – Buying Call Options</u></a> .....	10
<a href="#"><u>Strategy #2 – Buying Put Options</u></a> .....	10
<a href="#"><u>Strategy #3 – Bull-Call Options</u></a> .....	10
<a href="#"><u>Strategy #4 – Bear-Put Spread</u></a> .....	11
<a href="#"><u>Strategy #5 – The Covered Call</u></a> .....	11
<a href="#"><u>How to Get Started</u></a> .....	12
<a href="#"><u>Choosing a Broker</u></a> .....	12
<a href="#"><u>Getting “Approval” to Trade Options</u></a> .....	12
<a href="#"><u>Margin</u></a> .....	12
<a href="#"><u>Options Approval</u></a> .....	13
<a href="#"><u>Options Quotes</u></a> .....	13
<a href="#"><u>Glossary</u></a> .....	15
<a href="#"><u>Worksheet</u></a> .....	17

# Options Starter Kit: A Step-by-Step Guide to Options Trading

By Jon “Dr. J” Najarian  
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Welcome to the *Inner Circle Options Starter Kit: A Step-by-Step Guide to Options Trading* prepared exclusively for Inner Circle members. One way to get the most out of your *ChangeWave Inner Circle* membership is to use Toby Smith’s “Profit Maximizer” and hedging strategies to supplement your *ChangeWave Investing* recommendations. Those strategies often include buying and selling options.

Learning to trade options is like learning a foreign language: Initially it’s a bit slow while you pick up the basics but with a little practice it becomes second nature. Don’t pass up this chance to get a basic, working knowledge of something that could truly yield life-changing profits.

I’m not going to let fear take you prisoner, and I definitely don’t want you sitting out on some of Toby’s recommendations because you might feel like they’re a bit over your head. That’s why Toby asked me to put together this course for you. By the time you’re done with it, I have no doubt that you’ll be trading options like a champ. Pretty soon, you’ll be amazed at the “extra” profits you can earn by putting your money to work in the options market.

My goal is to prepare you to rev up your returns with the power of options; once you get the hang of that, and I know you will, you’ll be eager to see how options can supplement the rest of your portfolio.

In this course, you’ll find an overview of the options market and the things that professional traders know that can make the difference between taking a weekend trip to a local motel and booking a three-week vacation to Fiji all on your profits. Options-trading isn’t hard to learn nor does it have to remain a scary no-man’s land that only the most experienced, glued-to-their-monitors type of traders can maneuver.

Bottom line, there’s money to be made — lots of it — and we’re going to give you the tools to learn how to take advantage of the short-term nature of options-trading to make quick profits no matter whether the market is going up or down. That’s the beauty of options — once you understand the basic terminology and strategies (which I’ll show you!), it’s like a whole new world opens up to you.

You’ve probably heard that there is great risk in options-trading. I’m not going to kid you and say there isn’t risk, but there’s risk everywhere. However, with options you can risk only a nominal amount of cash, and you can make HUGE profits in a very short time frame.

I’ve been doing this for decades. I make a pretty decent living trading options, and I’m proof that anyone can learn how. I went from a short (but very promising, per my mom!) career playing football for the Chicago Bears to being a complete novice in the trading pits of the Chicago Board Options Exchange (CBOE) back in the early 1980s.

Back then, it was very hard for individual investors to buy options. It was very expensive for the time and advice of brokers. But today, it’s no longer cost-prohibitive to trade often and at any

time of the day. Thanks to online brokerages and the access to price quotes on the Internet, anyone can handle their own accounts. But a lot of folks don't know what they're doing — especially when it comes to options — because they've never had anyone show them how.

I don't want you to be one of those people. I want you to be able to talk the talk, walk the walk and, ultimately, do the “cha-ching” dance that my trading partner and brother Pete and I do around our office when we make BIG profits in a matter of weeks or even days on a particular options trade!

