

by sections discussing the special risks associated with options on the particular types of underlying interests.

RISKS OF OPTION HOLDERS

1. An option holder runs the risk of losing the entire amount paid for the option in a relatively short period of time. This risk reflects the nature of an option as a wasting asset which becomes worthless when it expires. An option holder who neither sells his option in the secondary market nor exercises it prior to its expiration will necessarily lose his entire investment in the option. (As noted in Chapter VIII, many brokerage firms have procedures for the exercise of options at expiration that are then in the money by a specified amount.)

The fact that options become valueless upon expiration means that an option holder must not only be right about the direction of an anticipated price change in the underlying interest, but he must also be right about when the price change will occur. If the price of the underlying interest does not change in the anticipated direction before the option expires to an extent sufficient to cover the cost of the option, the investor may lose all or a significant part of his investment in the option. This contrasts with an investor who purchases the underlying interest directly and may continue to hold his investment, notwithstanding its failure to change in price as anticipated, in the hope of waiting out an adverse price move and eventually realizing a profit.

The significance of this risk to an option holder depends in large part upon the extent to which he utilizes the leverage of options to control a larger quantity of the underlying interest than he could have purchased directly with the same investment amount. This is illustrated in the following example, which compares the consequences of three different approaches to investing the same amount of money in stock or options, with each approach involving a different degree of leverage.

EXAMPLE: Assume that Investors A, B and C each have \$5,000 to invest and that each anticipates an increase in the market price of XYZ stock, which is currently \$50 a share. Investor A invests his \$5,000 in 100 shares of XYZ. Investor B invests \$500 in the purchase of an XYZ 50 call (covering 100 shares of