What Investors Should Know About Options

Understand the potential risks before investing.

By **Dawn Reiss**, Contributor Sept. 15, 2016, at 9:32 a.m.

Should you steer clear of options? (ISTOCKPHOTO)

OPTIONS: MOST financial experts either love them or hate them.

"Many certified financial planners would not touch options with a 15-foot pole," says Barbara Kay, who coaches financial experts around the country via her certified woman business enterprise in Wheaton, Illinois.

Geared toward the sophisticated investor, these complex securities can be extremely risky but offer investors the ability to speculate. Expert advisors typically recommend only investing with a small percentage of money that you can afford to lose – known as risk capital – since this type of investing carries a high risk of loss. Many companies use options to hedge against certain risks, like an insurance policy against market fluctuations or when an investor has a large concentration of company stock options.

What are options? They are contracts that give the holder the right to buy or sell a security at a particular price for a certain period of time. Typically, one contract equals a 100 shares of stock.

A call option gives the investor the right to buy, while a put option the right to sell. The strike price is the contractual price at which the holder may buy or sell, coupled with an expiration date, the last possible date that an investor may exercise their right to do so.

[See: 7 Pharma Stocks and the Prognosis for Profits.]

How do call and put options work? One approach is when buyers of "calls" are hoping the stock will increase in price before the option expires, while buyers of "puts" hope the stock will fall in price before the option expires.

Alternatively, there are hedging strategies. Investors must decide what they hope to accomplish with options, says Rasheed Hammouda, who co-founded Bridge, a Chicago-based FinTech startup.

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For example, consider Amazon.com (ticker: AMZN), priced at $760.14 per share, with a call option strike price of $780 and an expiration date of Dec. 31. "The seller of the option has the obligation to sell me those shares at my discretion at the strike price of $780," Hammouda says. "Let's say in October, the price of Amazon goes up to $800 per share, I can now exercise the option to buy 100 shares of Amazon at $780 for a total of $78,000 even though those shares are worth $80,000 at their current market value."

The reverse is true for a put option, which increases in value as the asset falls in value. "For example, someone can buy a put option that gives them the right to sell 100 shares of Apple (APPL) stock for $100 per share at the expiration of the option," says Robert Johnson, president and CEO of The American College of Financial Services in Bryn Mawr, Pennsylvania. "That right only has value if Apple is selling for less than $100 per share. And, the lower Apple falls in value, the greater the value of a put option."

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Cautionary advice. Like many financial experts, Erik Kroll, a certified financial planner with Milwaukee's Hilltop Financial Advisors, says options aren't necessarily bad, they just don't have a place in most portfolios and should typically be avoided, especially if an investor has a well-diversified portfolio that covers much of the market.

One of the biggest downsides is that investors don't own anything except a bet on what the price will do. "Once an option expires, if you were on the wrong side of the bet, you lost all your money and you own nothing," says Kroll, and that comes with extra costs and can diminish returns.

One of the few exceptions, Kroll says is when an investor has concentrated positions and owns too much in particular stock in a singular company via a company stock compensation plan. In that instance, using options to hedge can temporarily protect against the downside, Kroll says.

Either way, experts say it's best to consult a fiduciary advisor to see if it makes sense for your investing strategy.

[See: 7 of the Best Socially Responsible Funds.]

Naked calls. Certain types of options trading can be particularly risky. While the purchaser of an option can only lose the premium, thus creating a limited amount of liability, the seller of an option has significantly more risk.

That's the case when an investor sells a call option on a security without owning it, also known as a naked call option. "You have unlimited risk since the stock has unlimited upside," says Martha "Marti" Awad, a founding partner and CFP at Cardan Capital Partners in Denver. "This is the riskiest of all stock option trading."

Conversely, when an investor sells a covered call option, a stock that is already owned, the only risk is losing the upside potential, Awad says, while the seller of a *put* option is at risk for the entire amount of the strike price if the underlying stock were to lose all value.

"The bottom line is that your liability is limited if you buy an option and not if you sell an option," Johnson says.

Why some investors use options. While options are extremely volatile and not for most people, they can be extremely useful for investors who want to hedge against potential losses in the stock market. For example, if someone has a diversified stock portfolio and is concerned about a dramatic fall in stock indices, they may want to buy put options on the Standard & Poor's 500 index to protect their gains, Johnson says.

If an investor is bullish on a stock in the short run, buying an option allows that investor to capture a much larger gain for a given investment, Johnson says.

Other things to consider. Investors may want to avoid predictable high volatility events, such as earnings releases or Food and Drug Administration announcements, says Mike Scanlin, CEO of Born to Sell, a Las Vegas website that focuses on option investing. Scanlin suggests avoiding short-term options, since investors don't have much time to be right about the directional move in the underlying stock. "If your option expires in 10 days then you only have 10 days for it to move the way you want," he says.

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Instead, he says investors are better off buying options that are three months or longer in duration since options lose value as time passes. He also recommends selling options to other investors via covered calls rather than buying. "And then sell a call option against those shares so that you can get monthly income every month," he says.

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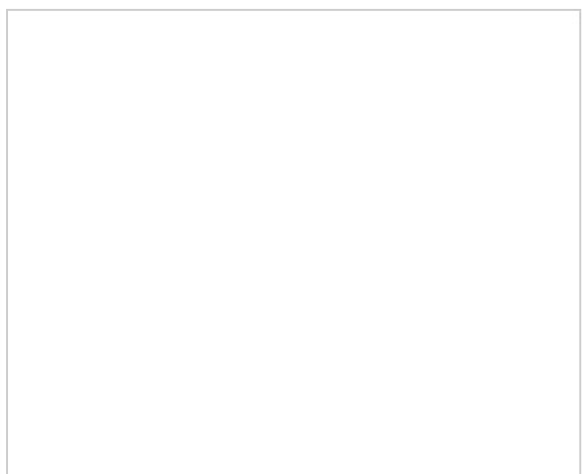

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