So why do people trade options?

Note: The securities in this video are fictional. Everyone's situation is different, and this video is not financial advice. Do your own research.

Generating Income

Investors can sell options against shares they own and collect the premiums

People trade options for a variety of reasons

One reason to trade options is to generate income. This is commonly done by selling call options against shares you own, and collecting the premiums from the buyers. This strategy is called a covered call.

Before we explain for this strategy works, we would like to make you aware of some key concepts:

A covered call strategy can be bullish, bearish, or neutral. A call represents the right to buy stock. The seller of a call is obligated to sell that stock. Each contract represents 100 shares, has an agreed upon price known as the strike price, and an expiration date – which is the seller's obligation period.
Every example that we use is for illustrative purposes only and we do not include any commission and fees.

Imagine you purchased 100 shares of XYZ at $50.00 a share.

You feel bullish about this company long term, but you don’t expect it to make any big moves in the near term.

Based on this belief, you decide to sell a call, which is a type of options contract.

When you sell the contract, you set an agreed upon price, called the strike price and an expiration date which is your obligation period.

You immediately collect the premium for that contract

If the stock never goes above the strike price you set, the option expires worthless and the money you collected is yours to keep. You can think about it like a discount on your purchase of 100 shares.

If, however, the stock goes above that price, and the buyer chooses to execute, you will have to sell your shares at the strike. However, you still keep the premium.

This is why selling a covered call is one way option traders generate income

Disclosure:

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" before considering any option transaction. You may also contact us call at 1.877.653.4732 for a copy. A separate client agreement is needed. Option orders are subject to a per-contract charge.

The maximum loss, gain and breakeven of any options strategy only remains as defined so long as the strategy contains all original positions. Trading, rolling, assignment, or exercise of any portion of the strategy will result in a new maximum loss, gain and breakeven calculation, which will be materially different from the calculation when the strategy remains intact with all of the contemplated legs or positions. This is applicable to all options strategies inclusive of long options, short options and spreads.

Long options are exercised and short options are assigned. Note that American-style options can be assigned/exercised at any time through the day of expiration without prior notice. Options can be assigned/exercised after market close on expiration day.
View definitions for investment terms in our Glossary.

For purposes of all the computations discussed in this article, commissions, fees and margin interest and taxes, have not been included in the examples. These costs obviously will impact the outcome of any stock or option transaction. Any strategies discussed, including examples using actual securities and price data, are strictly for illustrative and educational purposes only and are not to be construed as an endorsement, recommendation or solicitation to buy or sell securities. Past performance is not a guarantee of future results.

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