

The Option Advantage: Why You Should Be Paying Attention!

“Veteran Options Market Maker and Floor Trader Reveals Four Important Advantages of the Market’s Biggest Secret...”

(HINT: There is a Sleeping Giant About to Awaken... Read Below to Discover Why...)

By Ron Ianieri

Options trading has been around long enough to beg the question, “Why is it getting so much buzz now?” Well, consider this...

Mad Money’s Jim Cramer recently exclaimed that options trading is the hottest, fastest growing segment of the market. Barrons recently shed light on an increasing number of baby boomers moving to options trading as a way to gain additional income on their sagging retirement portfolios. A major online brokerage firm just polled its clients about which investment topics they would most like to learn about... Options trading was the number one answer drawing in a whopping 62% of the responses.

“After 30 years in existence, options are finally getting the attention they deserve!”

Those of us who understand options trading have long wondered why more people do not use options. Several reasons come to mind. Due to their sophisticated nature, many investors have avoided options trading because of their perceived stigma of it being too difficult to understand. Investors have had bad initial experiences because inadequate training on their use.

Finally, monikers such as ‘risky’ or ‘dangerous’ are synonymous with options trading thanks to the media and market leaders. Investors must take into consideration that these leaders might be in the limelight, but they are not necessarily ‘in the know’ as it pertains to options trading. Options actually have significant value to the individual investor. They provide increased cost efficiency, are less risky, give higher percentage returns and offer more strategic alternatives.

Let’s take a closer look at each of these 4 primary advantages of using options.

Advantage #1 - Cost Efficiency

Options have great leveraging power. An investor can obtain an options trading position that will mimic a stock position almost identically but at huge cost savings. For instance, in order to purchase 200 shares of an \$80 stock, an investor must pay out \$16,000. If the investor purchases two \$20 calls, the total outlay is only \$4,000. The investor then has an additional \$12,000 to use at his or her discretion. Obviously, it is not quite that simple.

The investor has to pick the proper call to purchase in order to mimic the stock position properly. Still, this stock replacement strategy is extremely viable and cost efficient. In addition, The Nasdaq recently petitioned the SEC to allow options to trade in pennies instead of nickels – ***a move which is extremely beneficial for individual investors.***

Advantage #2 - Less Risk

With less money invested, *there is less risk involved.* This makes options trading less risky than stock trading. Options are also less risky because they are impervious to the potential catastrophic effects of gap openings.

Options are the most dependable form of hedge and are safer than stocks in many instances. When an investor purchases stock, they frequently place a stop loss order to protect the position. The stop order “stops” losses below a prefixed price as determined by the investor. The problem is the essence of the order itself. A stop order occurs when the stock trades at or below the limit as indicated in the order.

Let's say you own a stock at \$50 and you do not wish to lose anything more than 10% of your investment. You will place a \$45 stop order. This order will become a market order to sell once the stock trades at or below \$45. This order works during the day, but may have problems at night. You go to bed with the stock having closed at \$51. The next morning, when you wake up and turn on CNBC, you hear that there is breaking news on your stock.

It seems that the CEO of the company has been lying about the earnings reports for quite some time. There are rumors of embezzlement. They expect the stock to open down around \$20 making \$20 the first trade below your stop order's \$45 limit price. When the stock opens, you sell at \$20 locking in a significant loss. The stop loss order was not there for you when you needed it most!

However, if you purchased a put option for protection, you would not have suffered this catastrophic loss. Unlike stop-loss orders, options do not shut down when the market closes. They give you insurance 24 hours a day, seven days a week. ***This is something that stop orders cannot do... This is why I, and many others, consider options the one and only perfect form of hedge.***

Advantage #3 - Higher Percentage Returns

Furthermore, as an alternative to purchasing the stock, you could have employed a stock replacement strategy where you purchase an in-the-money call instead of purchasing the stock. There are options that will mimic up to 85 percent of a stock's performance, but cost one-quarter the price. If you purchased the \$45 strike call instead of the stock, your loss would be limited to what you spent on the option. If you paid \$6 for the option, you would have lost only that \$6. Not the \$31 you would have lost if you owned the stock.

You do not need a calculator to know that if you spend much less money and make almost the same profit that you have a higher percentage return. *Options trading normally offers investors a much higher percentage return.*

For example, using the scenario from above, let us compare the percentage returns of the stock (purchased for \$50) and the option (purchased at \$6). Let's also say that the option has a delta of 80, meaning that the option's price will change 80% of the stock's price change. If the stock were to go up \$5, your stock position would provide a 10% return. Your option position would gain 80% of the stock movement (due to its 80 deltas) or \$4. A \$4 gain on a \$6 investment works out to be a 67% return - far superior to the 10% return on the stock.

More Strategic Alternatives

The final major advantage of options trading is that of increased investment alternatives. Options are an incredibly flexible tool. There are many ways to use options to recreate other positions. We call these positions synthetics, which give multiple ways of attaining the same investment goals. While synthetic positions are an advanced option topic, there are many other examples of how options offer strategic alternatives.

Many investors use a broker that charges a margin when they want to short a stock. This margin requirement is sometimes cost prohibitive when shorting stock. Some investors are involved with brokers that do not allow for the shorting of stocks by rule. No brokers have any rules against investors purchasing puts to play the downside. The inability to play the downside when needed virtually handcuffs investors and forces them into a one-dimensional world while the market trades in 3D.

Options trading allows the investor to trade both the passage of time and movements in volatility - not just stock movements. Most stocks do not have large moves most of the time. Only a few stocks actually move significantly and then not too often. An investor's ability to take advantage of stagnation could turn out to be the deciding factor in whether or not your financial goals are attainable. Only options offer the strategic alternatives necessary to profit in every type of market.

Thanks to online brokerages, coupled with very low commission costs, retail investors now have the ability to use the most powerful tool in the investment industry just like the professionals do. Options! It is the dawn of a new era for individual investors and traders. Don't be a dinosaur! Now it's time to dedicate some time for learning how you can use options properly in your trading.

Ron Ianieri enjoyed 14 years of experience as a floor trader on the Philadelphia Stock Exchange, including four years as the lead market maker in DELL computer options – one of the busiest books in history. He is currently chief options strategist and co-founder of The Options University, an options trading educational company that teaches investors how to make consistent profits using options while limiting risk.