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Audio Script: Introduction to Options, Trading Options at Merrill

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Options involve risk and are not suitable for all investors. Certain requirements must be met to trade options. Before engaging in the purchase or sale of options, investors should understand the nature of and extent of their rights and obligations and be aware of the risks involved in investing with options. Please read the options disclosure document titled "Characteristics and Risks of Standardized Options (PDF)" before considering any option transaction. You may also call the Investment Center at 877.653.4732 for a copy. A separate client agreement is needed. Multi-leg option orders are charged one base commission per order, plus a per-contract charge.

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Audio Script:

Welcome to the first on-demand webinar in our options series. If you are totally new to this, we are glad you are starting here. Trading with options is very different than trading with stocks and we are excited to guide you through this process.

Before we get started, Please take a moment to read through and be aware of all of the information contained in these disclosures. Options involve risk, and are not for everyone, and require a separate application and approval – we will go over the requirements a little later on. It is important to read the Options Disclosure Document titled “Characteristics and risks or standardized options”. You will find a link to this on all of our options experiences, you can access the full document at the bottom of the page where the disclosures are found. You can contact us if you have any questions on this information or anything else we cover today.

Let’s talk about what we are going to cover today. First, we are going to cover why investors would trade options. Secondly, we are going to explain how to add options to your account and the details you need to know from an account set up perspective. Third, we are going to discuss how an option differs from a stock. And we will finish off with a brief overview of all of the tools resources you will have available beyond this series.

Why do investors trade options?

Investors use options for various reasons, in today’s video we want to provide investors who are starting out, an understanding of the use of options within a portfolio. While many investors learn about options as an instrument that can potentially provide leverage with a high amount of risk, Options are generally used by many investors to manage risk, speculate and potentially generate income. Let’s dive into the use cases to learn a bit more.

To help investors understand the various ways you can use options, we will discuss the 3 different categories or investment objectives that most option strategies fall under. Let’s begin with speculation. Many investors are first attracted to options due to the asymmetrical risk-profile of options that is where an investor can take a directional view on a stock or an exchange traded fund, with leverage and a limited amount of capital, but still have limited downside risks. On the surface, it’s this concept of having leverage when the directional view is correct, but limited losses when they are incorrect, which is attractive for many investors. However, there are trade-offs to this asymmetrical risk-profile that we will learn in a later video on understanding call options.

Now Income. Investors use options for income-generating strategies such as covered calls. This allows an investor with a Stock or ETF holdings to sell call options against their position to generate income. This is a strategy that allows an investor to hold a call option to expiration, learning a valuable lesson in how an option’s value changes alongside the stock price and time. Once an investor has a sense for how the value of an option changes, only then does it makes sense to potentially speculate using options. Options can carry a high amount of risk, and may not be suitable for all investors.

Lastly, once an investor has a grasp on the concepts of options speculation, we can utilize that knowledge to hedge against a market downturn. While an investor has many choices when it comes to protecting securities against a downside correction, options can be utilized to hedge while remaining invested in specific assets. Let’s take a look at some specific strategies within each category to learn a bit more.

Let’s start with income, strategies are typically designed to reduce risk. Options can be used by investors to generate additional income. Our first strategy, a covered call is used by investors who already own stocks or ETFs to add additional yield to those holdings. As a reminder, all examples in this video do not include any commissions or fees.

The second strategy is a cash-secured put, used by investors who wish to purchase a stock or ETF to potentially acquire the stock at a lower price while generating a yield on the cash set aside to purchase the stock. A covered call strategy is a beginner strategy that only requires Options level 1, where a call option is sold against a stock or ETF position that the investor owns. The shares are sold if and when exercise and assignment occurs.

A cash-secured put is an intermediate strategy that does require a higher options approval level 2. For investors who are interested in acquiring a specific stock or ETF, this strategy generates yield on the cash set aside to purchase a stock or ETF at a specific price. Investors sell a put on an underlying security with cash set aside equivalent to the amount required to initiate the purchase. The shares are purchased if and when exercise or assignment occurs. While many investors first view this as a very risky strategy with substantial risk, the risk of a cash-secured put is similar to acquiring the same stock through a limit order. While generating income using options will not result in highly leveraged returns, it is a strategy that can allow investors to add an income stream to a stock or ETF portfolio. Next, let's explore how options can be utilized to speculate on the directional view of a stock or ETF.

The ability to trade with limited capital, applying leverage but remain limited in losses, attracts many investors to options. However, there are many options strategies that an investor can use to speculate. With the countless ways an investor can design options strategies, some strategies can carry a high degree of risk. We are only going to introduce two basic strategies that both have limited risk potential during this video. An equity option's contract provides an investor with the ability to obtain directional exposure to a stock or ETF with just a fraction of the capital it would take to purchase 100 shares of the underlying asset. This fractional capital requirement is the leverage factor that many investors seek when exploring options. There are various ways that we can utilize options to speculate on the directional view, each with various risk profiles and potential outcomes.

