

US EQUITY OPTIONS: FLEXIBLE AND VERSATILE INVESTMENT TOOLS



Introduction

Options are not a new concept and their use can be traced back to antiquity.

More recently, in the US in the 1970s, equity option exchanges were established. In contrast to earlier trading models, a clearing house, OCC, was interposed between buyers and sellers, enabling better risk management and offering option users confidence in the continuity of the market should any buyer or seller default.

Today there are 12 US equity option exchanges, all clearing their trades via OCC. In 2013 4.1 billion contracts were traded across the 12 exchanges.

The Role of Education

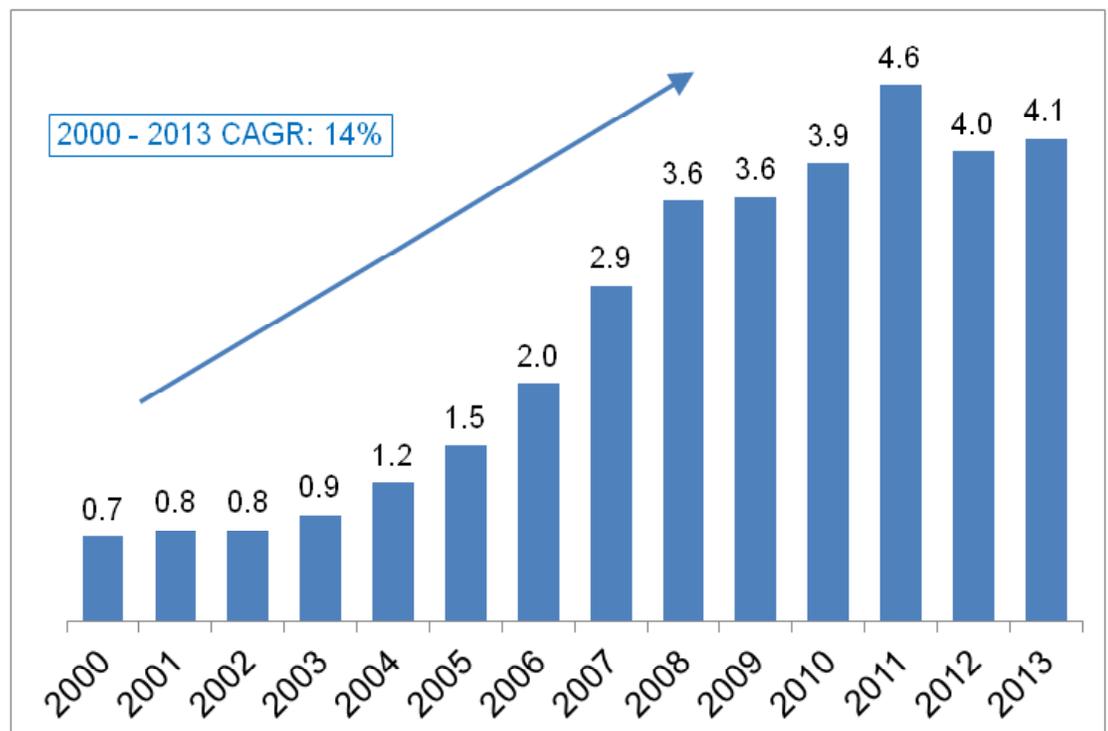
Educated investors tend to be more successful.

The Options Industry Council (OIC) is an industry cooperative, which was established by clearing house OCC and the US equity option exchanges in 1992.

Its mission is to increase the awareness, knowledge and responsible use of exchange-listed equity options among a global audience of investors, including individuals, financial advisors

Annual US equity options trading volume 2000 - 2013 (billions of contracts)

Source: OCC



and institutional managers by providing independent, unbiased education and practical knowledge.

As well as maintaining and developing website www.OptionsEducation.org, which is full of entirely free information on responsible option usage, OIC also commissions studies from independent research companies. One such company is Tabb Group and you can download – *free of charge* – their most recent study on the European usage of US equity options at:

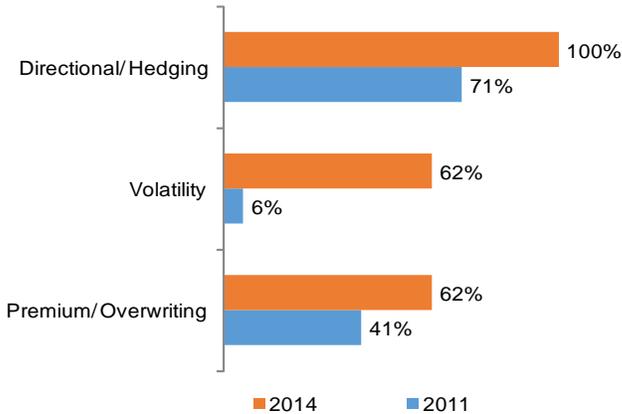
http://www.optionseducation.org/documents/literature/files/tabb_european_2014.pdf.