Why should you hone your option-trading skills and instincts? Other than that you want to refine your dancing skills, I'm going to give you:

## **7 Reasons Why You Want to Make Options-Trading Part of Your Portfolio**

### **1. Versatility**

Options have fantastic versatility, and you can make a profit on a stock or index when it's going up or down. With options, you can profit on a hot stock by paying a fraction of the cost of owning that stock outright. If you suddenly want to protect a larger part of your portfolio from a downside disaster, you can do it.

### **2. Benefit from anticipating the market**

You can profit from correctly anticipating a rising or falling market.

### **3. Earn profits in a sideways, non-trending market**

You can become an option seller, where you collect premium (cash) up front on the next business day.

### **4. Profit from the passing of time**

It's a fact: Time is the enemy of the option buyer. However, you can hop over to the other side and become an option “writer” (seller) and profit from the passing of time!

### **5. Get leverage and financial muscle**

With options, you can control tens of thousands of dollars' worth of stock for literally pennies on the dollar. Each option contract controls 100 shares, so you're not exposing a large amount of money, and in return you can't lose a large amount of money. In fact, with the puny cost of options compared to owning the stock outright, you can control the stock with a comparatively small amount of money and keep the rest of your stash in cash, where it earns interest!

### **6. Minimal capital outlay**

This is where the magic of leverage comes in allowing you to participate with only a minimal capital outlay.

## 7. Selective trading

With options, you can tailor-make strategies, with their own risk/reward scenarios, before you ever step a foot into play. Knowing your risk before you enter the trade is a HUGE advantage over most other traders out there.

You might have a substantial amount of money in stocks that you plan to hold for a significant amount of time — maybe some blue chip names that have been around forever that are doing well and are achieving stable, even incremental gains. But in the meantime, wouldn't you love to make some fast gains on stocks you already hold long?

Or, maybe you want to dabble in some names that you'd like to have in your portfolio — some new, up-and-coming “hot” stocks that have great upside potential but you're not ready to invest the serious dollars that go along with stock ownership. No problem, because option-trading is not only a great way to get into the names you want for a short while, but when a trade's going your way, you have the option to buy that stock at an agreed-upon price during the life of your contract. I'll tell you all about that in just a moment, but think about the possibilities that being a little more creative in your investing can bring!

Are you getting excited yet? Because as an Inner Circle member, through Toby's Profit Maximizers and hedging strategies, you have an incredible opportunity to harness the power of trading options and put your money to work even harder than it already is — for just pennies on the dollar!

## Options Basics

An option is exactly that — an option, or choice, that you have at your fingertips in the way you play the stock market. It is a securities contract that gives you the right to buy (call) or sell (put) at a predetermined price (strike) during a preset time period (expiration date). As you know, with any contract, there are two parties involved in every transaction — which means that someone is paying for those rights to buy or sell a particular option.

When you purchase options it's called an options contract. One options contract controls 100 shares of the underlying stock. Let's take Google (GOOG) for example. If one GOOG call is selling for \$23, one call contract will cost you \$2,300 ( $\$23 \times 100$ ). But with the stock trading for \$390 a share, 100 shares would cost you \$39,000. How much would YOU rather spend?

Also note that Google is priced much higher than the majority of stocks and therefore its options are priced accordingly. If we look at Apple Computer (AAPL) while it's trading at \$61, its 60 Call might only be trading in the neighborhood of \$5, or \$500 for a contract.

If you are holding a stock long, you would buy as many contracts as you need to cover your long positions in their entirety. Suppose you hold 1,000 shares of Sirius Satellite Radio (SIRI). You would want to buy 10 call contracts, or what's called a 10-lot. In plain English, each contract covers 100 shares, so you'd need 10 contracts to represent your 1,000 shares. With any options strategy you implement, you can ramp it up as big or as small as you like — it's really up to you!

## Risk

An often-asked question is: “What if there's no one out there who wants to sell me (or take the other side of) the option I want to buy, at the exact time I want to buy it?” The answer is that

there are a host of individuals, known as market makers, who are the ultimate buyers and sellers!

Market makers take on the obligation to post a bid and an offer for every stock or index option they trade. For taking on this obligation, the Securities and Exchange Commission waives the margin rules for these market makers. By law you must deposit into your brokerage account a minimum of 50% of the value of the stock being purchased. However, market makers are exempt from this rule, which is known as Reg-T.

