

## Options Basics

### Option Basics – What is an Option?

An option is a traded security that is a derivative product.

By derivative product we mean that it is a product whose value is based upon or derived from the price of something else. Since we are talking about stocks, a stock option is based upon, among other things, the price of the underlying stock.

There are also options on other traded securities such as currencies, indexes and interest rates, but here we will limit our discussion to stock options, or options based on stocks.

A distinguishing factor of an option is that it is a depreciating asset in the sense that it has a limited life, and has to be used before the date on which it expires. As time goes by, the option loses value as it moves closer to its expiration date.

When we speak of options in terms of volume, we refer to contracts. Each stock option contract is equivalent to 100 shares of stock. When we talk about two contracts, we are talking about 200 shares, 10 contracts; we are talking about 1,000 shares, 75 contracts 7500 shares and so on.

<u>Amount of Shares</u>	<u>Equivalent Amount of Option Contracts</u>
100	1
200	2
1000	10
7500	75
15000	150
50000	500
100000	1000

**NOTE:** It is important to understand the dollar cost of options before actually trading them. When an option is quoted at \$1.00 per contract, the investor must realize that the \$1.00 represents a price of \$1.00 per share, not per contract. Remember that each contract is worth 100 shares. This means that if you were to buy one option contract at a quoted price of \$1.00, your total cost will be \$100.00 (1 contract x \$1.00



per share x 100 shares per contract). If you were to buy 10 contracts for \$1.50 per contract, your total cost will be \$1500.00. Use the formula below when calculating total dollar cost of the option.

$$\text{Total Dollar Cost of Trade} = \text{Number of Contracts} \times \text{Price per Contract} \times 100$$

Option contracts are literally a sales agreement between two parties. The two parties are the buyer (or holder) and the seller (or writer). When you buy an option contract you are considered to be long the option. When you sell an option contract, you are considered to be short the option. This, of course, is assuming you had no previous position in the said option.

In an option contract, although it seems as though the buyer and seller must be tied together, they are not. You see, the buyer doesn't really buy from the seller and the seller doesn't really sell to the buyer.

In reality, an organization called the OCC or Options Clearing Corporation steps in between the two sides. The OCC buys from the seller and sells to the buyer. This makes the OCC neutral, and it allows both the buyer and the seller to trade out of a position without involving the other party.

For more Information about option trading, please click here:  
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