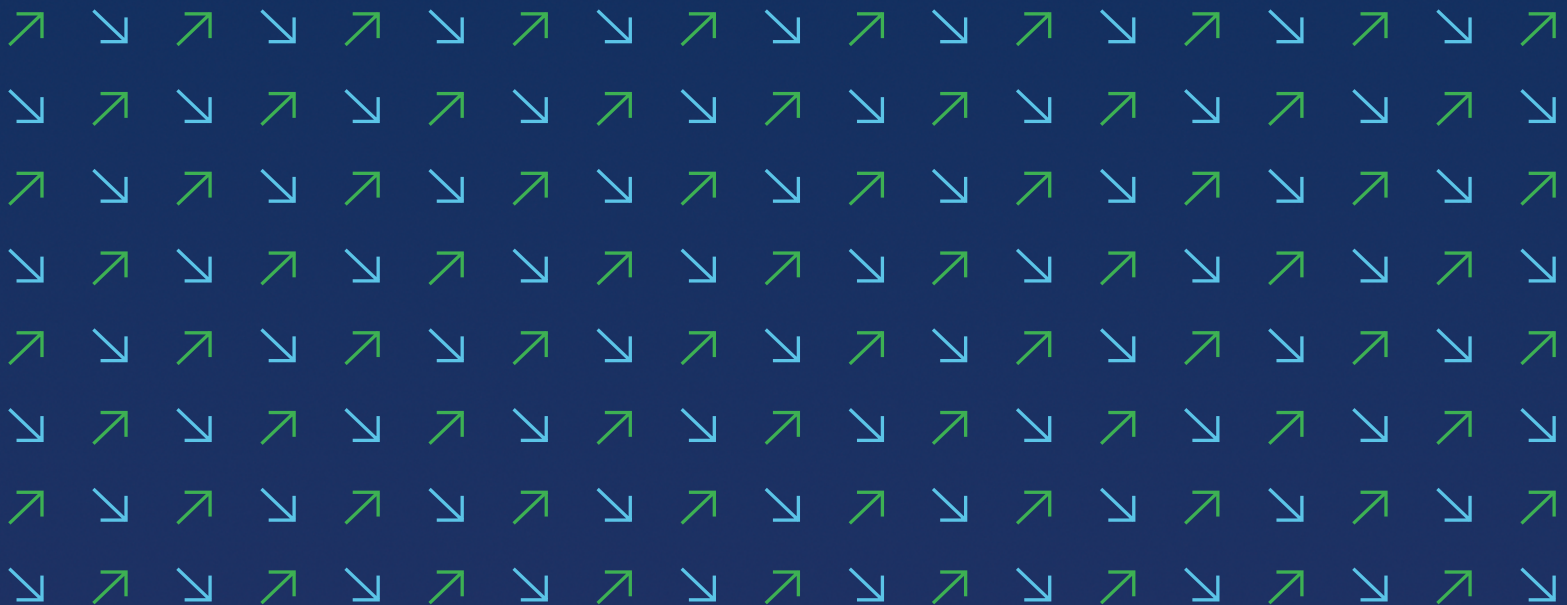




# Trading For The Forward-Thinking Investor

Benefits of Index Options

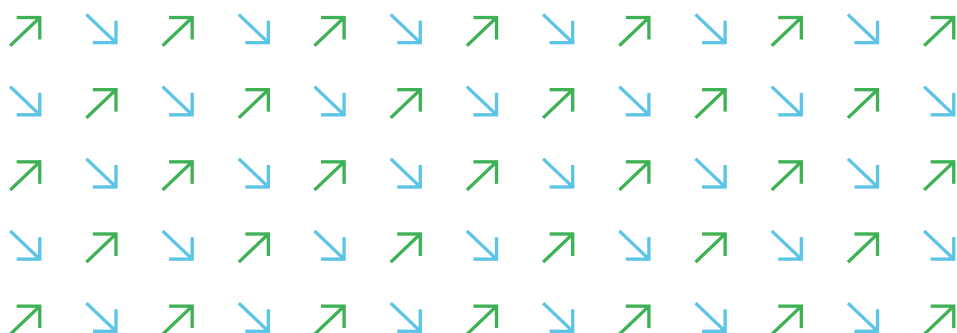




# Index Options Have Come a Long Way

Once the domain of floor traders, where wild swings and order imbalances were the norm, index options have evolved into assets that are now accessible to retail traders.

