What Is an Option?

Rights, Not Obligations — Lesson Explainer

The Concept

A call option gives its buyer the right - not the obligation - to buy 100 shares of an underlying stock at a fixed strike price on or before expiration. A put gives the right to sell. The buyer pays an upfront premium for that right.

The buyer's maximum loss is capped at the premium paid, no matter how far the stock moves against them, while potential gain (for a call) is theoretically uncapped. The seller takes the opposite side - collecting the premium upfront but carrying open-ended or substantial risk.

An option is 'in the money' if it would be exercised profitably, 'at the money' if the strike equals the current price, or 'out of the money' if it would expire worthless.

Illustrative Example: A Call Option's Payoff at Expiration

A hypothetical call option with a $100 strike, bought for a $4 premium.

Stock Price at Expiration	Option Value	Premium Paid	Buyer's P&L
$90 (Out of the Money)	$0	$4	-$4 (Max Loss)
$100 (At the Money)	$0	$4	-$4 (Max Loss)
$104 (Breakeven)	$4	$4	$0
$115 (In the Money)	**$15**	**$4**	**+$11**

Below $100, the option is worthless and the loss is capped at the $4 premium. Above the $104 breakeven, the gain grows directly with the stock price - capped downside, open-ended upside is the defining shape of a long call.

5 Things to Know About Options

1. Buying an option is a right, selling one is an obligation if exercised against.

2. Options can expire worthless - the premium paid is simply gone.

3. The premium reflects time remaining, volatility, and distance from the strike, not just price.

4. Options are typically for 100 shares per contract.

5. Selling uncovered (naked) options carries very different, potentially unlimited, risk versus buying.

4 Things to Check Before Trading an Option

- Know your maximum loss - as a buyer, confirm it's genuinely capped at the premium paid.
- Check the expiration date - time works against a long option buyer.
- Understand the breakeven - for a call buyer, it's strike + premium paid.
- Know your obligation as a seller - understand what exercise would require of you.

> **Worth knowing:**
> this explains options mechanics using illustrative numbers - it isn't personalized financial advice, and no strategy here is a recommendation. Options trading carries substantial risk, including loss of the entire premium paid, or for uncovered sellers, losses well beyond the premium received.

Quiz — Answer the questions, then check the key on the next page

1. What does a call option give its buyer?

A. The obligation to buy the stock at expiration
B. The right, but not the obligation, to buy the stock at a set price by a set date
C. Automatic ownership of the underlying company
D. The right to sell the stock at a set price

2. In the illustrative example, what was the buyer's maximum possible loss?

A. Unlimited
B. $100, the strike price
C. $4, the premium paid
D. $115, the highest stock price shown

3. What does it mean for a call option to be "in the money"?

A. The option has already expired
B. The stock price equals the strike price exactly
C. The premium was very expensive
D. The stock price is above the strike price, so it would be exercised profitably

4. Why does an option seller carry different risk than a buyer?

A. The seller has an obligation if exercised against, and can face open-ended risk on an uncovered call
B. Sellers never actually lose money on options
C. Sellers automatically receive the underlying stock for free
D. Sellers and buyers always have identical risk

5. What typically happens to an out-of-the-money option at expiration?

A. It automatically converts into shares of stock
B. It doubles in value
C. It expires worthless, and the premium paid is gone
D. The seller must pay the buyer the full premium back

Answer Key

1. What does a call option give its buyer?

Correct answer: B. The right, but not the obligation, to buy the stock at a set price by a set date

A call option gives the buyer the right, not the obligation, to buy at the strike price by expiration.

2. In the illustrative example, what was the buyer's maximum possible loss?

Correct answer: C. $4, the premium paid

An option buyer's maximum loss is capped at the premium paid.

3. What does it mean for a call option to be "in the money"?

Correct answer: D. The stock price is above the strike price, so it would be exercised profitably

A call is in the money when the underlying stock price is above the strike price.

4. Why does an option seller carry different risk than a buyer?

Correct answer: A. The seller has an obligation if exercised against, and can face open-ended risk on an uncovered call

The seller collects the premium upfront but carries an obligation, with open-ended risk on an uncovered call.

5. What typically happens to an out-of-the-money option at expiration?

Correct answer: C. It expires worthless, and the premium paid is gone

An out-of-the-money option at expiration is worth exactly zero, and the premium paid is gone.