In other words, market makers must post two-sided markets, bids and offers for calls and puts. For doing this, they can trade with 100 to 200 times the leverage of regular Mom and Pop investors. This, my friends, is a very powerful carrot and stick, and it has served our capital markets well!

Additionally, the CBOE created the Options Clearing Corporation (OCC), which serves as the clearing facilitator for every trade on every options exchange. The OCC is the only AAA-rated credit intermediary that guarantees the performance of every contract traded, regardless of the financial state of the buyer or seller.

## Options in Action

I can guarantee that you've seen options strategies playing out in the real world. Keep in mind that you have probably already purchased the rights to protect yourself against risk in some area of your life. An example would be home or automobile insurance. These same principles are applied to the options market.

Using car insurance as an example, you pay good money to purchase a vehicle. You decide on a car based on safety ratings, how smooth the ride feels and how well it will accommodate you and your family's needs. But would you drive that shiny, brand-new car off the dealer's lot without taking precautions (that are required by law!) in the form of insurance in the event anything happens to your investment?

When you buy an insurance policy — be it automobile, health, life or homeowner's insurance — you pay a premium for the protection it provides. The policy might ultimately be valued at several times more than what you actually pay for it, but the nominal amount you're charged for this security net is a small price to pay in comparison.

Even at the end of the year when your car insurance needs to be renewed and you haven't been involved in any accidents that required you to actually use your insurance, you've still come out a winner because you didn't lose any more than your initial investment and you drove for a whole year with peace of mind because you had the insurance in the first place!

Let's apply that to options-trading.

## Types of Options

Let's talk about the two types of options: calls and puts.

**Call options** are securities that give the buyer the right, but not the obligation, to buy something (i.e., to "call" it away from its owner) at a specified price during a specified period of time. Typically, you buy calls when you are bullish about the direction of the market and/or about a particular stock's prospects. For example, if you think shares of Google are going to

skyrocket, you'd likely want to buy calls.

**Put options** give you the right, but not the obligation, to sell stock (or “put” it to someone else) at a specified price during a specified period of time. Put-buyers are more often bearish on the market's and/or stock's potential, and purchase puts to protect them to the downside. Again using Google as an example, if you think the shares are going to go down in the near future, you'd want to buy puts.

Put-buying is similar in theory to shorting stock in that you expect the shares to fall below a certain price. But the put-buyer actually incurs less risk than the short-seller, as the most you can lose when you're buying options is the premium that you pay to get into the trade, while the person who shorts stock will have to come up with a lot of dough to cover their shorts should the stock price rally higher.

Just as a word of note, you can both buy and sell calls and puts (which I will explain later). There are benefits to using each strategy — it's all about knowing which choice is right for you at which time. And that's why I'm here — to help you understand the terminology and strategies so that you can make informed and CONFIDENT decision when you're ready to trade!

## Premium

When you enter into an options contract, you pay a premium (or a debit) for that privilege. You're not paying for the full value of a stock. For instance, if you wanted to get in on Google (GOOG), you'd be paying in the neighborhood of \$390 a share. Buy 1,000 shares, and that investment is the equivalent of a piece of real estate!

I'm not saying you can't play the market that way, but it isn't the ONLY way, and it might not be the BEST way. And it's certainly not the least expensive way. But there is a way to play Google — and thousands of other stocks — with a much-smaller initial investment and yet with the potential return that can equal and oftentimes even SURPASS what the traditional stock investor will see.

## Strike Price

The strike price is an important and static part of the options contract. The option you choose to buy or sell is largely based on the strike price of the option.

For instance, if you think that Google at \$390 has a shot of rallying up to \$400 a share in the next few months, you might want to buy a 390 Call in a month in the near future (generally two or more months away). Why is that? Because if the stock goes up, you're holding a very valuable opportunity in your trading account.

During the time that you are in that options contract, you have the right to buy Google stock at \$390 a share while others in the marketplace will have to buy it at the market value, which is \$10 more than you're paying. Thus, you've bought yourself the right to buy stock at an agreed-upon price during the life of your options contract.