The first strategy that we will explore is a call option. It is a beginner strategy that requires an options level 3 account to trade. A long call option provides an investor with a bullish view on a stock or ETF, unlimited profit potential while limiting the risk to just the cost of the option contract. The second strategy is a put option. It is also a beginner strategy that also requires an options level 2 account to trade. A long put option provides an investor with a bearish view on a stock or ETF, substantial profit potential, while limiting the risk to just the cost of the option contract. Both strategies are the building blocks for more advanced strategies, which you will learn as you progress through this learning series. Lastly, let's cover hedging.

Many investors who do not actively use options for income or speculation, may still need to hedge their positions. This is where options are used to mitigate risk by protecting securities against a market downturn.

This allows investors who have long-term holdings to remain invested in certain assets while providing some protection against a decline in value.

While we covered a Long-Put position from a speculative perspective on the previous slide, the same options strategy can also be used to hedge securities. It is a beginner strategy that will allow an investor to offset the losses from a stock or ETF holding with the profits from a put options contract with risk limited to the cost of the option. A put option does not limit the upside potential of the portfolio if the market continues higher.

Now that we have explored some examples of options strategies, Jess will review the process of adding options to your Merrill account!

How do I add options to my account?

Tony's explanation should have given you an indication if options may be right for you. If you do want to start trading options there are important processes and an application process you need to know about.

You are required to fill out an options application for every account that you intend to trade options with. Additionally, your options application will need to be approved before you can begin to trade options. This process can take a few business days. As you may have gathered from some of the examples, Options trading capabilities vary by what we call options levels, which range from level 1 through 5. Options levels are determined by strategy, investment objective, experience, capital requirements and risk. All the information you need to know to determine what level may be best for you is found on the application. If you are selecting level 4 or 5 margin will be required. Because margin is required, this type of options trading is not permitted in retirement or custodial accounts. There are important disclosures you should be aware of in regard to margin that are available at the end of this video. Most options applications can be submitted online. However, certain account types, normally entity accounts like a trust, require a paper application. Let's look at the merrilledge.com application experience.

After you log in to Merrilledge.com you will need to access the forms and applications center. You can do this by navigating to the help and settings tab and selecting forms and applications found in the additional resources section in the drop down menu.

You can select apply now to the left of the options application and agreement. If you do not see the application you can search for "options application" in the search bar at the top of the page. Once you select apply now, we will give you some important information to prepare you for the application process. You will then click on "select an account", where all of your eligible accounts will display with a blue link. If you see an account without a link like this UTMA demo, it either cannot have options trading or requires a paper application. Which can be found on the right hand side of the page. Once you select your account, you will be required to view the characteristics and risks of standardized options document. You will see this document referenced on all options experiences and even at other firms. This document is intended to be read in its entirety as there are other risks and considerations not covered in this video that this document outlines. Once you view the Options Disclosure Document, you will simply click on "begin" and follow the prompts from there. Remember, the approval process takes a couple of days.

What are the differences of stock and options?

Let's talk about the difference of stocks and options. We have already taken a glimpse into some examples of options earlier, but let's investigate how options differ from stocks or ETFs. The primary difference between stocks and options come down to what you are purchasing with each. For stocks, your purchase provides you with a slice of ownership in a company or basket of companies in the case of an ETF.

On the other hand with an option, your purchase provides you with the right to buy or sell a specific stock or ETF. We will explore the details of an options contract in a future video. When you buy a stock, your goal is to purchase it at a price today and sell it at a higher price sometime in the future. While with options your goal can be the same, there are other potential strategies with various outcomes that have various goals for buyers and sellers. That is the complexity that options add but may provide investors with more flexibility.

For a stock, your ownership provides potential capital appreciation, but also the potential to earn income in the form of a dividend, while an option does not pay any dividends. Lastly, for a stock investor, the time horizon of the investment is up to the investor and can in theory remain invested indefinitely. Options, however, have a limited life-span and an expiration date, after which the contract will cease to exist. Options traders can choose their time-horizons by picking expiration dates that typically range from just a few days to 2-3 years in length. It's also important for investors to understand how they can evaluate a stock or option to determine whether an investment may be within their best interest.

As many investors may be familiar, stock prices are influenced primarily by the corporate revenues, earnings, and management's decisions. And stock investors can utilize a variety of disciplines to evaluate a stock using technical, fundamental, or statistical analysis to determine the outlook. On the other hand, options prices are influenced not only by the stock price but also by volatility, time, and interest rates. This adds complexity to understanding how the value of an option's price changes and requires an understanding of all aspects.

One of the easiest things about stock investing to grasp is the symmetrical risk profile. For an investment in a stock, for every dollar the stock increases in value, it provides $1 in profits to the investor, while for every dollar the stock price declines by, the investor incurs a $1.00 loss. This makes an investment's potential risks and rewards, very easy to understand. While with options, there is an asymmetrical risk. This means when a stock increases by $1 the potential gains and losses on the option are not the same if the stock were to move the same $1 lower. We will dive deeper into this concept in our next video on Options Pricing. Lastly, one of the reasons that many investors use options, is the fact that the purchase of stock can require a large amount of capital. Options provide the ability for an investor to obtain directional exposure of 100 shares of a stock or ETF with just a fraction of the capital.

