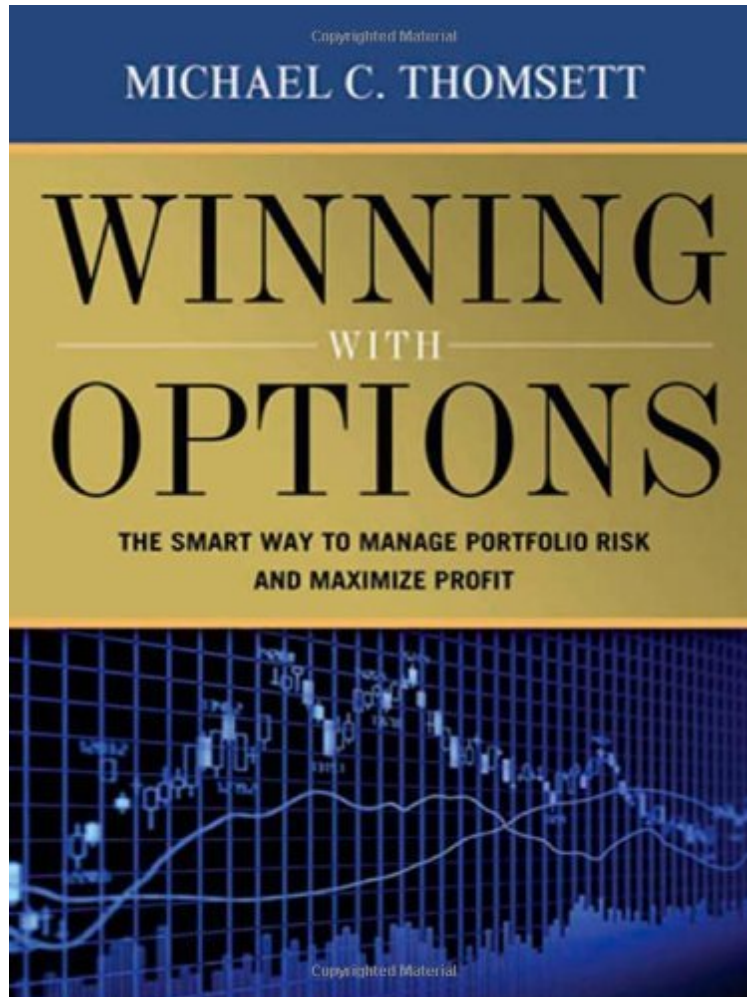


Winning with Options: The Smart Way to Manage Portfolio Risk and Maximize Profit

Michael C. Thomsett

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Michael C. Thomsett : Winning with Options: The Smart Way to Manage Portfolio Risk and Maximize Profit before purchasing it in order to gauge whether or not it would be worth my time, and all praised Winning with Options: The Smart Way to Manage Portfolio Risk and Maximize Profit:

0 of 0 people found the following review helpful. Excellent book for options noviceBy Linn SlattengrenThis is one of the better books on options for the novice. The author writes clearly and without hyperbole. He explains how options used properly are a conservative way to manage stock investments. I would recommend it to anyone who has experience investing in the stock market and is considering options to expand their repertoire. For a more comprehensive study, one needs to read McMillan and/or one of the other more substantial books of course.

Options are an integral part of any financial portfolio, but they can be intimidating to the average investor. While often

viewed as risky, the truth is that, if used properly, options can be one of the best tools for balancing a portfolio. In fact, they can help investors protect themselves from downside risk and leverage capital to make bigger plays than would otherwise be possible. In *Winning with Options*, Michael C. Thomsett offers nontechnical, easy-to-follow advice for readers who need guidance on important techniques related to portfolio management, such as diversification and risk management. Readers will discover how to: choose the right brokerage firm; use online resources; pick the right stocks; track options; set portfolio and risk goals; understand the complicated world of options lingo; make the most of day trading and swing trading. Straightforward and practical, this is the one book that will help the novice option trader navigate the sometimes daunting, but often rewarding, world of trading and investing in options.

From the Back Cover Michael C. Thomsett (Port Townsend, WA) has written more than 50 books, including *Getting Started in Options*, *Annual Reports 101* (978-0-8144-7367-2), *The Stock Investor's Pocket Calculator* (978-0-8144-7460-0), *The Real Estate Investor's Pocket Calculator* (978-0-8144-7296-5), and *Getting Started in Fundamental Analysis*. He has been a management consultant in the securities industry and is an active options trader.