Remember, though, you have the right but NOT the obligation to buy that stock. If the stock has increased in value, chances are on your side that the value of the option has gone up as well, as others will want the right to buy GOOG for \$390. And you can make a profit by selling your right to buy the shares at that price to someone else. Talk about a win-win situation!

## Expiration Dates

What I love about trading options is that it is all about buying time. Meaning you hold the options for a short period of time, depending on their expiration date. Options expire on the third Friday of every month. So if you own a May call, then you have between the day you purchased the call and the middle of May for it to become profitable.

During that time, you can exercise your right to sell the call, you can choose to buy stock at the agreed-upon price (as we noted above, if you purchased a GOOG May 390 Call, then you can buy stock for \$390 a share, even if the stock is trading at \$400, just as long as you do it before the third Friday in May when the options contract expires) or you can choose to not do anything and the call will expire worthless with no penalties to you.

With options having a built-in time limit, it's helpful to know that those cycles vary. With options traded on a majority of stocks, indexes and exchange-traded funds, that's a lot of cycles running concurrently. A good rule of thumb to know is that an optionable entity (that is, it has options available to be traded on it) will always have options available in the current month and in the next month. If it's May, GOOG will have both May and June options.

How will you know this? An easy way is to visit the Chicago Board Options Exchange Web site at CBOE.com. Go to the "Quotes" tab and select "Delayed Quotes." This takes you to a page where you can type in a stock ticker and check one of the boxes for "List All Options," then you will see all of the options currently available to trade.

## Bid/Ask Prices

Every option (whether it's a call or a put, expiring in a month or a year) will always have a "bid" and "ask" price. Said simply, you buy at the ask price and sell on the bid.

For example, if you're looking at May 45 Calls and it shows prices of \$6.20 X \$6.60. You would be buying at the ask price (the higher price) and you sell at the bid (the lower number).

## At-the-Money, In-the-Money, Out-of-the-Money

There are three terms you need to be familiar with, which you can determine simply by looking at the strike prices of a particular option.

An option is at-the-money if the strike price of the option equals the market price of the underlying security. For example if Gillette is trading for \$50.00 and you hold the July 50 option you are at-the-money.

A call option is in-the-money when the option's strike price is below the market price of the underlying stock. For a put option, it's when the strike price is above the market price of the underlying stock.

For example if you buy Gillette July 50 call options and two weeks later Gillette is trading for \$53.30 than you are in-the-money by \$3.30. It's simply a matter of math to figure this out ( $\$53.30$  stock price -  $\$50$  strike price =  $\$3.30$ ).

A call is out-of-the-money when an option's strike price is higher than the market price of the underlying stock. For a put, it's when the strike price is below the market price of the underlying stock.

Using Gillette as the example again, you bought the July 55 call options and Gillette is trading for \$53.30, then you would be out-of-the money \$1.70 ( $\$53.30 - \$55 = -\$1.70$ ).

Speaking of money, let's talk a little bit more about it — specifically, how an option's price is determined.

## Factors Affecting the Option Price

At this point, you might be thinking, “OK, Doc, I'm intrigued. But what kind of money am I going to be expected to lay out to get into these trades. And, more importantly, what kind of money do I stand to MAKE?”

The answers are, respectively, not a lot and a LOT.

A lot of the mystery behind options-trading is that, initially, it seems hard to make sense of all the components. But once you realize that it's a science and master it accordingly, then you can craft it into an art that works for you individually.

While the price of an option is influenced by many factors, 90% of the price is based on:

- Stock price
- Time left until the option expires
- Volatility of the underlying stock

## Stock Price

As we mentioned earlier, the market price of the underlying security (be it the stock, index or exchange-traded fund) is where you start once you've identified the underlying asset that you want to trade options on. The stock price greatly — and perhaps predominantly — affects the price of the options.

## Time

With options being a wasting asset (i.e., they expire), time erodes the value of all options. The further away the option is from expiration, the more value it could likely have. In the three months preceding expiration, what's known as time decay impacts an option the most.