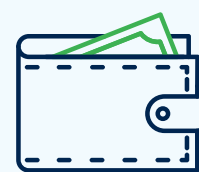
But they're still tradable assets, so they're not immune to risk. Before you get started, know their specs, understand their behavior and, most importantly, learn to manage your risks.



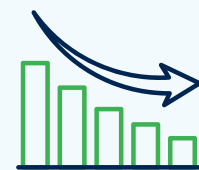
## Index Option Strategies for Traders:



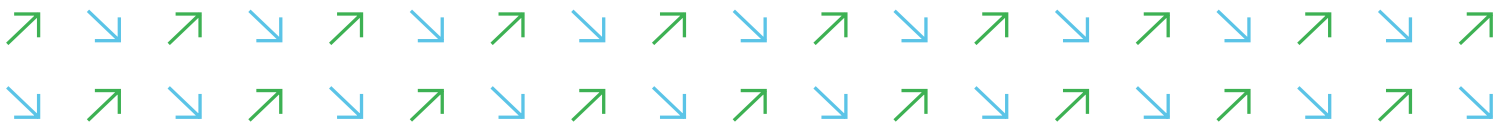
Speculate on the  
direction of a market



Generate income



Portfolio protection



# What Even are Index Options?

Index options are derivatives that offer the opportunity to trade based on your directional view—bullish, bearish or neutral—of the overall market.

For example, the S&P 500® Index comprises 500 large-cap companies and is a good representation of the overall U.S. stock market. If you have a strong view of how the broad stock market is going to move, you could consider trading index options on the S&P 500 or another index. Similarly, if you are looking to speculate on the small cap market, you could consider trading index options on the Russell 2000® Index.

Your first thought might be, “But can’t you do that with stock or exchange-traded fund (ETF) options?” You can, but index options come with unique benefits that are worth exploring.

## 1 Cash Settlement



**Most index options are settled in cash at expiration.**

That means your trade’s profits and losses are settled as a debit or credit directly into your trading account. You don’t have to worry about receiving or delivering securities upon exercise or assignment. An index option can be in the money (ITM) or out of the money (OTM) when it expires:

	CALL OPTION	PUT OPTION
<b>In the money (ITM)</b>	The value of the underlying index at expiration is <b>higher</b> than the option’s strike price	The value of the underlying index at expiration is <b>below</b> the option’s strike price
<b>Out of the money (OTM)</b>	The value of the underlying index at expiration is <b>below</b> the option’s strike price	The value of the underlying index at expiration is <b>higher</b> than the option’s strike price

Suppose you own index puts. When your long index put expires and it's ITM (the put strike is higher than the index settlement value), the difference between the option's strike and the settlement value of the index will be credited to your account (see *diagram below*).



To avoid some unpleasant surprises, it's helpful to know if the option is AM- or PM-settled. When an option is AM-settled, the option's value is determined by the opening price on the expiration date. The last trade would occur on the night before the expiration date, but the settlement value won't be determined until the expiration day's open, leaving the possibility of some overnight risk. A PM-settled option, on the other hand, trades right up to the close on the

expiration date, so the closing price is the settled value.

When trading an AM-settled option, remember that uncertainties can occur—aggressive Federal Reserve policies, geopolitical tensions or even a U.S. bank downgrade. To avoid overnight risk, you may want to consider exiting your position before expiration.

Maybe the market is looking stretched and you think a pullback is likely. If your option contract is close to expiration and getting close to being ITM, you may be better off exiting the position. You could also consider rolling the trade into another contract, that is, closing a position and simultaneously opening a similar position.

## Cash Settlement vs. Physical Settlement

 <b>INDEX OPTION BUYER</b>	 <b>ETF OPTION BUYER</b>
<b>1</b> Buys 1 long <b>5500 SPX call option</b>	<b>1</b> Buys 1 long call with a strike price of <b>\$100</b>
<b>At expiration</b> ↴	<b>At expiration</b> ↴
<b>2</b> SPX settles at <b>5540</b> <b>3</b> Index option buyer receives a credit of <b>\$4,000</b> into their trading account $(5540 - 5500) \times 100 = \$4,000$	<b>2</b> ETF closes at <b>\$100.10</b> <b>3</b> Call option is exercised <b>4</b> 100 shares of the underlying at strike price (\$100) will be credited to the ETF option buyer's account <b>5</b> ETF option buyer should have \$10,000 in account to buy the underlying shares and <b>now has a position in 100 shares of ETF</b>

## 2 European-Style

Index options are European-style, which means they can be exercised only at expiration.

