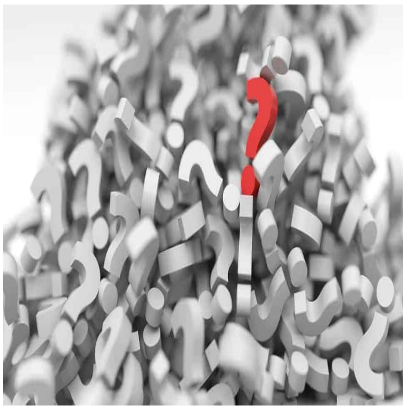

Why Buy Options When Stocks Are Available?

Description

For many investors who are familiar with the investing landscape, investing in stocks may no longer seem very daunting. After making a number of investments, most investors will reach a much higher level higher of comfort in the process. Investing in options is another story.

Before we look at options, we must begin by understanding stocks (or securities, as they are sometimes called). When an investor purchases shares in a company, they become a part owner of the company. The shareholder has the potential to make a profit when shares increase in value (when the company becomes more valuable) in addition to being paid dividends along the way. Once the investor decides to sell out of the investment, there are funds received from the buyer in exchange for the shares. Essentially, shares are owned until they are sold.

Looking now at options, the ability to make a greater amount of profit (or loss) is a sword that cuts both ways. For those not in the know, there are two types of options. The first kind will provide the owner of the option (the buyer) the right to purchase shares at a set price until a specific day. For this, the buyer of the option pays a premium to the seller of the option. The seller is required to deliver the shares at the specific price if asked to do so. This is called a "call option."

The second type of option is a "put" option, which gives the owner the chance to sell shares at a specific price up to a specific day. This is the expiration day. The seller of the option is required to buy these shares at the agreed upon price whenever called to do so.

Where options differ from securities is the term of ownership and right to dividends. Taking shares of **Royal Bank of Canada** (TSX:RY)(NYSE:RY) as an example, investors who purchase the shares outright will receive all dividends paid by the company and will be able to vote on all matters on the proxy statements. Most importantly, the investor will own the shares and have the opportunity to sell these shares when they so desire. There is no expiration date. Currently, shares trade near the $95 mark.

Options have a limited shelf life. An investor of Royal Bank of Canada wanting to make more money from an appreciating share price can purchase a call option, which expires in January 2018 for a price of approximately $1.10 per share. The strike price (which is the set price at which the owner can buy the shares) is $100.

Assuming the share price increases to a value above $100, then the owner of the option has made a good trade and will benefit from the option. But if shares do not cross the $100 mark, the option will expire worthless, and the investors will lose 100% of the money used to purchase the option. This is a terrible outcome.

Although there are clear benefits to delving into the universe of options, the challenge investors face when buying them is that time is not on their side. Once time is up, it's up.

Securities are much more forgiving.

CATEGORY

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1. NYSE:RY (Royal Bank of Canada)
2. TSX:RY (Royal Bank of Canada)

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1. Msn
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