Introduction

The Intelligent Option Investor

You have a tremendous advantage over algorithmic trading models, investment bank trading desks, hedge funds, and anyone who appears on or pays attention to cable business news shows. This book is written to show where that advantage lies and how to exploit it to make confident and successful investment choices. In doing so, it explains how options work and what they can tell you about the market's estimation of the value of stocks.

Even if, after reading it, you decide to stick with straight stock investing and never make an option transaction, understanding how options work will give you a tremendous advantage as an investor. The reason for this is simple: by understanding options, you can understand what the rest of the market is expecting the future price of a stock to be. Understanding what future stock prices are implied by the market is like playing cards with an opponent who always leaves his or her hand face up on the table. You can look at the cards you are dealt, compare them with your opponent's, and play the round only when you are sure that you have the winning hand.

By incorporating options into your portfolio, you will enjoy an even greater advantage because of a peculiarity about how option prices are determined. Option prices are set by market participants making transactions, but those market participants all base their sale and purchase decisions on the same statistical models. These models are like sausage grinders. They contain no intelligence or insight but rather take in a few simple inputs, grind them up in a mechanical way, and spit out an option price of a specific form.

An option model does not, for instance, care about the operational details of a company. This oversight can lead to situations that seem to be too good to be true. For instance, I have seen a case in which an investor could commit to buy a strong, profitable company for less than the amount of cash it held—in effect, allowing the investor to pay $0.90 to receive a dollar plus a share of the company's future profits!

Although it is true that these kinds of opportunities do not come along every day, they do indeed come along for patient, insightful investors.

This example lies at the heart of intelligent option investing, the essence of which can be expressed as a three-step process:

1. Understanding the value of a stock
2. Comparing that intelligently estimated value with the mechanically derived one implied by the option market
3. Tilting the risk-reward balance in one's favor by investing in the best opportunities using a combination of stocks and options

The goal of this book is to provide you with the knowledge you need to be an intelligent option investor from the standpoint of these three steps.

There is a lot of information contained within this book but also a lot of information left out. This is not meant to be an encyclopedia of option equations, a handbook of colorfully named option strategies, or a treatise on financial statement analysis. Unlike academic books covering options, such as Hull's excellent book[1], not a single integration symbol or mathematical proof is found between this book's covers. Understanding how options are priced is an important step in being an intelligent option investor; doing differential partial equations or working out mathematical proofs is not.

Unlike option books written for professional practitioners, such as Natenberg's book[2], you will not find explanations about complex strategies or graphs about how "the Greeks" vary under different conditions. Floor traders need to know these things, but intelligent option investors—those making considered long-term investments in the financial outcomes of companies—have very different motivations, resources, and time horizons from floor traders. Intelligent option investors, it turns out, do better not even worrying about the great majority of things that floor traders must consider every day.

Unlike how-to books about day trading options, this book does not have one word to say about chart patterns, market timing, get-rich-quick schemes, or any of the many other delusions popular among people who will soon be paupers. Making good decisions is a vital part of being an intelligent option investor; frenetic, haphazard, and unconsidered trading is most certainly not.

Unlike books about securities analysis, you will not find detailed discussions about every line item on a financial statement. Understanding how a company creates value for its owners and how to measure that value is an important step in being an intelligent option investor; being able to rattle off information about arcane accounting conventions is not.

To paraphrase Warren Buffett, this book aims to provide you with a sound intellectual framework for assessing the value of a company and making rational, fact-based decisions about how to invest in them with the help of the options market.

The book is split into three parts:

[1] Options, Futures, and Other Derivatives, John C. Hull, Prentice Hall
[2] Option Volatility & Pricing: Advanced Trading Strategies and Techniques, Shelton Natenberg, McGraw-Hill

- Part I provides an explanation of what options are, how they are priced, and what they can tell you about what the market thinks the future price of a stock will be. This part corresponds to the second step of intelligent option investing listed earlier.
- Part II sets forth a model for determining the value of a company based on only a handful of drivers. It also discusses some of the behavioral and structural pitfalls that can and do affect investors' emotions and how to avoid them to become a better, more rational investor. This part corresponds to the first step of intelligent option investing listed earlier.
- Part III turns theory into practice—showing how to read the necessary information on an option pricing screen; teaching how to measure and manage leverage in a portfolio containing cash, stocks, and options; and going into detail about the handful of option strategies that an intelligent option investor needs to know to generate income, boost growth, and protect gains in an equity portfolio. This part corresponds to the final step of intelligent option investing listed earlier.

No part of this book assumes any prior knowledge about options or stock valuation. That said, it is not some sort of "Options for Beginners" or "My First Book of Valuation" treatment either.

Investing beginners will learn all the skills—soup to nuts—they need to successfully and confidently invest in the stock and options market. People who have some experience in options and who may have used covered calls, protective puts, and the like will find out how to greatly improve their results from these investments and how to use options in other ways as well. Professional money managers and analysts will develop a thorough understanding of how to effectively incorporate option investments into their portfolio strategies and may in fact be encouraged to consider questions about valuation and behavioral biases in a new light as well.

The approach used here to teach about valuation and options is unique, simple without being simpleminded, and extremely effective in communicating these complex topics in a memorable, vivid way. Readers used to seeing option books littered with hockey-stick diagrams and partial differential equations may have some unlearning to do, but no matter your starting point—whether you are a novice investor or a seasoned institutional investor—by the end of this book, I believe that you will look at equity investing in a new light.