Buying Call Options

Buying a call option ("a call") gives you the right, but not the obligation, to purchase an underlying security at a predetermined price for a certain time period. Call options are available in various strikes and expiration dates. Expiration dates can vary from as short as one month to as long as a year or more. As a call options buyer, you are betting that the underlying security will rise within the time that your option is valid. The maximum risk you take by buying a call option is the amount you paid for the option; in other words, you cannot lose more than the premium you paid for the call. The extent of your potential profit depends on the price increase of the underlying security. As it goes up, the long call becomes more valuable, because you have paid for the right to buy the underlying security at a given strike price. That is why traders buy call options in a rising or bull market.

When trading call options, there are three ways you can exit a trade. You can:

1. Let the call expire worthless and thereby lose the premium you paid;

2. Exercise the call at a time when the price of the underlying security trades above the strike price. You can then purchase the stock at the call's strike price and immediately sell it at the current market price, keeping the price difference as your profit.

3. Sell the call to another trader prior to its expiration. In this case, you make money if the price of the call has risen in value given a rise in the underlying security.

Here is a simple example:

Assume a particular stock currently trades at $40. You buy a call with a strike price of $44 and an expiration date three months into the future. You paid $1 per contract for the right, but not the obligation, to buy 100 shares of the underlying stock for $44.

Now, let us assume the stock goes to $50 within the next three months (i.e., before the option is due to expire). You can now exercise your call option, demanding from the call seller (the option "writer") that he or she sell the stock to you for $44. Because you can sell the stock immediately at the current market price of $50, you have made a $6 (600%) profit, minus, of course, the cost of the option purchase.

On the other hand, if we assume the stock has declined to $35 by the time the option expires, it would not make sense to exercise

the call and buy the stock for $44. In this situation, you would let your option expire worthless and take a loss of $1 per contract. In this case, it is the seller of the call who will realize a profit (of $1 per contract).

Sell Call Options

By selling (writing) a call option, you are selling the right to an option buyer to purchase the underlying stock or index at a particular strike price. Option sellers (writers) have obligations. Selling a call option requires a credit to be deposited. If the option expires worthless, the credit is yours to keep. A trader who sells call options believes that the market will fall.

To make money on a short call, the price of the underlying security must stay below the call's strike price. The profit is limited to the credit received from the sale of the call.

If the price of an underlying security rises above the short call strike price, the option will be assigned to an option holder, who may choose to exercise it. In other words, the option seller must buy the underlying stock or index at the current price and sell it at the call's lower strike price (Current price - strike price = loss). When selling call options, the maximum loss is potentially unlimited, because the underlying stock's upside is theoretically infinite. This is why selling "naked" or unprotected call options (see below) can be a high risk venture.

Selling Covered and Naked Calls:

If you own a stock, you can sell a call on it and receive a premium. This is called writing a "covered call". If the stock declines in price, you keep the premium. If the stock rises, the options buyer may exercise the option and demand that you deliver the stock at the strike price. In this case, you give up your stock, but get to keep the premium.

In a situation where you do not own the underlying stock, you might still be able to sell a call on it (selling naked calls), depending on your broker, trading experience, and financial situation. By selling a naked call, you are in effect selling an option on a stock that you do not own. If the stock goes down, you keep the premium. If the stock goes up and the call buyer exercises his or her right to purchase it at the strike price, you will first have to buy the stock in order to be able to deliver it to the call buyer. Naked call writing is associated with potentially unlimited losses – it is the most aggressive and risky strategy an investor can use.

By selling a call option, you are selling the right to buy the underlying stock or index at a particular strike price to an option holder. Sellers have obligations. Selling a call option prompts the deposit of a credit. You get to keep this credit if the option expires worthless. A trader who sell call options believe that the market will fall.

- To make money on a short call, the price of the security must stay below the call's strike price. The profit is limited to the credit received from the sale of the call.
- If the price of the security rises above the short call strike price, it will be assigned to an option holder who may choose to exercise it. Other words the option seller must buy the underlying stock or index at the current price and sell it at the call's lower strike price (current price - strike price = loss). T**he maximum loss is unlimited to the upside**, which is why selling "naked" or unprotected call options comes with such a high risk.

Covered and not Covered Call:

If you owned a stock you can sell the call and receive the premium. This is called writing a covered call. If the stock declines in price you keep the premium. If the stock goes up in price the options buyer exercise the option and demands that you deliver the stock at the strike price. In this case you loose your stock but you keep the premium.

If you did not own the underlying stock you still might sell a call. If the stock goes down you keep the premium. However, if the stock goes up and the call buyer exercises the option you have to buy a stock to deliver it to the call buyer. **This this the most aggressive and risky strategy an investor can use.**