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C H A P T E R 1 A FEW BASICS

One of the greatest pieces of economic wisdom is to know what you do not know. —John Kenneth Galbraith, in *Time Magazine*, March 3, 1961

Imagine investing in a company, holding shares of stock for the long term while earning a nice dividend each year, and watching your portfolio grow over time in a robust and healthy economy. Now imagine expanding this idea to create additional benefits. These include being able to take profits when they occur as a result of short-term overreaction in the market, to protect your stock against price declines, and to use your shares of stock to increase current income each and every year—when the stock rises and when it falls. That environment does exist. With the careful, well-planned use of options, you can manage your portfolio to reduce overall risk while increasing current income. At the same time, you can satisfy the urge to speculate without placing your long-term investments at risk. You might not think of yourself as a risk taker, but most people like to imagine what it would be like to play short-term price movement and make a little extra money doing so. If you are typical, you probably have not gone down that road because you do not want to place your investment capital at risk, and that is a legitimate reason to play it safe. However, this book lays out a series of strategies involving options that you can use to create the ideal stock environment without added risk. Options are flexible and present many great opportunities, making them a practical income generator and risk-reducing device.

Ground Rules for Stock Selection

You have probably heard about options in terms of high risk and high loss. They are often seen as speculative “side bets” that only the high rolling risk taker wants to use. But this is not necessarily the case. A large number of option strategies are actually low-risk and worth considering even in the most conservative portfolio. To establish a clear definition of options and how they work, you need to be aware that an option is merely a “right.” It has no tangible value and only grants its owner the ability to transact stock at a predetermined price. This gets interesting when the stock price moves above or below that set price. The more the movement of the price, the more valuable the option becomes—because the option fixes the price of the stock, no matter what its market price is at the time. To understand this in a way familiar to many people, consider the case of a real estate lease-option contract. Under this deal, a person who wants to buy a home enters into a lease with the owner, agreeing to pay a specified amount of rent for a period of years. In addition, the contract specifies that at any time before expiration of the lease, the tenant also has the right (the “option”) to buy the house at a specified, fixed amount. Therefore, even if the market value of the home doubles, the tenant has the contractual right to exercise the option and buy the house. Numerous possible outcomes can occur, as shown in the example below.

EXAMPLE

You want to buy a house currently valued at \$265,000 but you do not have the down payment. You believe that you can save up enough to buy the house within three years, so you offer the owner a lease-option. It specifies that you will make lease payments over a 36-month period, and also that at any time you can exercise an option to buy the house for \$265,000. At the end of the lease term, the option expires. Several outcomes may occur:

- You are unable to save enough, or the house actually declines in market value. You allow the lease to expire without taking any action.
- The house doubles in value to more than \$500,000 and you exercise the option. The owner is required by contract to sell the house to you for \$265,000.
- The property increases in value and the owner does not want to sell, so he offers to buy your option from you. The price is negotiated based on current market value versus the option value of the property.

The kind of real estate transaction shown in this example occurs quite often. Now apply the same concept to the stock market and you have a fairly good idea of how it all works. For the price you pay to buy an option, you fix the price of stock. A call option gives you the right (but not the obligation) to buy 100 shares of a specific stock, on or before a specified deadline (the expiration date), for an exact price (the strike price). The opposite is a put, which is an option granting its

owner the right to sell 100 shares of stock on or before expiration and at a specific strike price. For option sellers, the rights are ceded to buyers. The rules for both types of options are summarized in Figure 1-1. Before jumping in and starting to buy (or to sell) calls and puts—or before investing in stock with option trading in mind—you need to consider the risk elements, not only of options but also within your stock portfolio. As a starting point, a series of commonsense rules will help you to keep your stock portfolio and options in perspective. First is the “rule” that your long-term portfolio objectives should govern all of your decisions: Rule 1: Pick stocks based on your well-defined objectives and risk tolerance levels, and never based on potential gains from options. Too many first-time option investors make the mistake of picking stocks based on the value of related options. Another mistake is keeping high-risk stocks in your portfolio because options are potentially profitable, when you would otherwise sell and replace those shares with safer stocks. Rule 2: Be sure the stocks you hold are appropriate for you, and when that is no longer true, sell and replace those shares. The third rule to remember is related to the long-term nature of most portfolios. Rule 3: Select stocks based on your belief about long-term price appreciation, above all other considerations. This final rule is the basic “value investing” approach. Under this premise, any long-term hold stocks should be in highly-valued, well-managed, competitively dominant companies whose stock you can buy at a bargain price (and then hold for the long term). Although this premise makes sense, it does not preclude options. In fact, value stocks are often the best stocks for various option-based strategies, assuming that you first apply the fundamental rules for stock selection.