

Basics: Option Contract on Stocks



By Charles Malize

***CM Capital Market Research LLC.
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Dear reader,

This manual is divided into three parts.

The first part provides a close insight into **CM Capital Market Research LLC's** operations, services and the metrics it employs in predicting price movement in the stock market. It also provides a guide on how it narrows down its stocks and options focus list.

The second part highlights the basics of stock and option investments, as well as some important definitions investors need to acquaint themselves with.

The final part addresses the need for an investor to create a strategic plan, while ensuring the necessary apparatus is in place to enable successful leveraging in the market arena.

I hope you find the information provided useful.

Regards,

Charles Malize
Author

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PART I

Introduction

CM Capital Market Research LLC is a research and a subscription based company. Its investment research tool is designed to empower investors to become more profitable in their investments. We try to maintain the highest level of success by following our own research philosophy.

Our company analyzes economic and political trends and provides strategic information, aiding its clients in formulating sound ethical solutions to challenges within the global business arena. Our ability to gather, analyze, and distribute information on a timely basis lends our service the efficiency it needs in recommending a **buy, sell or hold position** on investment or trades for investors.

Who are the investors?

Investors that trade stocks are generally categorized into two:

Institutional vs. Individual investors.

Institutional investors are the specialized fund managers that trade large volume of shares by investing other people's money into large funds. They are often pension funds, hedge funds, investment companies, trust, insurance companies etc.

Individual investors also referred to as "retail investors" or "small investors" are individuals that independently purchase small amount of shares for their own private accounts as opposed to the institutional investor. Most of these transactions are conducted on the internet and they only trade for their own accounts with no clients as does the financial institutions.

Institutional investors have a greater ability to influence prices when they carry out their investment decisions than individual investors. The reason is that these asset managers are able to place millions of dollars into the market

arena, buying and selling tens of thousands of shares of a single stock over the course of a given period. This financial strength has a significant impact as it tends to sway the movement of the underlying stock price.

Individual investors can capitalize on these movements by acquainting themselves with the right market information and in the process identifying what inspires institutional investors; **buy/sell/hold decisions**.

How do we pick our stocks?

Target undervalued stocks. These stocks normally have the potential of achieving a higher return and will usually lend it self to a lower downside risk. These stocks also have the ability to make money and are usually winners. We study stocks of companies with rapidly growing earnings, and choose those that did better than their previous year report.

The targeting of stocks that offer protection: Stocks like **Microsoft, Apple and Procter & Gamble** are more likely to weather a downturn in the market place when compared to stocks like **General Motor**, a company that is constantly in the news and is highly volatile. This is simply because the former companies mentioned have a positive track record of steady growth, while the latter has an irregular earning record.

Analysts recommendation following a positive earning report.

For example, analyst initiates an upgrade on a stock following a promising company's earning report with a strong future earnings projection. By using our research tools, we are able to obtain this information before hand and then pass this onto our subscribers.

The analyzing of multiple stocks on a daily basis.

Our company analyzes multiple stocks on a daily basis and a value is determined based on their potential. This technique uses micro and macro economic indicators including "**price to earning ratio**" and geo- political trends that surround the stocks that we shadow before a recommendation is made.

Institutional investors influence on stock prices.

They have an immense purchasing power that allows them the luxury to influence a stock price. When they receive new positive research data from a brokerage analyst on a company stating that the company's earning per share estimate is on the upside, and the stock is a bargain, the institutional investor wants to take advantage of this analysis and purchase more shares of the company in question.

The expectation is they will build their position in phases to avoid running up the price on themselves, as they end up adding to their positions over a period of time. This can give the individual investor time to tiptoe in ahead of the institutions to benefit from the rising share price.

The technical approach.

This is when we strongly examine charts of the stock past performance looking for movements or trends that we feel will be recurring in the near future.

Surprise in earnings and a positive guidance.