European customers account for an estimated 9% of total volume. One of the many interesting findings in this report, published in March 2014, is concerning the type of option strategies European investors are employing (*see diagram on following page*). The figures refer to percentage of total interviewees at some time using the strategy specified.

CONTINUED ON PAGE 5

US EQUITY OPTIONS: FLEXIBLE AND VERSATILE INVESTMENT TOOLS

US equity option strategies used by European investors



Source: Tabb Group interviews

What is interesting is the significant increase in the usage of each strategy, as European investors have become more sophisticated since the last study in 2011. Space is limited in this article, but below we discuss some of the more popular option strategies, which are only a selection of possible strategies that financial advisors can use on behalf of their customers. These strategies are strictly for illustrative and educational purposes and are not to be construed as an endorsement, recommendation or solicitation to buy or sell securities.

Protective Put

This strategy consists of adding a long put position to a long stock position. The protective put establishes a 'floor' price under which the investor's stock value cannot fall.

If the stock keeps rising, the investor benefits from the upside gains. Yet no matter how low the stock might fall, the investor can exercise the put to sell the stock at the strike price.

The time horizon is limited to the life of the option.

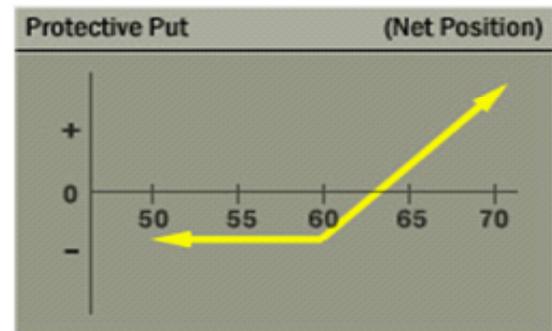
The choice of strike prices determines where the downside protection 'kicks in'. If the stock stays strong, the investor still gets the benefit of upside gains. If the stock falls below the strike, the investor has the benefit of several choices.

- Exercise the put, enabling the stock to be sold at the strike price of the option. The strike price sets the minimum exit price.
- If the investor remains nervous, the put can be held until expiration to extend the protection for as long as possible.

Then it either expires worthless or, if it is sufficiently in-the-money, is exercised and the stock sold.

- If the investor judges that the worst seems to be over, an alternative for still-bullish investors is to keep the stock and sell the put. The sale should recoup some of the original premium paid for the option.

The put can provide protection against a downturn during the life of the option. The major drawback of the strategy is its cost, but this can be addressed to some extent by the selection of the option's strike price.



Net Position (at expiration)

EXAMPLE

Long 100 shares XYZ stock
Long 1 XYZ 60 put

MAXIMUM GAIN

Unlimited

MAXIMUM LOSS

Stock purchase price less strike price less premium paid

For more information, readers are referred to http://www.optionseducation.org/content/oic/en/strategies_advanced_concepts/strategies/protective_put.html

Covered Call

This strategy consists of selling a call that is covered by an equivalent long stock position. It provides a small hedge on the stock and allows an investor to earn premium income, in return for forfeiting much of the stock's upside potential by writing the call.

An investor who buys or owns stock and writes call options in the equivalent amount can earn premium income without taking on additional risk. The premium received adds to the

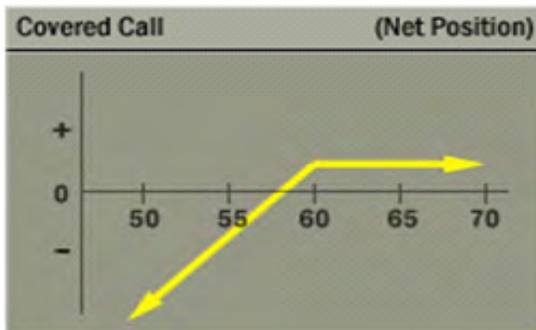
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investor's bottom line regardless of outcome. It offers a small downside 'cushion' in the event the stock price falls.

This benefit comes at a cost. For as long as the short call position is open, the investor forfeits much of the stock's profit potential. If the stock price rallies above the call's strike price, the stock is increasingly likely to be called away (i.e. sold) when the call option is exercised. Since the possibility of the option being exercised is central to this strategy, it makes more sense for investors who view this as a positive outcome.

The investor doesn't have to sell an at-the-money call. Choosing between strike prices simply involves a trade-off between priorities. The covered call writer could select a higher, out-of-the-money strike price and preserve more of the stock's upside potential for the duration of the strategy. However, the further out-of-the-money call would generate less premium income, which means there would be a smaller downside cushion in case of a stock decline.

An investor holding stock who would regret losing the stock during a rally should think carefully before writing a covered call. The only sure way to avoid assignment is to close out the position. It requires vigilance, quick action, and might cost extra to buy the call back especially if the stock is climbing fast.



