

Pros and Cons of Options Trading

By Chuck Hughes

Some of the benefits of option trading relative to trading stocks or mutual funds are:

When you purchase options you commit a limited amount of capital and thus have less total dollars at risk in the market. The surplus dollars can be placed in safe investments like a money market fund. Instead of buying stocks consider "leasing" them with options especially when your market expectations are likely to change more frequently with today's volatile markets. Set aside a small portion of your portfolio for options to benefit from the frequent market swings that can create big profit opportunities for traders positioned to capitalize on market swings.

Options offer profit potential not only when the market rallies, but also when it declines. With most mutual funds you can only benefit from bullish markets. If you are bearish on the stock market, cash is usually your only alternative. With options you can profit from both bullish and bearish markets.

Put options are normally a better choice than selling short a stock. Option purchases do not require a margin account. In addition, a short stock position has virtually unlimited loss potential whereas the maximum loss for a put option purchase is limited to the purchase price of the option.

Options offer greater leverage than stocks or mutual funds. A 10% move in a stock can easily translate into a 100% move in the related option. Purchasing options offer profit leverage if you are correct in your market view, but also offers limited risk if your market view is incorrect.

Options can allow for stock or mutual fund portfolios to be hedged without losing long-term capital gains status. This results in a more favorable tax treatment. This can improve the after-tax returns on stock holdings while allowing you to protect those stocks during market volatility.

Selling out-of-the-money put options allows you to acquire blue chip stocks at below market prices, or receive income while you wait (to buy the stock at a lower price). For example General Electric if is trading at 112-3/4. You would like to buy GE at a lower price so you sell the GE 105 put option at 4-1/2 points and collect a \$450 premium credit in your account. If GE stock closes at or above 105 at option expiration, you get to pocket the \$450 premium. If the stock closes below 105 at option expiration you acquire the stock at 100-1/2 (105 strike price minus 4-1/2 point premium received).

The negative aspects of options trading are primarily related to a general lack of understanding by the investing public. Options are not stocks. Options have their own characteristics that make them very different from stocks. The pricing of options can be difficult to understand. The biggest difference is that short-term options are time dependent. They will expire within a stated time frame. This adds a layer of complexity onto the option decision process as time can work for you or against you, depending on the strategy you utilize. A successful options trader must be knowledgeable about the underlying stock/index and must understand the dynamics of the related options.