

Advantages and Disadvantages of at-the-money option, in-the-money option and out-of-the-money option

An **at-the-money option** has both advantages and disadvantages over stock and **in-the-money** options. First, the at-the-money option will be cheaper than both the stock and the in-the-money option. So there is less capital requirement and less total risk.

Remember, when buying an option, you can only lose what you spend. The problem is the amount of extrinsic in the at-the-money option.

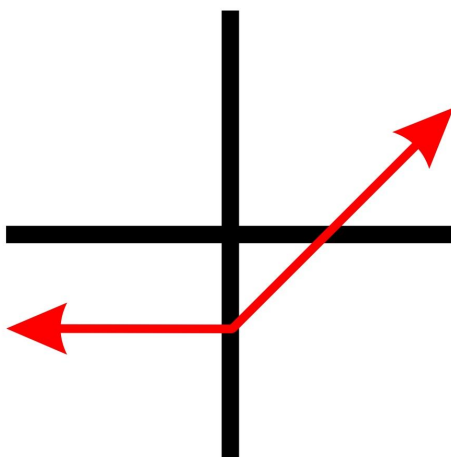
In order for you to profit from buying an at-the-money option, you need the stock to make a move very quickly. Because you have so much extrinsic value, you will be battling against the option's daily rate of decay.

So, the movement of the stock must happen quickly enough and large enough to offset the amount of money you will be losing daily as expiration draws near.

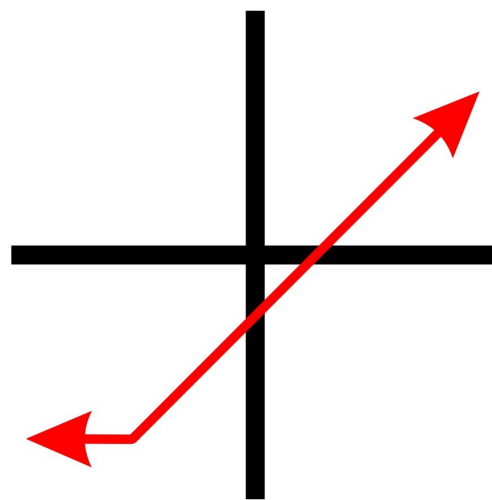
With this said, the best chance you have to make money when buying a naked at-the-money option is to use it as a short term trade. The longer you hold onto this option, the harder it is for you to be profitable due to the options decaying extrinsic value.

At The Money Call vs. In The Money Call

3. Long atm call



4. Long itm call.





For chart below, stock price= \$35.00

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

An out-of-the-money option presents many of the same advantage & disadvantage parameters to the investor. The out-of-the-money option is even cheaper than the at-the-money option which means more leverage and less risk.

However, with a smaller delta, the stock must move much more than either the in or at-the-money options in order for the options to become profitable. Again, we need the option's delta to outpace the option's rate of decay.

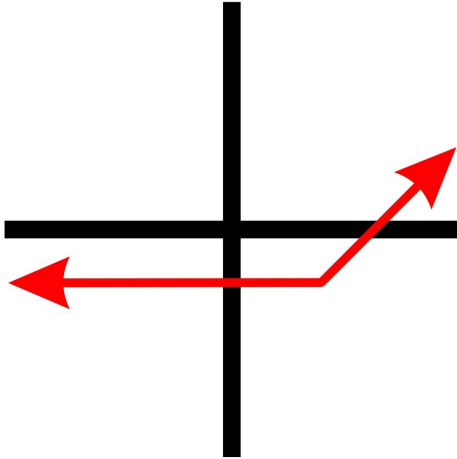
Now, with the out-of-the-money option, there is less extrinsic value than the at-the-money option so the amount of total possible decay (cost of the option) and the rate of this decay is less than the at-the-money option.

By being further out-of-the-money, this option needs more movement from the stock. As a naked option, this out-of-the-money example is extremely speculative and should only be used naked when the investor feels there is a very good chance of a stock having a large percentage move.

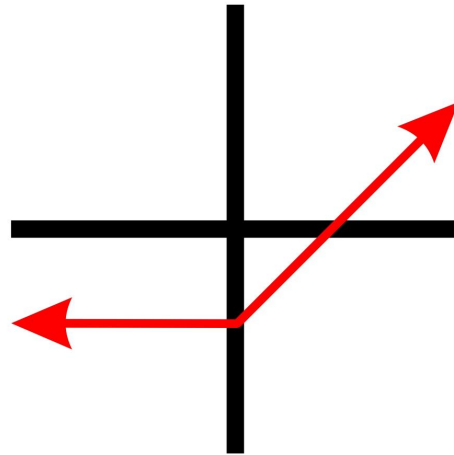
An investor must understand that the odds of them profiting from the purchase of a naked out-of-the-money option is very slim. When purchasing a naked out-of-the-money option, be prepared to lose your entire investment.

Out of the Money Call vs. At the Money Call

5. Long otm call.



3. Long atm call



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

Although options can be traded by themselves for directional plays, and can perform well under the right conditions, they are much better used in coordination with stock or other options in formatted strategies which will be discussed in the next section.

While buying naked calls and puts can provide some of the biggest leverage and highest returns, they can also involve the most risk. This strategy should only be used by experienced options traders or traders using risk capital.

For more Information about option trading, please click here:
www.options-university.com