Limit Risk with Options on Bitcoin Futures

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Here we are in the midst of a severe **Bitcoin winter** wondering if crypto prices will rise or fall with the next Fed interest rate pronouncement. Since the last **Bitcoin step down** to the $20,000 range the elder cryptocurrency does not seem to know where it will go next. Bitcoin true believers are still hoping for another dramatic upswing in price while many long term **Bitcoin holders are selling** as fears increase of another price collapse. At this point in time it might well be a good idea to limit risk with options on Bitcoin futures. How does that work?

What Are Bitcoin Futures?

A future is a derivative contract. Participants are obliged to buy or sell the asset specified in the contact as of a set future date. Buyers must buy and sellers must sell no matter where the underlying price has settled. Buyers of **futures** have expected the price of the underlying asset to rise and sellers have expected that price to fall. A common practice among futures traders is to exit the trade, hopefully with a profit, before the expiration date. The cost of a futures contract is substantially less than the cost of the commodity, stock, or cryptocurrency covered by the contract.

The Commodity Futures Trading Commission or CTFC considers Bitcoin to be a commodity, and since the CTFC oversees the futures market they categorize Bitcoin futures as commodity futures just like corn, soybeans, and gold. Trading of Bitcoin futures takes place on the CME, the Chicago Mercantile Exchange, as six-month quarterly contracts settled in cash. **Bitcoin futures contracts** cover 5 BTC and expire on the last Friday of the month.

What Are Options on Futures?

When one buys or sells a futures contract, they are obliged to buy or sell, or settle with cash as in the case of Bitcoin, unless they exit the contract prior to expiration. A way to add flexibility to this situation is to buy or sell options on Bitcoin futures. An option contract gives the buyer the right to exercise a futures contract which the buyer will do, providing that doing so is profitable. Options come in two flavors, calls and puts.

Buying a call gives the buyer the right to purchase the underlying, in this case a futures contract, at a price set by the contract and selling a call obligates the seller to sell the contract. The buyer pays a premium for this right.

The other flavor is the put which gives the buyer the right to sell the underlying at the contract price, called the strike price, which they will do if profitable. The seller is paid a premium and the buyer pays a premium.

Why Trade Bitcoin Futures Options?

Trading options on Bitcoin futures has a couple of advantages over simply buying or selling Bitcoin. The capital invested in a futures contract or an options contract on Bitcoin futures is significantly less than the cost of buying 5 BTC. But the potential profit is similar when BTC price moves as expected. Then there is the issue of losses when Bitcoin falls in value. Anyone who purchased 5 Bitcoin for $67,000 each or $335,000 in November of 2021 has lost $47,000 or $235,000 over the last year. In comparison, the maximum loss when purchasing an option contract, call or put, is the premium paid for the contract. If a trader believed that Bitcoin was going to rally and purchased call options on several Bitcoin futures contracts, the worst they would do if Bitcoin fell is lose the premiums paid for the options contracts. The best that they could do if Bitcoin rallied would be to experience profits similar to if they had just bought futures contracts or purchased Bitcoin directly. Thus one can limit risk with options on Bitcoin futures while at the same time leveraging trading capital.

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