Institute of Trading and Portfolio Management

Professional Options Trading Masterclass Video Series

POTM

Video 6

Long Call and Long Put Strategies

1. Long Call

Quick Explanation

The right but not the obligation to purchase a particular Stock at a specified price before a specified time.

The Long call, or buying Call Options, is about as simple as Options trading strategy gets, because there is only one transaction involved and it enables you to make potentially unlimited profits through the power of leverage, while limiting your potential losses at the same time. It works best if you are expecting a significant rise in the price of any asset that has options contracts traded on it within a specified time frame i.e. you have to be right / “In The Money” to profit from it by a certain date and the risk reward of buying a Call Option versus simply owning stock is better. See Marginal Benefits of Options Trading Video.

- **Directional Bet**
- **Bullish Strategy**
- **Simple**
- **One Transaction**
- **Net Debit (Upfront Cost)**
- **Max Risk (Limited)**
- **Max Gain (Unlimited)**

When to Use the Strategy

The primary use of the long call is when your outlook is bullish, meaning you expect a security to go up in value. It's best used when you expect the security to increase significantly in price in a relatively short period of time. Although there are still benefits to using it if you believe the security will rise more slowly over time. You just need to be aware of the effects of time decay, because the time value of calls will depreciate over time.

Generally speaking, any time you have a bullish outlook on a security you could consider using the long call. However, there are probably better alternatives if you are only anticipating that the price of the security will increase a little.

This is a very useful strategy to use for a number of reasons. For one thing it's really simple, so the calculations involved are quite straightforward. It's essentially an alternative to buying an asset that you expect to increase in value, but because of the leverage power that options have you can make a greater return on your investment. You can also use the Long Call strategy as a Hedge against a Short Stock Position.

How to Use the Strategy

The downside risk is lower than investing directly in an asset, because the most you can lose is the cost of the Calls (Premium) that you buy. No matter how much the underlying security drops in value this is true. It's also flexible, as you can effectively select the risk to reward ratio of the trade by choosing the strike price of the options contracts you buy.

The only transaction involved is to purchase calls on the security that you believe is going to increase in price.

You need to decide what expiration date to use and what strike price. If you are expecting the underlying security to quickly rise in price, then buying contracts with a short time until expiration makes sense. If you think the underlying security will take longer to rise, then you will need to buy longer term contracts. Longer term contracts will usually cost more, because they will have more time premium associated with them and a higher chance of volatility due to longer time horizon.

What strike price to use takes a little more consideration. Beginner traders should probably buy contracts that are At The Money, or very Near The Money. Obviously buying a Call that is very Out of the Money with a very short-term expiration has a much lower chance of being In The Money than a Call Option that is At or Near The Money with a Longer expiration. The probabilities of being In The Money by expiry will be reflected in the price of the Options.

Experienced traders compare the Delta values of options with different strike prices, and determine which strike price to use based on the returns that they are looking to make and exactly what they expect to happen to the price of the underlying security.

For example, if you were expecting a sharp increase in the price then buying cheaper out of the money contracts may enable you to maximize your returns. If you were expecting a more moderate increase in the price over a longer period of time, then buying in the money contracts with a higher Delta value may be the better choice. There is not a particularly a right or wrong

approach to making this decision; it ultimately comes down to your own expectations of Catalysts that are going to drive the underlying asset higher and what impact this will have on the asset price.

In another circumstance where the Long Call can be used effectively is as a Hedge against a short Stock Position. Let's say for example you are convinced that a Stock is going to halve in value in the next 6-12 Months due to your fundamental work. So, you have a Short stock position because it's better to be Short the stock than to be Long a Put because you don't know with suitable accuracy and confidence when this will happen. Now let's say you are up 15% on the Short Stock position within 10 weeks of having the trade on, however you are not sure that the Stock will go down over the next few weeks, but you don't want to miss out on the Stock collapsing if it does indeed collapse. You could of course buy some of the Short back. But you have to consider that if the Stock does collapse you will make less money on the Short Stock position. You can buy say a 5% Out of The Money (OTM) Call (Strike Price +5% from current Stock Price) with an expiry of 2-4 weeks. This will cost you some of your performance already made, however it will make you sleep at night, because if there is a "Short Squeeze" in the Stock for an unforeseeable reason, you will lose money on the Short Stock Position but you will make money on the Long Call Position. If the Stock does indeed continue to collapse and go down 50% you will only lose the premium you paid for the Call Option and maximise your Short Stock return with a Long Call Hedge.

Break Even

Break-even point is when **Price of Underlying Security = (Strike Price + Price of Option)**

Profit Calculations (Maximum Upside)

Unlimited

Profit is made when **Price of Underlying Security > (Strike Price + Price of Option)**

Profit per option owned is **Price of Underlying Security – (Strike Price + Price of Option)**

Risk Calculations (Maximum Downside)

Maximum loss is limited to the Premium paid / Net Debit

Maximum loss is made when **Price of Underlying Security < or = Strike Price**

Strategy Example

Here we have provided an example of the Long Call strategy, showing how it would be used and a few potential outcomes at the point of expiration. Please be aware this example is purely to provide a rough overview of how it can work and it doesn't necessarily use exact prices. For the purposes of this example we have ignored the commission costs.