## Volatility

Next to the market price of the stock, volatility is the second-most important factor in the determination of an option's price. Stocks that have been stable for years are going to be more predictably priced and, accordingly, priced lower than stocks whose charts are all over the place — up and down like a carousel horse gone amok.

History isn't the only determinant. Something called implied volatility impacts an option's price because it is based on the option's price at this very moment. A stock that's on the move is going to go up in price as more and more people want to get in on the action. Thus, its options will be worth more to investors who want to lock in a certain price at which they would be willing to buy the stock.

Take Apple again, suppose it's trading at \$61. Then they introduce a product that's even hotter than its iPod line of music players and the shares take off into the \$70 range with no signs of

looking back. You'd better believe that folks will want to secure their right to buy shares at \$61... and they would probably pay dearly to do so.

## 5 Options-Trading Strategies That Can Change Your Portfolio for Life

### Strategy #1 — Buying Call Options

This strategy is also known as the “Long Call” trade. Buying a call option is a simple and straightforward way to take advantage of an upside move or an upside trend. Once you purchase a call option (establishing a long position), you can:

- Sell it.
- Exercise your right.
- Let it expire.

Your main reason for buying a call option would be to turn around and sell it at a higher price than what you bought it for. The maximum amount you could lose with this trade is the initial cost of the trade but, the upside is unlimited. However, since options are a wasting asset time will work against you. So, be sure to give yourself enough time to be right. I'd recommend at least three months.

### Strategy #2 — Buying Put Options

This strategy is used to protect stocks you already own or to profit on stocks or indexes that are going down. I'm always amazed why more investors don't use protective puts to insure their portfolios. You're required by law to have car insurance, however, most investors don't bother insuring what they have in their accounts! Maybe the reason is that most don't know HOW to do this.

Put options make it all possible. They can prevent further loss in an individual stock (not to mention lock in a nice gain). They can also protect a million-dollar portfolio containing numerous stocks and mutual funds. With the versatility of options, there's a put option available to accomplish these basic goals.

You could calculate approximately how many put contracts it would take to equal your million-dollar portfolio size, purchase them, and sleep like a baby every single night. All without worrying about having to place stop losses.

### Strategy #3 — Bull-Call Spread

A bull-call spread should be used when you have a bullish outlook, yet want limited risk. There is limited profit potential with this spread but, there is also limited risk.

Whenever you hear of an option “spread,” remember this always means the buying of one option and the simultaneous selling of another. Sometimes it's in ratios, but with a bull-call spread, it's always a 1-to-1 ratio.

This means that for every call we buy, we sell one call at a higher strike price. In the case of a bull-call spread, both “sides” will involve call options. Basically you will buy calls of one strike price and simultaneously sell calls of a different (higher) strike price — with BOTH expiring in the same month.

An old-fashioned way to invest in Apple would be to buy 1,000 shares at \$70. Instead of putting \$70,000 on the table to buy a 1,000-share position, I'll show you what a 75-80 bull-call spread looks like. With the stock at \$70, the 75 Calls might be trading for \$2, while the 80 Calls might be going for 50 cents.

Here's how you would initiate the trade: Buy 10 of the Jan 75 Calls for \$2, and simultaneously sell 10 of the Jan 80 Calls for 50 cents. Our net outlay, or risk, is \$1.50, or \$1,500 for a 10-contract spread. If you give this spread to your broker to pay a net debit of \$1.50, then that's the most you could pay. You could pay less if your broker "works the spread" for you or gets lucky.

If you "leg into" the spread (i.e., getting into each side of the spread separately rather than entering a simultaneous order), then you take the risk that you could buy the 75 Calls and not sell the 80 Calls at a high enough price to have that net debit remain at \$1.50. Note that the full value of your spread is \$5, or the difference between the strike prices (\$80-\$75), so that's the maximum profit you can make — not bad for a \$1.50 investment if the stock goes up!

"Legging" is fine, but you should understand that you can do better or worse than the recommended net debit, whereas when you give your broker a net debit for the spread, you can only do better, not worse.

This limits your exposure, limits your risk and gives you more security — all while allowing you to profit up to 100%, 200%, even 300% to the upside!

