Call Options

When you buy a call option (a contract) from a seller (sometimes called the option "writer"), it gives you the right to buy a specific number of shares of a stock from him at a set price (strike price) for a limited period of time (until the option expiration date). For example, let's assume that BCD stock is now selling at $35 per share. You feel that within the next six months it will go way up, but you lack the funds to invest in the company now. You might buy an option today that allows you to purchase 100 shares of BCD at $35 at any time during the next half a year. For the right to buy the shares at $35 (regardless of the market price at that time) you must pay the current owner (the seller/writer) a premium, for example, $1 per share ($100 for the 100 share contract). If you predicted correctly, and the stock starts moving up, as the price goes above $35 and reaches, say, $38, you can exercise your option and buy the 100 shares at the strike price ($35 per share for a total cost of $3,500). Then you can turn around and sell the holding for $38 (total amount $3,800) and come out $300 ahead. Excluding taxes and commissions (as do all examples in this book, unless otherwise noted), you will profit by $200 – and your total risk was your $100 outlay. Your $100 investment made a profit of $200 (Sale value: $3,800, minus purchase cost of the shares: $3,500, minus option cost: $100, adds up to a profit of $200, or 200%).

Proceeds from sale of stock	$3,800
Cost to purchase stock when exercising option	-$3,500
Cost of option	-$100
Total profit	$200

Buying the call gave you the right, but not the obligation, to purchase the stock at $35. It's like in the chess example on page 190 of the printed version of *Rich As A King*, under the heading "23. Prepare to attack long before you fire the first shot." You knew that you wanted to get onto square d5 (that is, you wanted to buy BCD at $35), so you placed a piece on a square that would protect d5 for you in the future. Thus, you bought a call option to protect the $35 price at which you could purchase the stock for the next six months. With the options strategy, you bought the call to make sure that you would be able to buy the stock at a known price (no matter how much the stock had appreciated in value, you would be able to buy 100 shares at $35). You prepared for the future purchase by making a move well in advance.

Keep in mind that if you choose to buy options, time becomes your enemy. Like a chess tournament clock, if the time runs down to zero, you lose. In other words, if you buy a six-month $35 call and the stock drops to $30 and stays there for half a year, your option will be worthless when it expires.

After all, why would you exercise your right to buy the stock at $35 when you could just go ahead and buy it on the open market at $30? In such a situation, since you have no obligation to buy it, you would obviously simply let the call expire, thus losing your $100 investment. As most options expire worthless, meaning that if you hold one on expiration date you will get zero, make sure that you've got a rock solid strategy in place before trading in these often complex instruments. No grandmaster makes a move without a reason, and neither should you.