Tips for Beginners: How to Trade Options

Description

Using derivatives, or options, to trade in the markets can be an advantageous strategy for a variety of reasons.

While derivatives often bear the brunt of negative press in the news and financial media, if used properly, derivatives can actually be a cost-efficient way to manage risk in your portfolio.

But derivatives can also be a tricky thing to understand, so it's important to do your homework first.

Understanding the basics of how options work

In the equity markets, there are basically two types of options: calls and puts.

A call option gives you the right to buy a stock at a predetermined price, called the "exercise price."

A put option gives you the right to sell a stock at a predetermined price, also called the exercise price.

But these options don't last forever — they always come with a specific "expiry date."

Each company that has options attached to its shares will have what is called an "option chain."

The option chain will contain many specific options contracts within it, including various exercise prices at various expiry dates.

When to buy a call option

Similar to buying a company's stock, like, for example, **Molson Coors Canada Inc.** (TSX:TPX.B)(NYSE:TAP), buying a call option on a company's shares is considered to be "going long" or a "bullish strategy."

Essentially, when you buy a call option on a company's stock, you'll make money if the shares appreciate, or go up, in value.

When to buy a put option

The direct opposite of buying a call, when you buy a put on a company's shares, it's considered to be a "bearish strategy," or akin to when you are "selling a stock short."

When you buy puts, the value of your position will appreciate if the company's shares go down in value.

How to calculate the value of your options

Call options give you the right to buy a security at your predetermined exercise price, so if the exercise price on your options was below the company's share price, that would be the value of your call position.

For example, if you held the Molson Coors calls with an exercise price of $60, and the Molson Coors stock traded at $75, the value of your calls would be $15.

Put options give you the right to sell a security at your predetermined exercise price, so if the exercise price on your puts was above the company's share price, the difference between the two would be equal to the value of your put position.

For example, if you owned the Molson Coors puts with an exercise price of $80, and the Molson Coors stock traded at $70, the value of your puts would be equal to $10.

But remember…

While derivatives offer certain benefits in terms of efficiencies in minimizing your capital outlay and other advantages when it comes to risk-management strategies, they are not without their risks.

Buying out-of-the-money options, for example, while it can yield outstanding returns, is also a strategy that can see you lose the entire value of your investment in the blink of an eye.

So, be willing to trade with a Foolish mindset, but also make sure you've done your homework first.

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TICKERS GLOBAL

1. NYSE:TAP (Molson Coors Beverage Company)
2. TSX:TPX.B (Molson Coors Canada Inc.)

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jphillips