A strong earning surprise normally help propel a company's' stock to the upside. The opposite is expected when earning surprise is negative sending the stock on a downward path. CM Capital Market research helps identify these movements before they occur.

Bearish earning results leading to analysts revisions

If earning estimates are waning and the company issues a bearish or disappointing earning report due to a drop in sales and hence profits, this would lead to an analyst downgrade from a "buy or hold" to a "sell" position on the company's stock price. Institutional investors may then enter the fray as the stock is viewed negatively and they may start to conduct massive liquidation of their positions. When other investors, especially individual investors, notice the cascade of selling by institutional investors, the likelihood is an exodus of these investors exiting the same stock leading to further decline in the stock price. It is then that CM Capital Market Research LLC. conveys this information to their subscribers in order to stem the unforeseen.

There are other factors that could lead to analyst downgrade hence putting pressure on a stock:

Fewer customers buying the company's product.

Company in question could be facing a lawsuit.

Unfavorable rumors about the company.

A powerful competition from another company entering the same sector.

A competitor introduces a better product; this is very common in the technology and the health sector.

Some government regulation that may hurt the company's product and negatively impacting long term sales.

All of the above are expected to put downward pressure on the company's stock resulting in downward pressure on its price. CM Capital Market Research strives to alert its subscribers of this concern and makes recommendations in the process.

What is P/E ratio?

The price-to-earning ratio also known as the P/E ratio or earning multiple is a measure of the price paid for a share relative to the annual income or profit earned by the firm per share. It is used for valuation purposes: A higher P/E ratio means investors are paying more for each unit of the stock, hence the stock is more expensive and investors are likely to avoid such stocks as those stocks are likely to be overpriced compared to one with lower P/E ratio.

P/E ratio =

$$\frac{\text{Price per Share}}{\text{Annual Earning per Share}}$$

For example, if company X is trading at \$20 and the earning per share for the most recent twelve month period is \$2, then its stock has a P/E ratio of 20/2 or 10. In other words the purchaser of the company's stock is paying \$10 for every dollar of earnings. Companies with losses or negative earnings have an undefined P/E ratio, usually known as "Not Applicable". A company with a P/E ratio of "between" 10-17 is considered "fair value". Anything above is considered "overvalued".

Our focus list

We regularly research through vital economic and political indicators affecting the market in order to predict where it is headed, and more importantly, to assist you as an investor, in doing what is needed to profit from the market environment.

We use two stock portfolios for this purpose: **Market Edge Report and Investment Commentary Report**. Both are designed to aid you in outperforming the market.

These are an assorted portfolio of stocks maintained by us with the objective of outperforming the market over a period. In other words investors will find stocks from many different industries and market cap levels. They tend to appeal to two types of investors; the value and growth investors:

Value investors: They always seek out stocks that sell at a price under their "fair value", with the objective of purchasing a stock when the price is deemed low and selling it when it is high. They are prepared to stay for the long run. This category of investors rely mainly on the P/E ratio when deciding to take on a company's stock.

Growth investors: The primary objective of growth investing is to buy a stock regardless of its price and with the hope that the price appreciates over a short period of time before selling it. They tend to be more aggressive in

their operation. They also seek out companies with high earning growth. The potential for a handsome return in a short period of time could be huge. This is more like gambling than investing and could lead to total loss in one's investment.

Part II

The basics

The stock market is a place sometimes referred to as the stock exchange. This is where brokers meet to buy and sell stocks and other securities. This term includes transactions that are conducted electronically on a computer as most transactions today are carried out globally.

Buying a stock directly or through an exchange gives the investor the right to a partial ownership in the company that issued those shares. They have an equity interest in the company. Most stocks listed and traded on the United States stock exchanges are termed “equity” securities.

An option contract on the other hand, gives the investor the right to buy or sell a specific number of common shares (usually 100 shares) of a company at a predetermined price before a specified date.

What is an option?

