Grovalue Classroom

1. Introduction

Options are financial instruments that provide flexibility in almost any investment situation. Options give you options by providing the ability to tailor your position to your situation.

Following are the few benefits from option in which you

- You can protect stock holdings from a decline in market price.(hedging)
- You can increase income against current stock holdings.
- You can prepare to buy stock at a lower price.

The following information provides the basic terms and descriptions that one should know about equity options.

Describing Equity Options

- An equity option is a contract that conveys to its holder the right, but not the obligation, to buy or sell shares of the underlying security at a specified price i.e strike price on or before a given date i.e. expiration day. After this given date, the option ceases to exist. The seller of an option is, in turn, obligated to sell or buy the shares to the buyer of the option at the specified price upon the buyer's request.
- There are two types of options, American and European; in India we follow European options. In European option exercise of option contract in between the series is not possible; it will get exercise only on expiry date. On the other hand American option can be exercise before expiry.
- Strike prices are the stated price per share for which the underlying security may be purchased or sold by the option holder upon exercise of the option contract. Do not confuse the strike price, a fixed specification of an option contract, with the premium. Premium is the price at which the contract trades. This price fluctuates daily.
- Adjustments to an equity option contract's size, deliverable and/or strike price may be made to account for stock splits or mergers.
- Generally, at any given time, there will be three months contracts exists in stock options and in case of Nifty(index) it can be available till next few year on quarterly basis.
- On expiration of current month contact new contracts of third month will get introduced on next trading session post expiry days.
- Equity option holders do not enjoy the rights due stockholders (e.g., voting rights, regular cash or special dividends). A call holder must exercise the option and take ownership of underlying shares to be eligible for these rights.
- Buyers and sellers set option prices in the exchange markets. All trading is conducted in the competitive manner of an auction market.

Calls and Puts

The two types of equity options are calls and puts.

A call option gives its holder the right to buy shares of the underlying security at the strike price, anytime before the options expiration date. The writer (or seller) of the option has the obligation to sell the shares.

The opposite of a call option is a put option, which gives its holder the right to sell 100 shares of the underlying security at the strike price, anytime before the options expiration date. The writer (or seller) of the option has the obligation to buy the shares.

	Holder (Buyer)	**Writer (Seller)**
Call Option	Right to buy	Obligation to sell
Put Option	Right to sell	Obligation to buy

The Options Premium

An option's price is called the premium. The option holder's potential loss is limited to the initial premium paid for the contract. Alternately, the writer has unlimited potential loss.

Investors can use put and call option contracts to take a position in a market using limited capital. The initial investment is limited to the price of the premium.

Investors can also use put and call option contracts to actively hedge against market risk. Investors can purchase a put as insurance to protect a stock holding against an unfavorable market move while maintaining stock ownership.

A call option on an individual stock issue may be sold to provide a limited degree of downside protection in exchange for limited upside potential. I upcoming chapters we will discuss various strategies shows various options positions and explains how options can work in different market scenarios.

Underlying Security

The underlying security (such as XYZ Corporation) is the instrument that an option writer must deliver (in the case of call) or purchase (in the case of a put) upon assignment of an exercise notice by an option contract holder.

Expiry of Option contracts

Options that expire in a given month usually expire on the last Thursday of the month. This day is called Expiry Day. If last Thursday of the month is an exchange holiday, then expiry will be on preceding trading day of that week.

Ex. 26th Jan 2017 is last Thursday of this month, which is holiday so the expiry will be on 25th Jan 2017 preceding day 26th

Bank nifty now offer short-term options with weekly expirations of option contract only, so investors should know the exact contract terms, including expiration dates, for all contracts they trade.

On the options expiration date, the contract ceases to exist. At that point, the owner of the option who does not exercise the contract and the seller get cash settlement by exchange if the options are in the money if options are out of the money they will expiry at zero value.

The detail concept of In-the-money, Out-the-money and At-the-Money and there payoffs will be discussed in next chapter

Hope you liked today's chapter, any queries related to option can be solved by contacting us on research@grovalue.in

In next chapter we will discuss payoffs of different types of option.