Adding Futures Options to Your Trading

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FUTURESPLUS

IF YOU ARE CURRENTLY TRADING STOCK OPTIONS OR INDEX OPTIONS, then you probably already have a good understanding of how futures options work, but there are also some differences you should know.

Similarities Between Stock and Futures Options

Contract Characteristics

Stock options and futures options both have:

- An underlying market symbol;
- An option type (call or put);
- A strike price for the option; and
- An expiration month for the option.

Pricing

Stock options and futures options are both priced in relation to the price at which the underlying is trading, along with time to expiration, and volatility.

Trading Actions

The same four types of trading actions are available for both stock and futures options:

- Buy a Call
- Sell a Call
- Buy a Put
- Sell a Put

You can use these actions as building blocks to build a position to trade on price, time or volatility.

Limited Risk

Just like a stock option, when you buy a call or put futures option, your risk is limited to the price you paid for the option, which mitigates the leverage risk associated with the underlying future.

Greek Risk Measures

The same option pricing factors that affect both stock options and futures options are also considered risk measures.

THE "GREEKS" SUMMARY	
Delta	Impact on the option premium from change in underlying price
Gamma	Rate of change in Delta
Theta	Impact of change in time on the option premium
Vega	Impact of change in volatility on the option premium
Rho	Impact of change in interest rates on the option premium

The Greeks change independently of each other for both stock options and futures options. For example, when the stock or futures price changes over time, volatility can go up or down.

Option Expiration Styles

Both American-style options (which can be exercised at any time prior to option expiration), and European options (which can *only* be exercised on the option's expiration date), are available for stock options and futures options.

Option Leverage

A powerful benefit of both stock and futures options is leverage – allowing you to control more of an underlying asset with less money – but remember with increased leverage comes increased risk.

Differences Between Stock and Futures Options

Underlying Market

The underlying market for a single stock option generally equals 100 shares of stock, while the underlying market for a single futures option equals one futures contract. And while stock options are based on an underlying stock that always exists, futures options are based on a futures contract that will expire on a specific date.

Expiration Dates

A stock option's expiration date can be every week, every month, or every quarter, and it generally expires on the third Friday of the expiration month. Futures options expiration dates are based on conditions of the underlying futures contract and they can expire on any day of the week, generally prior to the futures expiration date.

Exercise and Assignment Settlement

When stock options are exercised or assigned, the option contract generally settles with the delivery of the stock. For futures options there are two general categories of settlement: a cash-settled option and a physically-settled option.

Cash-Settled Options

A cash-settled option can expire in the same month as the futures contract. A quarterly stock index futures option expires at the same time the futures contract expires, on the third Friday of the expiration month, the same as a stock option. If the option expired in-the-money (ITM), it will be settled in cash.

For example, a March E-mini S&P 500® (ES) option will expire at the same time a March E-mini S&P 500 futures contract expires.

If the futures options and the futures contract expire in different months, the option is settled to the next futures contract expiration. For example, if a February ES call expires ITM, you will end up with the March future. But, if the March futures contract expires ITM, it settles to cash.

Physically-Settled Options

Physically-settled options will expire prior to the futures contract expiration, or can be exercised into the active futures contract. This provides an opportunity for traders to determine if they will take delivery of the physical product.

For example, a West Texas Intermediate (WTI) Crude Oil futures option will expire in February and the WTI Crude Oil futures contract will expire in March. By allowing the option to expire or be exercised into the active futures contract, the trader will have time to determine whether to offset the futures position or to take delivery of the physical product underlying the futures contract.

Futures Options Expiration Choices

Another difference between stock options and futures options is the variety of available expirations for some futures options, giving the futures option trader the flexibility to fine-tune their trading.

For example, the CME Group complements the American-style quarterly options on the full-size futures contract, and E-mini S&P 500 futures with European-style contracts expand strategy and date flexibility.

E-MINI S&P 500 EXPIRATION EXAMPLES

Let's examine expiration examples on an E-mini S&P 500 futures contract with a September settlement date.

Quarterly Options

The September E-mini S&P 500 quarterly option contract on an E-mini S&P 500 futures contract would expire at the same time as the futures contract.

Monthly Options

The monthly option contracts on the September E-mini S&P 500 futures contract provide the flexibility to express a shorter-term opinion on this longer-dated futures contract.

For each listed month, such as July and August, the option will expire within a month and settle to the same September ES futures contract.

Weekly Options

If the futures option trader has a short time horizon, there are weekly options choices on the September E-mini S&P 500 futures contract with expirations on Monday, Wednesday and Friday.

The Monday, Wednesday and Friday expirations make it possible to create trades more fine-tuned to the fundamental information flow within a week, especially in front of market-moving reports and events.

Futures Options Exercise

Option buyers exercise options and option sellers are assigned options. The assignment is the obligation sellers take opposite the option buyer for the premium received to accept the assignment risk.

When a futures option is exercised, a futures position is opened at the strike price in both the buyer and the seller's account. Based on whether a call or a put is exercised, the option buyer and seller have either a long futures position or a short futures position.

For example, here is how positions result based on exercise or assignment:

Exercise or Assignment	Position at the strike price in the traders account
Long futures call option exercise	Long futures position
Short futures call option assignment	Short futures position
Long futures put option exercise	Short futures position
Short futures put option assignment	Long futures position

Regulatory Oversight

Regulatory oversight for stock options is overseen by the Securities and Exchange Commission (SEC) and futures regulatory oversight is overseen by the Commodity Futures Trading Commission (CFTC).

Summary

In summary, while stock options and futures options have many similarities, there are also key differences that you should consider when choosing the assets in your portfolio.

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