As mentioned above, an option is a contract that gives the owner the right, but not the obligation, to purchase or sell 100 shares of the underlying stock at a specific price (*strike price*), on or before a specific date (*expiration date*).

In other words, it is actually a contract. Unlike stocks, an option does not convey to the purchaser any ownership in anything. Instead, an option contract conveys the *right* of its owner to buy or sell the underlying stock on which it is based.

For example, you can have an option contract on Cisco (ticker symbol; CSCO) which is publicly traded just like stock and its price fluctuates with the underlying stock. This gives you the right to buy or sell Cisco stock at a fixed price.

As Cisco changes in price, there will be many different option contracts on Cisco that also will fluctuate following this price change on the underlying stock.

If an investor has a **call option** with a strike price of \$20 that expires in July 2009. The owner of this call would have the option to purchase the stock at \$20 anytime before the option expires in 2009.

Conversely, if the investor has a **put option** on the same stock with a strike price of \$25 that expires in October 2009. The owner of this put will have the option to sell this stock for \$25 anytime before the option expires in October 2009.

How buying a call option is like buying a house

Let's say for instance you were interested in buying a house and the seller's attorney draws up a contract of sale for the transaction with an agreed purchase price of \$100,000. It is further agreed between the seller and the buyer that the buyer is to pay a deposit of \$5000 on contract signing and the balance to be paid in six months time.

When you pay your down payment (*call option*) with signed contracts from both parties you are given a guaranteed contract to close the transaction at an agreed price and a closing date.

Lets say, for example, in between the time specified in your contract, you were lucky and the price appreciates \$20,000, and you have a buyer willing to pay the new value, you can choose to exercise your right to sell your contract to this new buyer and pocket the difference, which in this case is \$20,000, plus your initial down payment of \$5000.

Some important definitions

Two types of option contract:

Call options: This is a financial contract between two parties, the buyer and the seller, that gives the buyer the right, but not the obligation to purchase shares of a stock from the seller or the writer, as it is known, at a specified price (*strike price*) on or before the date of expiration. *This option is exercised when the buyer expects the price of the underlying stock to go up.* And its application is very common when the broad market is strongly bullish.

Put options: This is a financial contract between two parties, the seller also known as the “writer”, and the buyer also known as the owner of the option, and gives the buyer the right, but not the obligation to sell a specified number of shares of a stock at a specified price (*strike price*) on or before a specified date (expiration date). *Put options are used when the buyer expects the price of the underlying stock to go down.* And its application is common when the broad market is exceedingly bearish.

“Follow the trend”

Strike price:

The strike price is the price at which the security or the underlying stock will be bought or sold if the option is exercised. In other words it is the price at which the option holder can buy or sell their stocks. *It is also referred to as exercise price, call or put price.*

Month of Expiration:

This is the date on which the option contract ceases to exist. They expire at the end of the trading day on the third Friday of the month for which they are named. On this date the option contract becomes invalid and the right to exercise it no longer exists.

Options may expire in the current month, the following month, or later months depending on how far the investor wants to go.

At the money: (ATM)

When an option strike price is approximately equals to the present price of the underlying stock this is classed as **at-the –money**. For example, if company X underlying stock was trading at \$50, and it has a February 2009 \$50 call, then the option contract is **at- the -money**.

In the money: (ITM)

This is described as a call options that have a strike price below the underlying share price, or put options that have a strike price above the current underlying share price. An option that is in the money possesses “intrinsic value”.

For example, if you have an underlying stock on company X at \$50 and you purchase an “**in- the –money**” option at \$49, you have an instant “intrinsic value” of \$1.00

Out of the money: (OTM)

This is a situation where the strike price is higher than the present price of the underlying stock. There is no “intrinsic” value. They are considered “extrinsic value”.

When considering put, the out of the money option will have a strike price below the current underlying share price. As options move further out of the money, their value diminishes.

If you were buying company X option contract of say March \$60 call while the underlying stock was trading at \$55, you are out of the money with a \$5 loss.

