# Understanding **Options** From Basics

# What is an Option?

An **Option** is a type of derivative contract that derives its value from the underlying asset or security. The underlying usually stocks.

An option contract gives its owner the **right but not the obligation** to buy or sell an underlying stock at a specific price (**Strike Price**) in the future.

To get this right, the option buyer pays a small **premium** to the option seller.

# Types of Options Contract

- **Call Option:**

The owner of the call option has the right to buy the underlying at a specific strike price for a specific time period.

- **Put Option:**

The owner of the put option has the right to sell the underlying at a specific strike price for a specific time period.

# Let's understand with Example:

Let's say you believe that the stock price of ITC currently trading at ₹ 200 will increase in the near future.

You decided to buy the one-month call option of ITC with a strike price of ₹ 205 by giving a premium of ₹ 2 to the call seller/writer.

If ITC reaches ₹ 215 next month you can exercise the option and buy the ITC stock for ₹ 205 only.

If the price doesn't increase or decrease in the next month. You have a choice to not exercise the option.

In the first case when it reaches ₹ 215, your profit will be (215 - 205 -2 )=(₹ 8). ₹ 2 will be subtracted since it is already paid as a premium.

In the second case, you do not exercise the option. The loss is only the premium that you paid which is ₹ 2.

It works exactly the opposite for the put option where you only exercise the option when it reaches below the strike price.

# Option Buyer

- The option buyer pays a premium to the option seller for the right to buy or sell the underlying.
- Buyer of an option has limited risk up to the premium paid and can earn an unlimited profit.
- The biggest risk for option buyers is time decay and a drop in volatility.
- Due to these risks, the option buyer loses most of the time in the trade.

# Option Seller/Writer

- The option writer only receives a premium and has an obligation to perform if the buyer exercises the option.
- The risk is unlimited for the seller and profit is fixed to the value of the premium.
- Although the risk is high, the option seller has a high probability of success due to factors like time decay and volatility.

# Option Terminologies

- **Option Premium:**

  The option buyer pays a small amount as a premium to the seller to get the right to buy or sell the underlying. It is also called the price of the option.

- **Strike Price:**

  It is the price at which the buyer buys the underlying in the future if he decides to exercise the option.

- **Expiry Date:**

It is a date on which an options contract expires and becomes invalid. It only expires if it is not exercised.

- **Contract Size:**

Contract size represents a specific number of underlying shares that a trader may be looking to buy.

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