RULES FOR OPTIONS
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1. Long = Buy = Hold → choice ("may") → $ out / **-** / DB

   Short = Sell = Write → obligation ("must") → $ in / **+** / CB

2. Four basic option positions

B/S OPTION		B/S STOCK
↑ LC = Long Call	⟩	(*may* buy stock)
↓ SC = Short Call	⟋	(*must* sell stock)
↓ LP = Long Put	⟩	(*may* sell stock)
↑ SP = Short Put	⟋	(*must* buy stock)

3. "You CALL UP someone to PUT him DOWN"
   [Use proverb when setting up LONG position]

4. Side of the Market: Either both UP or both DOWN
   If bullish or "worried about" markets going up (↑): LC or SP
   If bearish or "worried about" markets going down (↓): SC or LP

5. When long an option, you need volatility to make option profitable
   When short an option, you need stability to make option profitable

6. Spreads: WED/NUC
   <u>D</u>ebit spreads must <u>w</u>iden and be <u>e</u>xercised to be profitable ["When Debbie widens, she should exercise"]
   <u>C</u>redit spreads must <u>n</u>arrow and remain <u>u</u>nexercised to be profitable ["Credit crunch']

7. Straddles:

↑	↓
LOSS	**GAIN**
↓	↑
"Long LOSS between"	"<u>S</u>hort <u>S</u>traddle <u>S</u>tability"

8. Max Loss when buying (long) an option = Premium
   Max Gain when selling (short) an option = Premium

9. If seeking protection by hedging against
   markets going down when you own the stock: SC or LP
   markets going up when you sell the stock: LC or SP

<u>e.g.</u> You bought stock (LStock). To protect yourself against a drop in market value, you write a call (SC). ➔ LStock + SC = Covered Call (a.k.a. Hedge)	<u>e.g.</u> You could also do the following combinations: • LStock + LP • SStock + LC • SStock + SP ➔ A Hedge *always* includes a stock and an option

10. Least aggressive strategy = Covered Call Writing
    Most aggressive strategy = Uncovered Call Writing

11. Intrinsic Value = option is in-the-money [ignore premium!]
    • Call: Market Value > Strike Price
    • Put: Market Value < Strike Price

12. Options can never be bought <u>on</u> margin; but they may be bought <u>in</u> a margin account.

13. OCC = "God"

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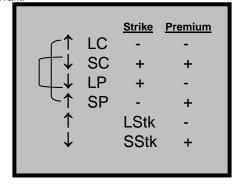1534 South Edris Drive * Los Angeles, CA 90035 * (310) 286-9161 * FAX (310) 557-1626 * e-mail: mhaven@pobox.com

Solving Options Problems

A. Convert all word problems to short-hand:

- "Long" or "Short"? ➔ L or S
- "Call" or "Put" or "Stock"? ➔ C or P or STK
- Strike Price?
- Premium or Stock Price?

The result should look like: LC 40 @ 2 or…SP 60 @ 5 or…LStk @ 73
REMEMBER: Market price in an <u>option</u> problem is always irrelevant!

B. Insert "+" or "-"
"+" for money IN or received
"-" for money OUT or spent

		Strike	Premium
↑	LC	-	-
↓	SC	+	+
↓	LP	+	-
↑	SP	-	+
↑	LStk	-	
↓	SStk	+	

C. Then decide which method to use:
- Use +/- game® if looking for "Maximum Gain", "Maximum Loss" or "Breakeven" [see D below]
- Use T-Chart (+/- Chart) for *all* other problems [see E below]

D. Five Steps to Happiness® (a.k.a. +/- game®)

Step	Options Only (Basic, Spreads, or Straddles)	Hedges (Stock + Option)
1	Identify position as Basic, Spread or Straddle	Identify option as either Call or Put
2	Assign "+" and "-"	Assign "+" and "-"
3	Add premiums ➔ If sum is positive, then **Max. Gain (MG)** ➔ If sum is negative, then **Max. Loss (ML)**	Add <u>Stock</u> Price and Premium ➔ Sum is **Breakeven**
4	Add Strike Price to Subtotal from Step # 3 • If SPREAD, use Strike from option with highest Premium (="favorite" option) ➔ Sum is **Breakeven** • If STRADDLE, add Strike from each position separately to Step # 3 Subtotal ➔ Sums will be <u>two</u> **Breakevens**	If PUT, skip to Step # 5 If CALL, Step # 3 Subtotal will also be: ➔ If sum is positive, then **Max. Gain** ➔ If sum is negative, then **Max. Loss** Then add Strike Price to Step # 3 Subtotal to obtain <u>other</u> **MG** or **ML** ➔ If sum is positive, then **Max. Gain** ➔ If sum is negative, then **Max. Loss**
5	Add Unused Strike Price to Subtotal from Step # 4 (make sure to add both Premiums and both Strike Price into one grand total) ➔ If sum is positive, then **Max. Gain** ➔ If sum is negative, then **Max. Loss** ➔ If result conflicts with (**MG** or **ML**) from Step # 3, then answer is "unlimited"	If PUT, add Strike Price to Step # 3 Subtotal ➔ If sum is positive, then **Max. Gain** ➔ If sum is negative, then **Max. Loss** Remaining unsolved **MG** or **ML** is "unlimited"

E. T-Chart Problems:
- Buy/Sell (**Trade or Close Out**) OPTION @ **Premium**
- To "close out" a position means to do the opposite of the original transaction and so premium is entered into the opposite column of the T-chart (i.e. if you started by being "in" money, then you close by being "out" money)
- Buy/Sell (**Exercise**) STOCK @ **Strike or Exercise Price**

F. "Offset" problems:
The answer will be one of the 2 Strike Prices given:
- If "above", select higher Strike
- If "below", select lower Strike

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