

>: 5 Ways to Capitalize on Options

Tuesday, June 9, 2009 | Chris Rowe

I hate to repeat myself, but Chris Rowe is a real financial genius when it comes to options, and since you're looking for a good article to read, I want to deliver first-class goods. I selected this one, which was originally published on September 13, 2007 under the title "No, Seriously - Profit from Options."

But I have to repeat what I said last week, because it's that important ...

You should absolutely use options instead of stock in so many cases. Please do me a favor, because I really want to know where our readers are coming from (because it will help me help you). Please leave a message below this article telling me what your fears are about using options, and also tell me what, if anything, has made you WANT to use options. Elaborate if you like ...

Here's why I'm repeating myself:

You will reduce your risk if you take your 500 shares of ABC stock, sell them, and then buy five ABC call options that are a few strike prices in-the-money. (I'll explain which expiration date the call options should have in a minute - it's important.)

Example:

If ABC is at \$60.00/ share, and you pull up the option chain and look at the 2009 January calls, you might see these call options available:

2009 January 60 calls trading at \$9.00 (These are at-the-money)
2009 January 55 calls trading at \$12.00 (These are one strike price in-the-money)
2009 January 50 calls trading at \$15.00 (These are two strike prices in-the-money)
2009 January 45 calls trading at \$18.50 (These are three strike prices in-the-money)

I'm saying that it makes more sense, instead of buying **500 shares** of ABC stock **at \$60.00** (for \$30,000.00), to buy **five** of the 2009 January 45 calls **at \$18.50** (for \$9,250.00). THEN, put the remaining \$20,750.00 in a money market account and earn 5%.

Take my word for this, and learn more about it if you like by reading my old articles, but in this case, the *intrinsic value* of the option is \$15.00 (because the stock price of \$60.00 minus the strike price of \$45.00 = \$15.00) and the *extrinsic value* of the call option is the remaining \$3.50 (because the call costs \$18.50 minus \$15.00 intrinsic value = \$3.50). That means that over the life of the call option (especially in the last few months leading up to the January 2009 expiration), that \$3.50 extrinsic value (*aka* "time value") deteriorates. That means that if your ABC stock trades flat at \$60.00 for the next 16 months, the option would lose \$3.50 and move to \$15.00.

Keep in mind that the \$3.50 loss (assuming that you actually held on for the next 16 months) is a loss of \$1,750.00. But since you put the rest in a risk-free money market account, you earned \$1,383.33 interest. So the loss is reduced to \$366.67. (And that would equate to 73 cents of the call option instead of \$3.50.)

Now - what are you getting in return for your willingness to lose 73 cents over the course of 16 months on a \$60.00 stock (which really only equates to 1.21%?)

#1) You know that your absolute MAXIMUM downside risk is the \$18.50 (or \$9,250.00) that you invested in the call option, instead of the \$60.00 (or \$30,000.00) on the stock which likely wouldn't lose all of its value, but as we know, a loss of anything between one cent and \$30,000.00 is possible.

There are many benefits here that one wouldn't consider at first. One of them is the psychological benefit. I mean, you would be a lot less worried about the stock market crashing, for one. That would allow you to feel more confident when buying when people are fearful. That means that you would be buying when things are down.

(Also, remember that you should usually play both sides of the market. So you can also buy in-the-money put options to bet on the downside. That means if the stock is at \$60.00, and you were betting that it would trade lower, you would buy the 2009 January 75 puts.)

#2) If your stock moves higher, you are making *almost* the same amount that you would have made on the stock.

#3) If your stock moves lower, you are probably going to lose *much* less than you would have on the stock. (A very basic hypothetical example is that if the stock trades up 10 points, you will probably make 9 - 9.5 points, but if the stock trades down 10 points, you will probably lose about 7