Initial Trade

- Company X stock is trading at $50, and you expect it to increase in value.
- At the money calls on Company X stock (strike price $50) are trading at $2.
- You purchase 1 call contract (one contract = 100 shares) for an investment of $200.

If Company X stock increases to $52 by expiration

Your contracts will be worth roughly what you paid for them and you will break even on the trade at expiry. You could exercise them to buy 100 shares at $50 each and either sell them for a profit or hold on to them if you felt they would increase further in price. Alternatively, you could sell the contracts just before expiration.

If Company X stock increases to $55 by expiration

Your contracts will be worth roughly $500 and taking into account your initial investment of $200, you will have made a profit of around $300. You could either exercise them or sell them just before expiration for a profit.

If Company X Stock falls or does not increase by expiration

Your contracts would expire worthless, and you would lose your initial investment.

Remember, you don't have to hold your options all the way until expiration. Their price will increase as the price of Company X stock increases, so you can sell them for a profit at any point if you choose. Equally, if the price of Company X stock is falling or staying stable, then you could sell them to recover any remaining value and reduce your potential losses.

2. Long Put

Quick Explanation

The right but not the obligation to sell a particular Stock at a specified price before a specified time.

The Long Put, or buying Put Options, is about as simple as Options trading strategy gets, because there is only one transaction involved and it enables you to make potentially very large profits through the power of leverage while limiting your potential losses at the same time. However, unlike being long a Call Option the upside in terms of Profit although large is theoretically limited because a Stock can only go to Zero. Whereas on the flipside a Stock can theoretically go to "infinity." So being simply Long a Put is different to being simply long a Call. However, you should not let this "put you off" (no pun intended) from owning a Put option when your fundamental predisposition is bearish. There are many uses for being Long a Put and at the end of the day your risk is limited to the premium you pay for the Put and your upside is still massive. So, the risk reward is still excellent. Plus, in reality, stocks vary rarely go to Zero and NEVER go to infinity. Additionally, it is much easier to buy a Put especially on large and Mid-Cap names than it is to short a stock on Margin for many Retail Traders in the World who have high Margin requirements from Brokers. Remember there always needs to be a marginal benefit in trading an Options strategy versus simply being Long or Short a stock. Capital requirement should always be a consideration. In many cases you can get the same $ notional exposure being Long a Put or a Call (over a certain time frame) with significantly less capital than it would take to simply be Long or Short the Stock. The Capital consideration must be right, the Risk Reward must be better than simply have a Stock position and you have to be right before a certain time. See Marginal Benefits Video 4.

- **Directional Bet**
- **Bearish Strategy**
- **Simple**
- **One Transaction**
- **Net Debit (Upfront Cost)**
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- **Max Gain (Limited)**

When to Use the Strategy

The best time to use this strategy is when you have a bearish outlook and you are expecting an asset to drop significantly in value in a fairly short time frame. Although you can still use it if you think the asset will drop in price over a longer period of time. However, using a Long Put (Naked) to bet on falls in Stock prices over Long Periods of time can obviously suffer from the effects of time decay on the value of the Option. This will have a negative impact on any profits you make as Puts lose value over time and the loss of value of a Put and / or a Call Option accelerates into Expiry. There are other strategies that are probably better if you are only expecting a small drop in value, but the Long Put can be used whenever you have a bearish outlook. It can also be used for a hedging strategy if you want to protect a Stock that you own against a possible fall in value.

How to Use the Strategy

So, the Long Put strategy has two main uses. For trading purposes Naked Long, a Put can serve as a quick way to make money out of a Stock that drops quickly versus just being short the stock which may require a lot of Capital / Margin to be allocated to the Stock trade and the Long Put has limited downside. You can sell the Put as well if you make money from the fall in the stock whilst being Long the Put if you think the stock will rally and the price of the Put Option will fall. Additionally, you can trade out of the Put if it drops in value and you are wrong to get back some premium if you are wrong and the stock rallies. The same applies to Call Options when simply trading a Naked Long Call. For investing purposes, a Long put can provide a Hedge in a few main ways. If you are long a Stock that has an active listed Options market and you believe in say 3-4 weeks' time there may be a retracement in the stock of a decent magnitude due to a catalyst like Earnings, but you are a long-term holder of the stock and perhaps you want to continue to collect the dividend and you do not want to sell the stock. You can Hedge the position by buying an At The Money (ATM) or slightly Out of The Money (OTM) Put Option. Say maximum 5% Out of the Money. So, strikes to consider maybe ATM, -1%, -2%, -3%, -4%, -5% in a contract with expiry that encompasses the catalyst date. So if Earnings are due on February 8th.., you want to consider expiry's later than February 8th. This way if the stock has a fall into Earnings you will lose money on the stock position but make money on the Put. If you hold the Put position over earnings and the stock drops

