Option Trading: Definition, Types and How Does it Work

Option trading is about buying and selling contracts giving the holder the right to buy or sell assets at a set price within a timeframe.

Options trading have become one of the most popular modes of investment in the last couple of years. However, observations suggest that most traders suffer losses in options trading due to a severe gap in knowledge & understanding of these derivatives. It is always advised that one should never place an options trade without adequate knowledge.

Here, we've discussed all an investor needs to know about trading options, option strategies and more.

What is option trading?

Options trading gives the buyer the right but not the obligation to buy (call option) or sell (put option) a certain underlying asset at a predetermined price within a stipulated period. Options trading involve strategies that provide traders with various market positions to make gains or mitigate the spot market risk.

Understanding options trading

Options trading provides an opportunity for traders to make gains from the change in the stock price without paying the purchase price in full, where only a premium amount has to be paid. Therefore, it is a type of trading that provides the flexibility of not purchasing securities at a certain price for some time.

There are two types of options that traders need to learn about:

Call option: It is an option that gives the holder a right but not an obligation to buy an asset at a particular price before the date of expiry.

Put option: It is an option that provides the holder with a right and not an obligation to sell an asset at a particular price before the date of expiry.

How does options trading work?

Whenever an options trader is buying or selling options, he/she receives a right, but not an obligation, to exercise an option before expiration. The purchase and sale of an option contract do not mandatorily need to be executed; if the position gets unfavorable, one can simply avoid executing.

Difference between options trading and other instruments

Options trading is a type of financial trading that allows buyers to purchase the right, but not the obligation, to buy or sell an underlying asset at a predetermined price and date. Options trading differs from other financial instruments in several ways. Firstly, options contracts are highly flexible, allowing traders to customize their investment strategies by selecting a variety of variables, including the strike price and expiration date. Secondly, options contracts provide leverage, allowing traders to potentially earn high returns with relatively low capital.

It comes with limited downside risk, making it a safer investment than futures or margin trading. In addition, options trading can be more complex than other financial instruments, as it requires traders to have a good understanding of the underlying asset and market conditions.

Lastly, successful options trading requires good timing and market knowledge, as traders must correctly predict the direction and magnitude of price movements to profit.

Advantages of options trading

Cost-efficiency:

Options have great leveraging power, allowing investors to obtain an option position similar to a stock position, but at significant cost savings. This makes options trading a more affordable way to invest in the market.

Risk reduction:

Options contracts can provide investors with risk-reduction strategies. Used as a hedging device, options can help investors protect their portfolios against adverse market movements.

Higher percentage returns:

Options have the potential to deliver higher percentage returns than other forms of trading. This is because options allow traders to profit from both upward and downward price movements in the underlying asset.

Flexibility:

Options give traders and investors more flexible and complex strategies such as spread and combinations that can be potentially profitable under any market scenario. This flexibility allows traders to customize their trades according to their specific needs and risk tolerance.

Strategies in option trading

There are various strategies prevalent in options trading, which include the following:

Long call strategy:

This strategy involves buying a call option, which gives you the right, but not the obligation, to buy the underlying asset at a specified price (strike price) before or on the expiration date.

Traders use this strategy when they anticipate the price of the underlying asset to rise significantly.

Short call strategy:

In this strategy, you sell a call option without owning the underlying asset.

You're obligated to sell the underlying asset at the strike price if the option buyer exercises their right.

Traders use this strategy when they expect the underlying asset's price to remain relatively stable or decrease.

Short put strategy:

This strategy involves selling a put option without owning the underlying asset.

You're obligated to buy the underlying asset at the strike price if the option buyer exercises their right.

Traders use this strategy when they believe the underlying asset's price will remain stable or increase.

Long straddle option strategy:

In a long straddle, you simultaneously buy a call option and a put option with the same strike price and expiration date.

It's used when you expect a significant price movement in the underlying asset but are uncertain about the direction (up or down).

Short straddle strategy:

This strategy involves selling a call option and a put option with the same strike price and expiration date.

Traders use it when they expect the underlying asset's price to remain relatively stable within a specific range.

Long put strategy:

This strategy entails buying a put option, giving you the right to sell the underlying asset at the strike price.

Traders use this strategy when they anticipate a significant drop in the underlying asset's price.

Each of these strategies has its own risk-reward profile and is chosen based on a trader's outlook on the underlying asset's price movement.

Participants in options trading

Here are the participants who take part in options trading:

Buyer of an option:

Option buyers are the ones who purchase a right to exercise a contract in return for a premium.

Seller/writer of an option:

Option sellers are the ones who receive the premium; therefore, an options seller becomes obligated to sell or buy the underlying asset in case the buyer exercises the contract.

Call Option:

A call option is a type of financial contract that gives the buyer the right (but not the obligation) to purchase an underlying asset at a specified price (the strike price) before or on the expiration date.

Call options are often used when traders anticipate the price of the underlying asset will rise.

Put Option:

A put option is a type of financial contract that gives the buyer the right (but not the obligation) to sell an underlying asset at a specified price (the strike price) before or on the expiration date.

Put options are commonly used when traders expect the price of the underlying asset to fall.

Participants in options trading, such as buyers and sellers, use call and put options to manage risk, predict price movements, or enhance investment strategies. The roles of buyers and sellers differ in terms of rights and obligations within option contracts.

Notable terms in options trading

Here are some notable terms in options trading:

American option: American options are those contracts that can be exercised at any date before their expiry date and also on the expiry date itself.

European option: European options are those contracts that can be exercised only on the expiration date. Only European options are available in the Indian market.

Strike price: The strike price is the price at which both parties entered the contract. It is also known as the exercise price.

Premium: It is the amount that the buyer of an option pays to the seller.

Expiry date: It is the date specified in an option beyond which the contract becomes invalid.

To trade with options, you'll need a Demat and trading account with any SEBI-registered broker.

Profitability Scenarios in options trading

Listed below are the three profitability scenarios in options trading:

In-the-money (ITM): This is the profitability scenario in options trading that results in a positive cash flow to the option holder when executed immediately.

At-the-money (ATM): In this scenario, the option's spot price is the same as its strike price. This results in a situation of no profit or no loss when executed right away.

Out-of-the-Money (OTM): This is a scenario that would result in a loss if executed immediately. OTM options do not have any intrinsic value.

There is often a misconception among people that options involve high risk. Although options trading can result in losses, individuals with sufficient market knowledge will make more profits over time. Options serve different purposes like hedging, speculation, or leveraging. But it is always recommended to acquire knowledge of options before trading.