Time Value:

This is the difference between options value and the “intrinsic value” that embodies the *cost of time* from the present to the date of the associated options expiration.

For instance: The cost of Cisco June \$18 call option will be more than the cost of a Cisco March \$18 call option. In this occurrence, the June \$18 call will be more expensive due to the benefit of the added three months prior to expiration date.

Due to the continuous price swings in the underlying stock, it is more

valuable to have more time for price to change in the investors favor. In this situation, the investor is expected to pay a higher premium for the added time.

As option contract moves towards expiration date, the option premium decreases. **(time erosion)**

Another example: Let's assume an option was purchased at \$3.00 per share or \$300 per contract with a three month expiration date. If for the next two months the underlying stock moved, but only faintly, the option premium will decrease.

This is “time value erosion”. In other words, as the expiration date draws closer, the time value of the option depletes.

Because of the “time decay” it is recommended to exit position one month prior to expiration.

Option contract are arranged in this order

- 1. Name of the underlying company**
- 2. Expiration Date.**
- 3. Strike Price**
- 4. Call or Put**

Option symbols

An option symbol is a code by which the option is identified on the exchange. It is designed to provide separate identity to the options in the stock market.

It is essential to note that when buying and selling “calls” or “puts” options online, the exact ticker symbol has to be used. Each option has a symbol just as each stock has, and this symbol is located on the option chain page. **You can log onto: <http://www.yahoo.com/finance> and go to stock quotes and option chains and work it from there.**

Volatility is your friend

For most investors, they buy and hold stocks hoping that it will go up in price. But your smarter investor is more tempted and prefers higher volatility in an unpredictable market environment because that's where the profit is made, acknowledging that volatility creates opportunities for bigger gains and is prepared to pay the premium for this gain.

For instance, an underlying stock that usually moves \$1 or so is usually unpredictable compared to a stock that takes longer to make a similar change. In order to benefit from this increased volatility, the investor pays a higher premium for the option trade as the option is expected to appreciate more when compared to the one that is not.

Leveraging the stock market

We are going to continue using the same example as the real estate transaction. When you invested the \$5000 down payment on the house, this initial down payment or investment controlled the earning power of a \$100,000 house. **This is leveraging** and the same principle can be applied when buying and selling options on a stock.

Purchasing an option on a stock with your initial capital outlay is like a down payment for the underlying stock and is usually far less when compared to a down payment on a house or if the investor decides to buy the underlying stock outright. For example if an underlying stock price of a company is \$50 per share, securing 1000 shares would cost the investor, \$50,000. If the stock price then spikes up \$1 the investor would have made \$500, representing a 1% profit.

If on the other hand the investor exercises his right to purchase **call options** to control 1000 shares on the very same stock and at the same time paying approximately \$2,500 for this investment, although this price may vary, this \$2,500 will control all 1,000 shares of the stock. (i.e. \$2.50 per contract). If the stock goes up another \$1, your option may also go up another \$1 to \$3.50 (varies depending on the option in question). With leveraging, the

investor has profited 40% on the same stock by means of options instead of the 1% gain by owning the underlying stock.

To sum up:

The stock market is an exchange where investors / brokers gather to buy and sell stocks and this includes electronic trading that is conducted over the internet.

Option on stocks is categorized into “call” and “put” options and both allow the option holder the right, but not the obligation, to buy or sell shares of the associated stock at a specified price on or before the expiration date.

CM Capital market research objective is to own the option as long as possible, giving us time for the underlying stock to appreciate in value. For example, if the underlying stock moves in our favor we advise exercising our selling rights before the expiration date.

Always note that, in the case of buying options we are not interested in owning the underlying stock as this is in opposition to our game plan. What we recommend is to capitalize on the “**expiration date**” by holding on to the option contract as long as possible, thereby giving you enough time for the tide to move in your favor. In some cases, this favorable move may take a week and in other cases longer.