## **Strategy #4 — Bear-Put Spread**

This strategy is the mirrored opposite of the bull-call spread, and you profit when the stock is moving down. Again you're limiting your upside, but remember, you're also limiting your losses.

A bear-put spread is established by purchasing one put at a higher strike price and selling another put with a lower strike. Both strike prices must have the same expiration date.

Using Wal-Mart (WMT) as an example, you would establish purchasing the WMT June 55 Put and sell the same number of the WMT June 50 Puts.

Instead of buying an expensive put option by itself (with the risk of losing this entire amount if the stock moves the wrong way), you are also simultaneously selling another high-volatility (high-priced) put. This offsets some of the cost of the put you purchased.

This strategy is perfect when you find expensive, volatility-laden options. It's a great way to chip away at the cost of the options by selling another one to help pay for it.

## **Strategy #5 — The Covered Call**

This strategy is also known as the Buy Write. It's one of the frequently used strategies along with being one of most conservative and low-risk strategies of them all.

You can easily add an additional 10%–20% or more to your long-term portfolio by using buy writes and covered calls.

This is a great way to put some of your stocks to work that are just sitting there doing nothing. The best part is that you'll continue to collect the dividend payments as you write covered calls.

If you're using a margin account, you could double your return. Instead of a 10% return, you would get 20%. Remember, by using a margin account you only have to put up half the money.

Let's start with a refresher on the call option. A call option buyer has the right, but not the obligation, to buy stock at a certain fixed price. On the other side of that contract is the seller.

When you sell a call you collect the premium. This is known as selling a call to open. The premium is the cost of the option, and when you sell them, real, tangible cash hits your account the next day. If you decide to sell calls (against stock you already own), you are obligating yourself to sell your stock away at a certain price by a certain date.

## How to Get Started

OK, you've done your homework and know exactly which companies and even which options you want to trade. Better yet, armed with the five options-trading strategies we've outlined above, you now know HOW you want to trade them!

Now, how do you make that happen?

### Choosing a Broker

I recommend finding a broker (or an online brokerage firm) that is built specifically for options traders. Options-specific firms don't mean that you can only trade options with them — they're just more geared toward helping options traders to execute their investment goals and thus better able to help you along in your journey by answering your questions and maybe even walking you through your initial trades.

Keep in mind, though, that the lower the commission, the less support you can expect. Full-service brokers can charge \$2–\$5 per options contract, while discounters might charge \$2 or less.

Applying is easy — and it's all done online. Expect to pay anywhere from \$8.95 to \$19.95 commission per transaction for an option trade. Some option brokerage firms have a \$1.50 per contract commission schedule, with a minimum of, say, \$14.95 per trade. (Meaning, even if you only do one contract, they will get you for the \$14.95.) Keep in mind that all of these prices are very reasonable.

## Getting “Approval” to Trade Options

### Margin

When you're ready to open a trading account, you'll be asked if you want to open a “cash” or “margin” account. As you might know, a margin account allows you to borrow the broker's money to buy certain securities, which means you can have double the amount of shares that you could otherwise afford. More specifically, you are only allowed to borrow money against “marginable securities,” which includes most stocks, bonds and mutual funds.

However, options themselves aren't marginable securities — meaning, you cannot buy them on margin. They are “cash-only trades.” Because they settle during the same day or within one business day, enough cash must be in your account to cover the amount of the trade.

More advanced option trades (like selling puts) require that you have some funds set aside in your account, just in case you are called upon to perform your obligation of buying a certain amount of shares at a set price by a certain date.

When opening an account, it's always a good idea to check the "margin" box — even if you don't plan to use margin at all. The fact is, if you want to be able to do more advanced kinds of options-trading, you must first have a margin account approved — which is as easy as checking the box.

Bottom line, a second of your time now could earn you amazing rewards when you're ready to get started using these options-trading strategies we've outlined.

## Option Approval

If you are granted approval to trade options, normally right out of the gate you are given the go-ahead to:

- Sell covered calls
- Buy calls
- Buy puts

The covered call is one of the most conservative and least risky option strategies available. Before you sell the calls, you have to own the stock (i.e., you're "covered") in the event the stock gets called away from you. It's simple, and there's virtually no risk to the brokerage firm.

