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Intrinsic and Time Value

Time Value vs. Intrinsic Value

- Time value is the component of an option that erodes to zero as an option approaches expiration.

- Intrinsic value is the component of an option that reflects the real value and does not erode with time.

- Intrinsic value is directly related to the value of the underlying security.

“At-The-Money” Call Option

- A call option is referred to as “at-the-money” when the stock and strike prices are equal or close together.

“At-The-Money” Call Option

- XYZ is trading at $50.00 a share.
- The XYZ one-month $50-strike call option is trading at $2.00.
- The call buyer has the right to buy the shares at $50.00. However, the underlying is trading at $50.00.
- There is no intrinsic value in the option.

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“At-The-Money” Call Option

- $50.00 share / $50.00 strike
- The $2.00 option premium is pure time value.
- If nothing happens, then the option will expire worthless in one month.

“Out-Of-The-Money” Call Option

- A call option is referred to as “out-of-the-money” when the stock price is less than the strike price.

“Out-Of-The-Money” Call Option

- XYZ is trading at $45.00 a share.
- The XYZ one-month $50-strike call option is trading at $0.30.
- The call buyer has the right to buy it at $50.00. However, the underlying is trading at $45.00.
- There is no intrinsic value in the option.

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"Out-Of-The-Money" Call Option

- $45.00 share / $50.00 strike.
- The $0.30 option premium is pure time value.
- If nothing happens, then the option will expire worthless in one month.

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“In-The-Money” Call Option

- A call option is referred to as “in-the-money” when the stock price is greater then the strike price.

“In-The-Money” Call Option

- XYZ is trading at $55.00 a share.
- The XYZ one-month $50-strike call option is trading at $5.50.
- The call buyer has the right to buy shares at $50.00 and XYZ is trading at $55.00.
- There is a $5.00 intrinsic value in the option.

"In-The-Money" Call Option

- $55.00 share / $50.00 strike

- The $5.50 option premium is broken into:
  - $5.00 intrinsic value
  - $0.50 time value

- If nothing happens come expiration, then the option will be exercised because it has a $5.00 intrinsic or real value.

"At-The-Money" Put Option

- A put option is referred to as "at-the-money" when the stock and strike prices are equal or close together.

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“At-The-Money” Put Option

- XYZ is trading at $50.00 a share.
- The XYZ one-month $50-strike put option is trading at $1.90.
- The put buyer has the right to sell the shares at $50.00 and XYZ is trading at $50.00.
- There is no intrinsic value in the option.

"At-The-Money" Put Option

- $50.00 share / $50.00 strike
- The $1.90 option premium is pure time value.
- If nothing happens, then the option will expire worthless in one month.

“Out-Of-The-Money” Put Option

- A put option is referred to as “out-of-the-money” when the stock price is greater then the strike price.

“Out-Of-The-Money” Put Option

- XYZ is trading at $55.00 a share.
- The XYZ one-month $50-strike put option is trading at $0.25.
- The put buyer has the right to sell the shares at $50.00 and the shares are trading at $55.00.
- There is no intrinsic value in the option.

“Out-Of-The-Money” Put Option

- $55.00 share / $50.00 strike
- The $0.25 option premium is pure time value.
- If nothing happens, then the option will expire worthless in one month.

“In-The-Money” Put Option

- A put option is referred to as “in-the-money” when the stock price is less then the strike price.

“In-The-Money” Put Option

- XYZ is trading at $45.00 a share.
- The XYZ one-month $50-strike put option is trading at $5.40.
- The put buyer has the right to sell the underlying at $50.00 and the shares are trading at $45.00.
- There is a $5.00 intrinsic value in the option.

“In-The-Money” Put Option

- $45.00 share / $50.00 strike
- The $5.40 option premium is broken into:
  - $5.00 intrinsic value
  - $0.40 time value
- If nothing happens come expiration, then the option will be exercised because it has a $5.00 real value.

Picking The Right Option

Advantages of “at-the-money” options:

- If you are right, the intrinsic value starts to be realized immediately.

- The at-the-money options tend to be the most active and liquid.

Picking The Right Option

Disadvantages of “at-the-money” options:

- The options are the most expensive from a time value perspective.

Picking The Right Option

Advantages of “out-of-the-money” options:

- They require the least amount of capital.
- Provide the greatest leverage.

Picking The Right Option

Disadvantages of “out-of-the-money” options:

- The time component erodes quicker.
- You need a bigger move in the stock to realize intrinsic value.
- Higher probability of expiring worthless.

Picking The Right Option

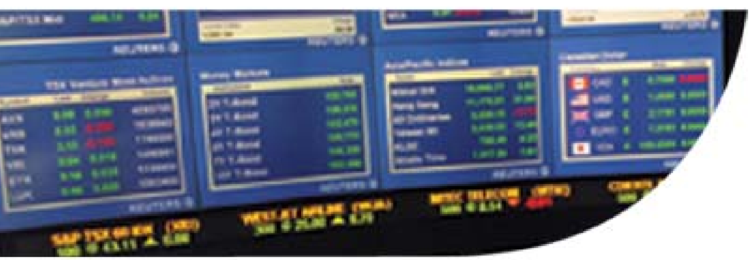
Advantages of “in-the-money” options:

- They are more expensive, because you are buying intrinsic value on top of the time value.
- Provide the less leverage.
- Time decay is only effecting a portion of the option price.

Picking The Right Option

Disadvantages of “in-the-money” options:

- Require more upfront investment.
- A wrong move in the stock can see the intrinsic value disappear.



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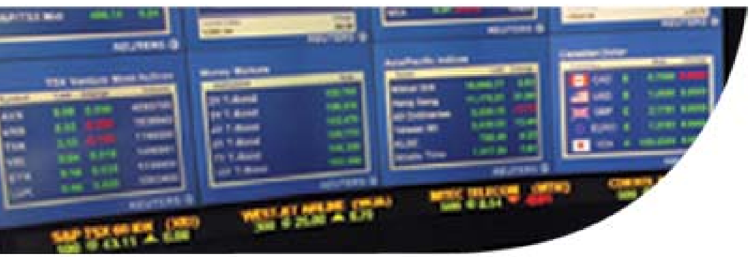

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