Investors can leverage their positions on option contract by using any of the following:

In the money call (ITM)

At the money call (ATM)

Out of the money call (OTM)

At all times, avoid “**time erosion**” on your option contract investment.

At CM Capital Market Research, we advise investors to purchase options that are likely to achieve a considerable return on their investment, and our research aids us in applying the right tools to assist you in meeting this objective.

Part III

Formation of a plan and maintain consistency

“One of the most important ingredients for successful investing in the stock market is the development of an ideal game plan ready for execution”.

The formation of a game plan:

The task here should not be a daunting one as this is an essential ingredient for any successful investor that wants to generate income in a reliable and consistent manner. The creation and implementation of a solid game plan is recommended for any investor who wants to thrive in the stock market using options contract. *Do not leave your trading to chance as anyone who enters the market with an ambiguous plan is doomed to failure.*

Option investors that invest based on instinct and emotions are unlikely to achieve long term success in their investment.

Consistency with your game plan:

Progress and success is gained when the rules of your plan are implemented consistently allowing you to stay in the game. As an option investor you need to have clear objectives and guidelines for yourself. Establish an entry and exit point when securing a position on your trade and stick to it. Always remain focused and disciplined. Avoid acting on emotions as this will actually work against you at certain critical times in the trading process. *Consistently applying the rules of trading is the solution to the many challenges one faces in this arena.*

Common basics for a successful trading strategy:

*A method for choosing an underlying stock:

Visit: www.cmcapitalmarketresearch.com. Try the products: Investors Commentary Report or Market Edge Report **or** both.

*A technique of establishing those options or stocks that are ideal for your portfolio.

*A method to know when to exit a trade.

*A strategy for monitoring your investment and limiting risk in the process.

What you need to get started

- 1. A comparatively up-to-date and reliable computer.**
- 2. An internet connection that will allow you access to a broker of your choice and the ability to trade online from anywhere in the world.**
- 3. An account with any of the online brokerage firms. I personally prefer Optionsxpress <http://www.Optionxpress.com> or E trade <http://www.etrade.com>. They have a simple platform and cater to clients globally.**
- 4. For your portfolio, consider subscribing to our products: Investors Commentary Report or Market Edge Report or both.**

The freedom you gain from option trading

Eliminating the usual and customary overhead costs: of running an office based business, including: employee salary and insurance, inventory purchasing, storage, advertising and handling costs.

Mobility: the ability to work anywhere at any time. Minimal initial investment, anywhere from as little as \$500 to as much as \$10,000. Although, I recommend an initial outlay of at least \$2000.

Flexible schedule: you can work, or not work, whenever you want. There is no time clock. The amount of time and effort required daily is usually about 2 hours.

Our stock/option contract products and pricing

1. Market Edge Report

This product is developed to assist investors profit from stocks and options investment. We have the flexibility and the necessary apparatus to conduct detailed research on multiple numbers of stocks on a regular basis. This allows us the luxury to give guidance on when to enter, hold or exit a position.

The regular price for this service is \$199.00 per annum. This covers:

- *Weekly analysis of specially selected stocks.
- *Access to our newsletter on markets and its sectors.
- *Email alerts directly sent to your mailbox.
- *Updates on stocks /Exchange Traded Funds (ETF) and their movement.
- *Password protected privacy

This report is published weekly.

2. Investors Commentary Report

This provides an in- dept market analysis of economic and political trends that highlight investment opportunities globally. The market analysis used focuses on commodities and stocks of publicly traded companies in various sectors; industrial and precious metal, energy, agriculture, technology and global capital markets for their viability. We select those which optimize a positive return on investment. The report guides you on entry, hold and exit positions. The price for this service is \$299.00 per annum. This covers:

- *The examination of multiple stocks to establish winners.
- *Researched commodity reports.
- *Market alerts that afford you the information to protect your portfolio.

*Access to our newsletter on various markets and sectors.

*Updates on stocks/ETF and their movements

*Password protected privacy.

This report is published weekly

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