When Should Investors Trade Options?

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The point of investing is to make money. At least the point is to avoid having inflation eat up all of your savings and require you to work long into your retirement years. So, what is the best way to invest? Successful long term investors will tell you that buying a mix of secure stocks and holding them for five, ten, twenty years, or longer is the key to making the stock market work for you. Then things like the Financial Crisis or Covid crash come along and wreck your plans. Here is where options traders will remind you that by trading options you can make money as the market falls and not just when it is going up. So, when should investors trade options?

What Are Options?

Options are contracts to buy or sell stocks, currencies, futures contracts, or even Bitcoin futures contracts. Options come in two basic flavors, calls and puts. In the case of stocks, a call gives the buyer of the contract the right to purchase a stock at a price specified in the contract called the strike price. This right lasts until the contract expires. Because the strike price does not change, the buyer can make money when the stock goes up in price. He or she can buy the higher priced stock for a bargain at the strike price. More commonly the buyer can simply exit the contract with a profit. For this opportunity the buyer pays a premium. Puts work in a similar fashion in conveying the right to sell a stock at a set price.

Selling Options

While the buyer of an option contract, call or put, pays a premium for the contract, the seller collects the premium. In return they take a risk. If a stock goes up above the strike price of the contract the seller of a call ends up having to sell the stock at the strike price. This means they have to buy shares at the higher market price first. Or they may be able to exit the contract for a loss without having to deal with the stock in question. On average selling options is more profitable than buying them. The trouble is that every so often the seller guesses wrong and takes a huge loss. This generally means that selling options without offsetting the risk is done only by folks with deep pockets.

Options Trading As a Business

Professional options traders use strategies like vertical spreads. For example, they sell a call for which they collect a premium. And they buy a call at a somewhat higher strike price. This contract is cheaper so they start the trade with a credit. If the trade goes badly the second contract acts as a stop loss. This sort of hedging of risk is routine for professional options traders just as it should be for any investor who wants to trade options. So, when should investors trade options?

Covered Calls for Extra Cash

A common strategy used by investors is a **covered call**. They sell calls on stocks that they own. They will do this when they do not believe the stock will go up in price. They receive a premium for the sale and keep the stock when the price does not go up. If the stock does go up above the strike price, they still keep the premium and simply sell their stock. For a stock that is approaching the top of its trading channel, the owner recognizes that the stock is likely to head down again and profits from the buyer who is betting that it breaks out of the channel and continues on up.

Puts In a Falling Market

If you were invested in an ETF that tracks the S&P 500 at the start of the Covid crash you lost 31% of your investment in a bit over a month. Of course if you just hung in there you got that back and more. But, what if you recognized what was going on and purchased puts on your S&P 500-tracking ETF? If your timing was perfect you bought those puts on or before February 14 and sold them just before March 20. You would have virtually printed money all the way down. Then you could have reinvested using your profits at the bottom and amplified what you made on the way back up. This is what makes options trading potentially so attractive.

Who Should Trade Options?

A simple options strategy like a covered call is something that does not require at lot of options expertise and is relatively safe. Buying puts when you suspect that the market is going to fall is also pretty basic. In both cases, the risk is limited. The next step into using a strategy like a vertical spread requires that you understand options and have some skill at timing the market. It also requires that you have the time to do this and the inclination. Do you want to come home from your day job and spend every evening managing an options portfolio? Do you have the ability to take time from your work day to do this when the market offers potential profits? The majority of novice options traders lose money. This is why investors typically limit their options exposure to covered calls and the occasional purchased put on a stock that they own.

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