=========================5.1 Buying Calls=========================

Hello, my name is Chris Douthit and I want to welcome you to the advanced option training course. Before we jump in, I want to make sure you have gone through the beginning course and understand all the concepts discussed. This is going to be important, as we’re building on these previously covered concepts. In the beginning course, we learned option trading terminology and the principles that supply the building blocks to successful trading. Now we’re finally ready to jump and get into the fun strategy stuff.

At OptionStrateigesInsider.com, we understand that getting started in options can be overwhelming at first. But our goal is to get you up and running so you can start making profitable trades as soon as possible. It doesn’t matter if you’re a new or experienced trader; the trading strategies covered in this course are going to add value to any option trading business.

I want to now move to an option trading strategy that most new option traders start out with: buying options. First let’s talk about calls.

Why would we want to buy a call option?

The first and most obvious reason is that we think the stock is going to go up and buying a call option gives us a little more flexibility verses buying the stock.

We don’t have to tie up all that capital in the stock to still participate on the upside. If the stock costs $50, and we buy 100 shares, that’s going to cost us $5000. If the option costs $2.50, purchasing one contract would only cost us $250. Because we’re spending less capital, our return on capital is also going to be far greater.

In addition, buying a call option limits our maximum loss. If we purchase 100 shares of stock and the company goes bankrupt, we just lost $5000. The call option will limit our loss to what we purchased it for, --in this case, just $250.

==(5.1 picture)==

Let’s now pull up some real option prices in DIA, which has 22 days to expiration. The underlying price is currently trading at $210.60. Comparing this to the calls, looking at the 210 call, it has a mark price, the average between the bid and the ask, of $2.03. The 211 call has a mark of $1.40, the 212 call has a mark of $.94, and the 213 call has a mark of $.57.

Now let’s compare the returns on each. First the stock: if we purchase 100 shares of DIA, and are right about the direction and it trades up to $218, we would make a profit of $7.4, which is a great trade for a 22 day investment, this would provide a return on capital of 3.5%.

Comparing that to the call options we considered buying, the 210 call, which we could purchase for 2.03, in 22 days, this contract will be worth its intrinsic value of $8 per contract. So if we purchased it for $2.03 and then sold it for $8, we would have made $5.97 per contract. Our return on capital on this investment would have been a hefty 294%.

Going through the rest of the strike prices listed, we see the following results. Notice that the further out of the money we go, the higher our return on capital. The 213 strike made an astonishing 777% return.

If we would have purchased one 213 strike price call, we would have only invested $57 and we could have been able to cash out for $500. Talk about a great 22 day investment!

Just imagine if we would have bought 10 or even 20 contracts at this level. 20 June 213 strike contracts would have cost us $1140 and we could have sold it 22 days later for $10,000, an incredible trade. As we have just demonstrated, buying options is a method to make huge returns while putting up very little capital.

One thing I want you to notice while looking at this picture is that the further out of the money we went the higher the return on capital. So why would we ever buy an in the money option? Why not only consider the 213 call or even further out of the money?

That is a great question and what most new option traders think when they first start. Anyone looking at this picture would immediately think buying far out of the money options is the best way to go and want to funnel their money into that as soon as possible.

The issue is, the further out of the money we go, the lower the probability of that option finishing in the money. If DIA did trade up to 218, yes we would make a lot of money, but that’s a big if. In fact, I can personally all but guarantee that it won’t reach 218 in the next 22 days. If we look at our probability of it in the money column, we can see what our probability of success is for each strike. The further out of the money we go, the lower the probability of making any money. The 213 strike price has the lowest probability of all the options on our list of only 24%.

Chances are, if we bought this 213 call, we have a 76% of this option finishing out of the money, which means a 76% chance of losing all our money, if we hold onto this position until expiration. --And don’t forget, for this option to turn a profit, not only does it has to finish in the money, but it has to finish in the money by enough to also make up for the premium we paid.

So, if you remember how to calculate our breakeven from the beginning course, which is the strike price plus the premium paid for the call, DIA would have to reach 213, then trade up another $.57 to account for our premium just to break even. So, the further out of the money we go, the lower the probability of success and the higher the breakeven point.

This is the reason why we make a higher return the further out of the money we go. There’s a direct correlation between risk and reward. The more difficult it is to turn a profit, the more reward for taking on such a trade. Unfortunately, most new option traders make the mistake of concentrating on what they risk vs. what they can make and jump into something with a very low probability of success, hoping to strike it big. Then later they wonder why they can’t make any money.

Go out and buy this DIA 213 call, lose 100% of your investment, and you’ll soon realize that this is not a good trading strategy.

Think of it like going to a casino. As a player you’re hoping to get lucky and hit it big. There’s always that chance of hitting a jackpot and leaving with a huge pocketful of money. Maybe it has happened to you, maybe you know someone who it has happened to, but it does happen. But how often does it happen? Not very often.

Buying options is a lot like being a player in a casino; people are hoping they will get lucky and hit it big. Unfortunately, most people end up playing games they don’t even know how to play very well, making their chance of hitting it big that much more difficult, and then go home with a big loss. Sure, they lost; they were supposed to lose, because they were on the wrong side of the trade from the start. This is what also happens to option traders who don’t know how to play the game very well.

Sellers of options are like the casino. They understand that they‘ll end up having to pay some jackpots, but few and far in-between, for a size that they are comfortable with, and for a risk profile they accept. Casinos make many high probability trades that bring in a lot of profit, with consistency, and in the end they will come out on top. This is the exact type of trading strategy we’re going to implement when we trade options.

That’s it for call buying theory, in the next lesson we’re going to walk through an actual purchase of a call. See you soon.