Net Position (at expiration)

EXAMPLE

Long 100 shares XYZ stock
Short 1 XYZ 60 call

MAXIMUM GAIN

Strike price less stock purchase price plus premium received

MAXIMUM LOSS

Stock purchase price less premium received (can be substantial)

For more information, readers are referred to http://www.optionseducation.org/strategies_advanced_concepts/strategies/covered_call.html

Collar

An investor writes a call option and buys a put option with the same expiration as a means to hedge a long position in the underlying stock. This strategy combines two other hedging strategies: protective puts and covered call writing (*see above*).

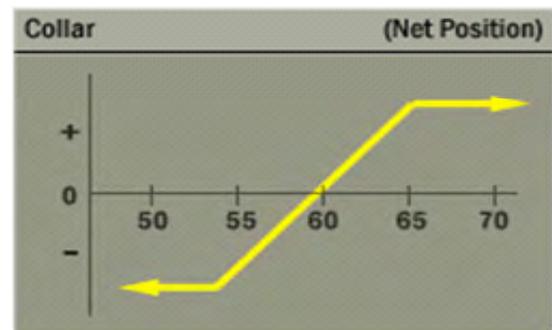
Usually, the investor will select a call strike above and a long put strike below the starting stock price. There is latitude, but the strike choices will affect the cost of the hedge as well as the protection it provides. These strikes are referred to as the 'floor' and the 'ceiling' of the position, and the stock is 'collared' between the two strikes.

The put strike establishes a minimum exit price, should the investor need to liquidate in a downturn.

The call strike sets an upper limit on stock gains. The investor should be prepared to relinquish the shares if the stock rallies above the call strike.

In return for accepting a cap on the stock's upside potential, the investor receives a minimum price where the stock can be sold during the life of the collar.

This strategy is for holders or buyers of a stock who are concerned about a correction and wish to hedge the long stock position.



Net Position (at expiration)

EXAMPLE

Long 100 shares XYZ stock
Short 1 XYZ 65 call
Long 1 XYZ 55 put

MAXIMUM GAIN

Call strike less stock purchase price less net premium paid

OR

Call strike less stock purchase price plus net credit received

US EQUITY OPTIONS: FLEXIBLE AND VERSATILE INVESTMENT TOOLS

MAXIMUM LOSS

Stock purchase price less put strike less net premium paid

OR

Stock purchase price less put strike plus net credit received

For more information, readers are referred to http://www.optionseducation.org/strategies_advanced_concepts/strategies/collar.html

OIC has also commissioned more detailed studies on the collar strategy. Go to www.OptionsEducation.org and search by 'collar strategy'. There are two articles of interest: 'Loosening your collar' and 'Options-based risk management in a multi-asset world'.

Disclaimer

Options involve risk and are not suitable for everyone. Prior to buying or selling an option, a person must receive a copy of Characteristics and Risks of Standardized Options. These may be obtained from your broker, one of the exchanges or OCC, One North Wacker Drive, Suite 500, Chicago, IL 60606, call +1 312 463 6193 or visit www.OptionsEducation.org.

For the sake of simplicity, any examples used do not take into consideration commissions and other transaction fees, tax considerations, or margin requirements, which are factors that may significantly affect the economic consequences of a given strategy. An investor should review transaction costs, margin requirements and tax considerations with a broker and tax advisor before entering into any options strategy.

Any strategies discussed, including examples using actual securities and price data, are strictly for illustrative and education purposes and are not to be construed as an endorsement, recommendation or solicitation to buy or sell securities.

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Other Strategies and Information

The OIC webpage http://www.optionseducation.org/strategies_advanced_concepts/strategies/getting_started.html carries a full listing of possible strategies and their pros and cons.

www.OptionsEducation.org should be an investor's first port of call. It features a glossary of terms, tools, simulators, delayed prices, podcasts, news, research and other free educational material.



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Gary Delany is the Director of European Marketing and Education for the Options Industry Council (OIC). Mr. Delany develops options marketing and educational material for the European audience and is the key point of OIC's outreach in Europe.

Based in London, Gary has 30 years' experience in the derivatives sector and is a regular speaker, presenter and writer on options and exchange developments. He started his financial career managing the option book at a firm of commodity brokers. Previously he served as global marketing manager at Rolfe & Nolan, a supplier of futures and options software to banks and brokers. Before that, Mr. Delany worked for The Philadelphia Stock Exchange in their European office in several capacities developing order flow for foreign exchange, equity and equity index options programs.

Gary holds a B.Sc. in Business Administration from the University of Bath in the UK.

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Go to www.OptionsEducation.org to view our FREE material. No matter what your knowledge level, you'll find something to interest you.

The website includes an 'Options for Advisors' section (free log-in required).



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