Options do have increased risk as they do expire and a stock can theoretically be held indefinitely. If an option is used for leveraging this can expose the investor to substantial risk potential. With an introduction now of the differences between a stock and an option, let's look at an example of an options quote using the Merrill platform.

Let's look at a quote of XYZ on merrilledge.com. If you were to get a quote on XYZ, you could look at the last price and change for the day and get an indication where the stock is trading at. With options, we look at the option chain. At the top of the chain we see that XYZ last traded at $130.89 and has total volume of about 87 million. With any quote, the last price is an indication of the last price the stock traded at – it already happened. If we want to see the best prices available to buy and sell we would look at the bid and ask. The ask is the next available price where we can buy the stock at and the bid is the best available price to sell the stock at. When a security does not have any liquidity or has not traded in a while – we need to look at the bid and ask to get an indication of price.

XYZ will have many option contracts issued that trade independently and have significantly less volume than its underlying stock. This is why we look at the bid and ask to gather an indication of price of the option and different data points than what you would find on a stock quote. All of which can be found on the option chain. Calls are normally on the left. Puts are normally located on the right. The strike price is found at the center of the chain. And the chain is then organized by series or expiration periods, the most recent is normally found at the top. Expiration dates are expandable or can be selected or de-selected depending on the option chain. We will explain the anatomy of an option in much more detail later on in the series, however, it is important for you to know what an option chain is and its uses. It lists all available options and provides data to help determine price.

What tools and resources are available?

There are a variety of tools and resources available on merrilledge.com we want to introduce you to. The options education hub will be a great resource to expand your knowledge beyond this series. The education hub has many articles that will help compliment concepts that we'll take you through. You can access the options education hub in the investor education tab on merrilledge.com. OptionsPlay is a great tool to generate ideas, and we will take a deeper dive later on in the series – you can access this tool in the Merrill Edge MarketPro platform.

We mentioned margin earlier when we were discussing the various options levels. As margin is required for options level 4 and 5, there are some important disclosures in regard to margin we would like you to be aware of.

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When you purchase securities, you may pay for the securities in full, or if your account has been established as a margin account with the margin lending program, you may borrow part of the purchase price from Merrill. If you choose to borrow funds for your purchase, Merrill's collateral for the loan will be the securities purchased, other assets in your margin account, and your assets in any other accounts at Merrill. If the securities in your margin account decline in value, so does the value of the collateral supporting your loan, and, as a result, we can take action, such as to issue a margin call and/or sell securities in any of your accounts held with us, in order to maintain the required equity in your account. If your account has a Visa® card and/or checks, you may also create a margin debit if your withdrawals (by Visa card, checks, preauthorized debits, FTS or other transfers) exceed the sum of any available free credit balances plus available money account balances (such as bank deposit balances or money market funds). Please refer to your account documents for more information.

Before opening a margin account, you should carefully review the terms governing margin loans. For Individual Investor Accounts, these terms are contained in the Margin Lending Program Client Agreement. For all other accounts, the terms are in your account agreement and disclosures. It is important that you fully understand the risks involved in using margin. These risks include the following:

You can lose more funds than you deposit in the margin account. A decline in the value of securities that are bought on margin may require you to provide additional funds to us to avoid the forced sale of those securities or other securities in your account(s).

We can force the sale of securities in your account(s). If the equity in your account falls below the maintenance margin requirements or Merrill's higher "house" requirements, we can sell the securities in any of your accounts held by us to cover the margin deficiency. You also will be responsible for any shortfall in the account after such as sale.

We can sell your securities without contacting you. Some investors mistakenly believe that they must be contacted for a margin call to be valid, and that securities in their accounts cannot be liquidated to meet the call unless they are contacted first. This is not the case. We will attempt to notify you of margin calls, but we are not required to do so. Even if we have contacted you and provided a specific date by which you can meet a margin call, we can still take necessary steps to protect our financial interests, including immediately selling the securities without notice to you.

You are not entitled to choose which securities in your account(s) are liquidated or sold to meet a margin call. Because the securities are collateral for the margin loan, we have the right to decide which security to sell in order to protect our interests.

We can increase our "house" maintenance margin requirements at any time and are not required to provide you advance written notice. These changes in our policy may take effect immediately and may result in the issuance of a maintenance margin call. Your failure to satisfy the call may cause us to liquidate or sell securities in your account(s).

You are not entitled to an extension of time on a margin call. While an extension of time to meet margin requirements may be available to you under certain conditions, you don't have a right to the extension.

If you have any questions or concerns about margin and the margin lending program, please contact the Merrill Investment Center.

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We invite you to continue the series and watch our next introductory on-demand webinar on options pricing. If you have any questions or concerns please feel free to give Merrill a call at 877.653.4732 Also, we would love to hear from you. We welcome any feedback or question in regard to today's presentation as well as suggestions for future webcasts. Fill out the "ask a question box" at the bottom of this page. On behalf of the Merrill team and on behalf of the OptionsPlay team, thank you!