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Trading Naked Calls & Puts

An option is a derivative trading product that is best used by investors as a hedging tool providing profit protection and profit enhancement. Although it is a powerful risk management tool, it can also be used effectively as a stand-alone trading vehicle.

Under the proper conditions, options do not have to be paired with stock or another option to be an effective trading tool. To successfully trade naked options, an investor must realize that certain options will fit certain scenarios and certain options will not.

One of the major misconceptions that investors have about options stems from the fact that most do not know how to trade them properly. When they lose money trading them, they feel that there is something wrong with the option. They do not understand that options are on a higher, more sophisticated level when compared to stocks.

Stock trading has fewer variables involved and is therefore easier. No one is saying that the individual investor isn't smart enough to trade options. The problem is not intelligence; it's just education and experience. Most investors have not been properly educated in the proper use of options, and even fewer have had any real experience trading them.

One of the biggest problems investors have is this: Even if you buy a call and the stock goes up, you can still lose money. Most investors tend to buy out of the money options at a cheap price. The stock trades up a little, which is the right direction, but the option still loses money and the investor wonders why.

What the investor fails to realize is that in order for the option to be profitable the options delta must out-pace its rate of decay. Implied volatility also plays a key role if the stock does trade up while implied volatility decreases, the options delta must then outperform the decrease in volatility. Remember, when volatility increases, the price of all options goes up. When volatility decreases, the price of all options goes down.

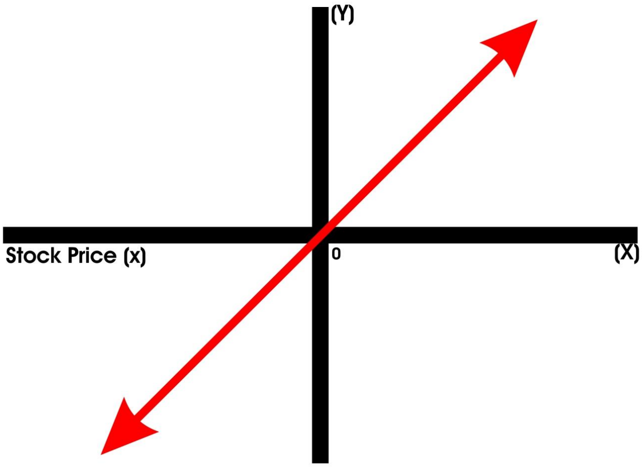
We have categorized options in several ways. One way is by the option's strike price, and its distance from the stock price. We identified these options as either in-the-money, at-the-money, or out-of-the-money.

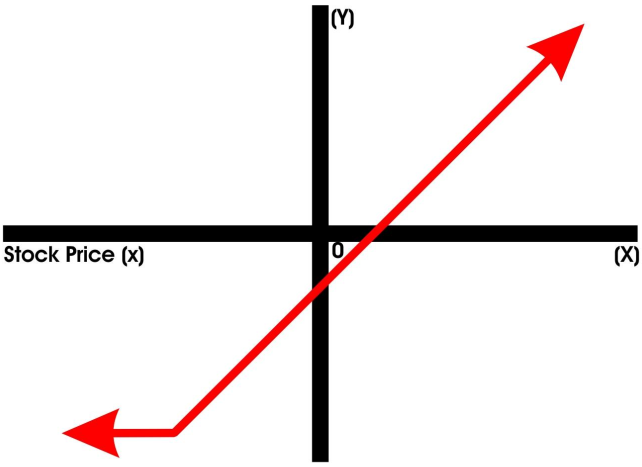
In our discussion about trading naked calls and puts, we will identify trading opportunities or situations that fit each of these types of options, for both calls and puts.
But it is important to first review the definition of Delta before continuing.

Remember, delta tells you how much the option will move with a similar move in the stock and is given as a percentage. For example, a 33 delta option means that the option will move 33% of the movement of the stock and 70 delta option will move 70%.
In-the-money options act like stock. The deeper in the money the calls are, the more they act like the stock. As the call moves deeper and deeper in the money, the calls delta approaches 100 which means it's price movement will reflect 100% of the stock's movement. (This is discussed in more detail later in "The Stock Replacement Covered Call Strategy").

In fact, deep-in-the-money options are sometimes even used to replace stock positions. If you look at the charts below, you can see how closely the in-the-money call mimics the upward movement of the stock (2nd quadrant).

Stock VS Deep In-The-Money Call





In the money options are best used for smaller stock movements. The reason is that in-the-money options contain less extrinsic value. The extrinsic value can work against you when purchasing an option because extrinsic value is affected by time decay.

As you wait for your stock movement, the in-the-money option will decay less than either the at-the-money or out-of-the-money options because it has less extrinsic value. The amount of money you lose in time decay must then be made back by additional stock movement.

Obviously, the less you lose in decay, the less the stock has to move for you to be profitable because it has less decay loss to make up for.

This is because an in-the-money call has a high delta and a much higher percentage chance of finishing in-the-money by expiration so they follow the stock more closely.

With less extrinsic value loss to make up for, a smaller movement in the stock will produce a greater profit. For a call example, as you can see in the chart below, the in-the-money produces a profit with the least amount of stock movement. With less extrinsic value, the ITM option has a lower break-even point.

For chart below, stock price = $35.00

Strike Price	Option Price	Delta	Breakeven	Extrinsic Value
$30.00	5.20	85	35.20	$ .20
$35.00	1.00	52	36.00	$1.00
$40.00	.30	20	40.30	$ .30

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