quickly you are protected. This is why being Long a Put is sometimes called being long a “Protective Put…,” …, because it is protecting a Stock position. Another way in which a Put is useful as a hedge is as a Portfolio or “Burn the House Down” Hedge. When Hedging by buying a Put you are buying insurance against a current Long position in either a Stock or a Portfolio. Long Dated Puts 3,6,9,12 Months that are significantly Out of The Money can be very “cheap” and effective ways of “insuring” against unforeseen events. So, if you have Pension for example that is Long Only and the market is up 15% half way through the year…, you might decide to protect your “property” by spending 1.5%-2% of your performance on a Long Dated OTM Put to protect your Net Worth against a Crash. The best way to explain and distinguish this strategy from the short-term hedge mentioned above is that in the short-term hedge example you are simply buying some insurance against a specific foreseeable potential issue and you have a high degree of confidence that it might happen and it makes you fearful that you could lose money on your Stock position. This is like buying Travel insurance for a Skiing Vacation. In the Long-Term hedge, you are buying insurance to hedge yourself against “tail risk” i.e. an unforeseeable reason why everything comes crashing down. This is more commonly known in Financial Markets as a Black Swan event. So, this is more analogous to buying Fire Insurance on your home. The premiums are low for a reason because its very unlikely to happen, BUT the unforeseeable could happen and that is why you buy Fire Insurance every year for your home i.e. because you don’t want to lose your home due to an unforeseeable event. Buying a 3, 6, 9, 12 Month 5%-15% OTM Put Option provides Pension holders with “Burn the House Down Insurance” and can make you sleep at night, especially if you have spent several years watching your pension go up by 20%-30% per year for several years in a row. Of course, you have to pay for the insurance and in years when the market is up you will most likely slightly underperform the market. But who cares? In the year that a market crashes and everyone loses, you will probably not be losing money if you hedge well.

The long put is about as straightforward as it gets. There's just one transaction involved: the purchase of puts on the relevant underlying security. There are three particular factors that you need to decide upon when using this strategy; the strike of the options contracts, the expiration date and whether there is a marginal benefit in doing so over having a Stock Position i.e. Capital Requirements and Risk Reward. There are no hard and fast rules when it comes to making these decisions, because they ultimately depend on your own analysis, outlook and risk appetite / assessment.

The strike you choose will affect two things: the price you have to pay and the potential profits you can make. Beginners traders should at first stick to buying At The Money (ATM) contracts (where the strike is equal to the current trading price of the underlying security) or slightly Out of the Money (OTM) contracts (strikes below the current trading price), because this is a good place to start to get used to trading Options. For Retail Traders that seek Long Only Portfolio / Long Pension Asset insurance it is best to go for Long Dated 3, 6, 9, 12 Month Put Options that are way Out of The Money (OTM) say 10%+ OTM. The Puts will be cheaper than ATM or slightly OTM Puts and you are putting on a trade that serves its purpose i.e. protecting against a crash / the unforeseeable tail event so when your “house burns down” you don’t lose your house. You keep it!

Out of the money contracts are cheaper, but you will need the underlying security to fall further to make a profit than with at the money contracts. In the money contracts are more expensive, but they have a higher delta value which means their value will increase more rapidly in relation to a drop in the price of the underlying security.

Choosing an expiration date is really just a matter of deciding how quickly you think the underlying security will fall in value. If you are expecting a quick drop, then it would be logical to buy contracts that have a short time until expiration. If you are expecting the price to drop more slowly, then longer term contracts would be a better choice.

Break Even

Break-even point is when **Price of Underlying Security = (Strike Price – Price of Option)**

Profit Calculations (Maximum Upside)

Limited only in the sense that a Stock can only go to Zero, but still large.

Profit is made when **Price of Underlying Security < (Strike Price - Price of Option)**

Profit per option owned is **(Strike Price – Price of Underlying Security) – Price of Option**

Risk Calculations (Maximum Downside)

Maximum loss is limited to the Premium paid / Net Debit

Maximum loss is made when **Price of Underlying Security > or = Strike Price**

Strategy Example

Here we have provided an example of the Long Put strategy, showing how it would be used and a few potential outcomes at the point of expiration. Please be aware this example is purely to provide a rough overview of how it can work and it doesn't necessarily use exact prices. For the purposes of this example we have ignored the commission costs.

Initial Trade

- Company X stock is trading at $50, and you expect it to fall in price.
- At the money puts on Company X stock (strike price $50) are trading at $2.
- You purchase 1 put options contract (one contract = 100 shares) for an investment of $200.

If Company X stock falls to $48 by expiration

At the time of expiration, the puts will be worth approximately $2 due to their intrinsic value. You could therefore sell them for around $200, meaning you will break even on the trade.

If Company X stock falls to $45 by expiration

In this scenario the puts will be worth around $5, meaning you could sell them for $500. This would give you a profit of $300 from a $200 investment.

If Company X Stock increases or is still at $50 by expiration

The options would expire worthless, and you would lose your initial $200 investment.

It's worth pointing out that you are under no obligation to keep hold of your options all the way until expiration. If they go up in price and you want to take your profit at any point then you can sell them whenever you want. You can also sell them if they start to go down in price and you want to cut your losses.