Buying calls and puts involves having cash in your account (which is how all options settle). You buy a call or a put, and you are limited to losing the amount of your investment and nothing more. Again, the brokerage firm is not assuming too much risk here.

However, depending on your account size, the brokerage firm and your past experience, you might not be approved (initially) to do anything else.

After all, the more advanced option account approvals involve selling "naked puts" or "naked calls" and doing more complex strategies like spreads.

There is also a higher margin requirement for something like selling naked puts. Since you're taking on an obligation to buy stock, the brokerage firm wants to cover their behind if you're out there selling 50 put contracts to buy a \$50 stock ... that's a \$250,000 obligation if you are suddenly forced to buy 5,000 shares of stock at \$50 each!

The broker will force you to have a certain amount in cash in your account so they can see that you'll make good in the event you have to fulfill your obligation.

Some of the best option brokerage firms are the options-specific brokers, which you can find online with a simple Google search. Try the search term, "option brokers," and you'll find plenty!

## Option Quotes

Your broker will have all the quotes you'll need to trade listed online. If you are an active trader, you will have all the free, real-time quotes you need.

The Chicago Board Options Exchange (CBOE) is another source for option quotes. You can go to their website at [CBOE.com](http://CBOE.com). They have a free 20-minute delayed screen, and for different

fee levels, you can get real-time quotes and even real-time streaming quotes.

Option quotes also are available at [OptionsClearing.com](http://OptionsClearing.com).

Now that you have a basic understanding of options, you can see how they can help you profit in any type of market. You're now ready to take your first steps to becoming an options trader.

Good luck trading.

A handwritten signature in black ink, appearing to read "Jon Najarian". The signature is stylized and cursive, with a large initial "J" and "N".

Jon "Doctor J" Najarian  
Editor, *ChangeWave Options Trader*

# Glossary of Options Terms

**Ask** – The price at which a seller is offering to sell an option or stock.

**At-the-Money** – an option is at-the-money if the strike price of the options equals the market price of the underlying security.

**Bear-Put Spread** – When you sell a lower strike put and then buy a higher strike put. This trade has limited profit, but also you limit your risk. A fall in the underlying stock price increases the value of the spread.

**Bid** – The price at which a market maker is willing to buy a security (buy it from you). Whenever a quote is obtained, the bid is always the smaller number (on the left-hand side).

**Bull-Call Spread** – When you buy a lower strike call and simultaneously sell a higher strike call. This trade has limited profit but also you limit your risk. A rise in the underlying stock price increases the value of the spread.

**Buy Write** (also see **Covered Call**) – Having a long position in an asset (stock), combined with a short position in a call option on the same underlying asset. The covered call option strategy is one of the most widely used by investors.

**Call Option** – In the financial world, a call option gives the option buyer the right, but not the obligation, to buy something (or to “call” it away from the owner) at a specified price over a specified period of time.

**Chicago Board Options Exchange (CBOE)** - The Chicago Board Options Exchange; the first national exchange to trade listed stock options.

**Covered Call** (also see **Buy Write**) – Having a long position in an asset (stock), combined with a short position in a call option on the same underlying asset. The covered call option strategy is one of the most widely used by investors.

**Expiration Date** - The day on which an option contract becomes void. The expiration date for listed stock options is the Saturday after the third Friday of the expiration month, so for all trading purposes it is the third Friday of each month.

**In-the-Money** – For a call option, when the option’s strike price is below the market price of the underlying stock. For a put option, when the strike price is above the market price of the underlying stock.

**Leverage** – In investments, the attainment of greater percentage profit and risk potential. A call holder has leverage with respect to a stock holder – the former will have greater percentage profits and losses than the latter, for the same movement in the underlying stock.

**Margin** – Borrowed money that is used to purchase securities. This practice is referred to as “buying on margin.”

**Margin Call** – A broker’s demand on an investor using margin to deposit additional money or securities so that the margin account is brought up to the minimum maintenance margin. This is sometimes called a “fed call.”

