Option Basics: It all started with tulips

Options and futures have been around for a long time. Some say they were in use as a financial product as far back as ancient Egypt, although well-documented evidence of their use dates back to the tulip mania in Holland in the 17th century.

Tulip Mania

The incredible story of *tulip mania* started shortly after 1590, when this gorgeous and gentle flower was first imported to Holland from Turkey. Within a decade, it became the object of intense speculative frenzy. During the build-up of the tulip market in Europe, the demand for varieties of tulips vastly exceeded the supply, and prices for individual bulbs began to rise to unwarranted heights.

Futures markets developed, called the "windhandel" or "wind trading". The most amazing sale in the futures market for tulips saw a contract sold for as much as $25,000 CDN (in the 17th century dollars). When the speculation crashed to a halt in 1637, it took the Dutch economy many years to get over the side effects.

What is an option?

There is a language that is unique to the options market. Although some terms may already be familiar to you, to fully understand and use options, you must be familiar with the proper terminology and be able to use these terms in discussing potential strategies with your investment advisor.

An option itself does not represent a tangible, physical thing in the same way a stock or bond represents ownership or money owing. An option is really just a contract or agreement between two parties – a buyer and a seller. This contract clearly specifies all the agreement's details, including what the contract is based on and how long it is to be in force. You can buy and sell these contracts just as you can buy and sell other securities.

More importantly, options can add choice and dimension to your portfolio. By purchasing an option, you can achieve a high degree of exposure with a limited and known risk level. Selling options when you own the underlying security can improve its income potential. And options also provide flexibility. By mixing and matching various options positions, you can create a vast number of strategies, to take advantage of pricing anomalies or to generate a position that reflects a complicated and personal view of the market.

As mentioned earlier, an option is an agreement between two parties, the buyer and the seller. The buyer pays a fee or premium to the seller to purchase the right to buy or sell a specific underlying security or interest, and can be any one of a variety of things. There are options based on equities, indexes, bonds, actual interest rates, currencies and precious metals.

Options have a limited lifespan, called the time to expiry, which can be anywhere from one day to three years. The greater the option contract's lifespan, the greater the premium or value of the option.

Options give you options

As the word option connotes, an option is about choice. It offers opportunities to the average investor that were never available before.

Say you believe the markets are overpriced and there may be a sell-off. With options, you can sell the market as represented by an index in one transaction, that is, by purchasing an index put in a dollar amount suitable to your own circumstances. Or, maybe you think the Japanese yen is going to stage a rally. Want to participate? It's as easy as buying a call on the yen. Do interest rates look like they are destined to rise? Buy puts on bonds. Now you can take advantage of your opinion to either protect your assets or to gain from your unique insights and trade an option product that will reflect your opinion.

There are two types of options: puts and calls. The put option allows the holder to sell the underlying interest, while the call option allows the holder to buy the underlying interest, either at expiration or at any time prior to the contract's expiration.

If an optionholder decides to exercise the right to buy or sell the underlying interest or security, the transaction would be done at the price specified in the contract. This price is called the strike or exercise price.

Call buyer

The call buyer pays a premium for the right to buy the underlying security at the strike price any time up until expiration of the option. The call buyer is bullish or is anticipating a rise in the price of the underlying security and will profit if the price of the stock rises. The maximum profit is theoretically unlimited, as it is possible that the stock could rise to infinity. The risk for the call buyer is limited only to the price paid for the call itself; that is, the premium.

Call writer

The naked call writer gets a premium to take on the obligation to sell the underlying security at the strike price any time up until expiration of the option. Call writers are neutral to bearish: they want to see the underlying security's price fall in value or at least stay the same.

The call writer has a maximum profit potential of the premium and, like a short seller of stock, has unlimited risk. The stock can theoretically rise in value to infinity, and the writer could be required to purchase the stock at this inflated price, only to have to sell it at the strike price. Risk can be large and profits small.

Put buyer

A put buyer obtains rights for premiums paid. A put buyer has the right to sell the underlying security at any time until the expiration day at the strike price stipulated in the contract. Put buyers are bearish on the outlook for the underlying security and want to profit from decreasing market values.

Put writer

The put seller or writer, on the other hand, takes on the obligation to buy the underlying security at the strike price until expiry and gets a premium for the trouble. This obligation can be enforced at any time up until the option's expiration.

Put sellers are usually considered bullish to neutral, as they will profit if the underlying security stays above the strike or exercise price. The maximum profit that the put writer can make is the premium received from the sale of the put, and this maximum profit will be made if the put itself has little or no market value on the expiration day.

Rights and Obligations

	Holder or Buyer	**Seller or Writer**
CALL	Pays premium Right to BUY Unlimited profit potential Limited risk	Receives premium Obligation to SELL Limited profit potential Unlimited risk potential (if uncovered writer)
PUT	Pays premium Right to SELL Limited risk Limited profit	Receives premium Obligation to BUY Limited profit potential Limited but substantial risk

And as a word of caution, put writing is an aggressive strategy that may be quite profitable for an investor during buoyant markets, but should only be attempted if you can pay for the stock position that you might be obligated to buy. Keep in mind that there is no upper limit on the price of a stock. The dollar amount of the premium can sometimes entice investors into taking on more risk than they can afford. This is one of the common dangers of investing in options.

As you probably have concluded by now, there's much to learn about options. Yet, we've barely touched the surface. And while the tulip mania of the 17th century Holland is not very likely to happen again, at least not in such proportions as to affect an entire economy, surely you have heard of an occasional rogue trader in options or futures that has managed to bring down an entire financial empire, or two! Caution is the word then. While more and more investors these days are taking direct control of their investments, options are one area where it pays to proceed cautiously and seek out expert advice. Choosing an investment advisor, who is registered to trade options, knowledgeable and helpful, is a great place to start.