**Option** – A security sold by one party to another that offers the buyer the right, but not the obligation, to buy (call) or sell (put) a security at an agreed-upon price during a certain period of time

on or before a specific date.

**Options Clearing Corporation (OCC)** – The issuer of all listed option contracts that are trading on the national option exchanges.

**Options Contract** – Denotes the deliverable quantity of goods – options are traded in contract units. Each option contract represents 100 shares of the underlying stock. Hence, it's necessary to multiply any option premium quote by 100 to get the true cost to the option buyer (or seller). An option quoted for \$2.50, really costs \$250 for each contract.

**Out-of-the-Money** – For a call, when an options's strike price is higher than the market price of the underlying stock. For a put, when the strike price is below the market price of the underlying stock.

**Premium** – The total cost of an option. The premium of an option is basically the sum of the option's intrinsic and extrinsic (time) value.

**Profit Maximizer** – An advanced strategy for ChangeWave Inner Circle members intended to turbo-charge your profits from a *ChangeWave Investing* recommendation.

**Put Option** – A “put” option, in the financial world, gives the option buyer the right, but not the obligation, to SELL a stock (or “put” it to someone else) at a specified price, over a specified period of time.

**Strike Price** – The stated price per share for which an underlying stock may be purchased (for a call) or sold for a (put) by the option holder upon exercise of the option contract.

**Time (Extrinsic Value)** – The difference between an option's price and the intrinsic value. Also known as “time” value. Extrinsic value is made up of several important variables: the number of days left until expiration, volatility, prevailing interest rates and dividends.

**Trailing Stop** – A stop-loss order that is set at a percentage level below (for a long position) the market price. The price is adjusted as the price fluctuates (it is not adjusted downward).

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

**Volume** – The number of shares or contract that is traded in any given period of time within a security or an entire market.

**Wasting Asset** – An asset that declines in value over time. An option is an example because it is only valuable until expiration, after that it becomes worthless.

# Worksheet

## Fill in the blanks

1. An option contract controls \_\_\_\_\_ shares.
2. A \_\_\_\_\_ option gives the buyer a right but not the obligation to buy a stock at a specified price during a specified time period.
3. A \_\_\_\_\_ option gives you the right but not the obligation to sell a stock at a specified price during a specified period of time.
4. A Call option is in-the-money when the strike price is \_\_\_\_\_ the market price of the underlying stock.
5. An option is at-the-money when the strike price is \_\_\_\_\_ to the market price of the underlying security.
6. A put is out-of-the-money when the strike price is \_\_\_\_\_ the market price of the underlying stock.
7. A \_\_\_\_\_ \_\_\_\_\_ is good to use when you want to offset the cost of expensive volatile options.
8. The \_\_\_\_\_ \_\_\_\_\_ is the price that the underlying stock may be purchased or sold by the option holder.

## T/F

1. An option expires on the last day of the month.
2. An option has more time value the further away it is from expiration.
3. A Bull-Call spread is always played in a 1-to-1 ration.
4. You would be in-the-money if your stock is trading for \$21 per share and you have the \$25 call option.
5. A Bear-put spread is used when you believe the market will decline.
6. When you sell an options it's sold at the ask price?
7. Writing options on stocks you already own is called a Covered Call?
8. With options you can profit in any market condition at a fraction of the cost of buying stocks.

## Answer

### Fill in the blank

1. 100
2. Call
3. Put
4. Below
5. Equal
6. Below
7. Bear-Put Spread. By purchasing the higher strike price and selling another put with a lower strike price, you help offset some of the costs. Remember, both puts must have the same expiration date.
8. Strike Price

### True/False

1. False. For trading purposes an option contract expires on the third Friday of the month.
2. True.
3. True
4. False. If the stock is trading for \$21 per share, your call option gives you the right to buy the stock at \$25 per share. Since the stock is trading at a lower price, you are out-of-the-money.
5. True
6. False. It will be sold at the bid price which is lower than the ask price.
7. True. The Covered Call is one of the most used options strategies.
8. True