Stock and ETF options, in contrast, are American-style. They can be exercised at any time before expiration.

If you've followed the stock market for a while, you know anything unexpected can happen. Negative news, management changes, dividends and more can cause significant price changes to the underlying assets.

Take dividends, for example. Suppose you sold a call option on a stock. The owner of that call option isn't entitled to any dividends, so before the ex-dividend day, the call owner may exercise the contract. As the option seller, you might be surprised by an assignment notice. You'll be forced to liquidate your position at the strike price.

If you trade European-style index options, unexpected market surprises won't arise because there's no risk of assignment before the index option's expiration date. As long as you hold the contract, there are no potential assignment surprises.



### EUROPEAN style options

(Index Options)

The option holder has the right to exercise the option **only at expiration**.

**The risk of early assignment is eliminated.**

Traders can implement hedging strategies with more confidence.



### AMERICAN style options

(ETF Options)

The option holder has the right to exercise the option **anytime**.

You'll have to monitor option prices. **If an option is in the money, you can get assigned.**

It's riskier to implement hedging strategies since you can be assigned at anytime.



### 3 60/40 Tax Treatment

**Capital gains from trading index options may qualify for hybrid tax treatment.**

Because index options are 1256 contracts\*, they may qualify for the 60/40 tax treatment—meaning 60% of your profits are treated as long-term capital gains and 40% as short-term capital gains.

It doesn't matter how long you hold the position. Equity and ETF options, on the other hand, get taxed at the short or long-term capital gains rate depending on how long you hold the position. The tax rates are dependent on your income.

Remember that most options are generally short-dated products. As a result, options traders generally hold their positions for less than a year (considered short-term). So trading index options could mean tax savings, as 60% of any profits will get the more favorable long-term capital gain treatment. Keep in mind that profits and losses for index options, regardless of

whether you closed your positions, are mark-to-market at the end of the year. This means you can't carry gains or losses over to the following year. Always consult your tax advisor to figure out how your trading profits and losses will be taxed. (Note that this tax benefit doesn't apply to IRAs or other non-taxable accounts.)

### Let's look at a hypothetical example.

**Investor A** is an index options investor; **Investor B** is an ETF options investor. Both made \$15,000 in options trading profits at the end of the year. Both are in the 35% tax bracket and filing jointly. Their long-term capital gains tax rate is 20%.

	 <b>Investor A</b> Index options	 <b>Investor B</b> ETF options
<b>Total Profits</b>	\$15,000	\$15,000
<b>Short-term capital gains tax (@35%)</b>	\$2,100	\$5,250
<b>Long-term capital gains tax (@20%)</b>	\$1,800	\$0
<b>Total tax</b>	\$3,900	\$5,250
<b>Profits after tax</b>	\$11,100	\$9,750



**Investor A**, who's taxed at the 60/40 rate, has a potential **tax savings of \$1,350**

## 4 Flexibility and Availability

When index options were first traded, they were mostly for institutional traders. Contract sizes were large and out of reach for retail traders and investors. But as the interest in index options grew, Cboe® created contracts with smaller values to better align with the objectives and account sizes of retail traders and investors. **Now there are several Cboe index options with different notional sizes and expirations including S&P 500 and Russell 2000 index options.**

In the S&P product suite, you can trade standard S&P contracts (SPX®), Minis (XSP®), which are one-tenth the size of standard, or Nanos (NANOS<sup>SM</sup>), which are one-hundredth the size of XSP. The Russell 2000 suite offers similar contract sizes, with standard (RUT®) and Minis (MRUT®) contracts.

And if these choices aren't enough, you can customize your options specs with [Flexible Exchange® Options](#) (FLEX Options), which allow you to specify contract terms, exercise prices, exercise styles and expiration dates. There are also FLEX® micro options on some of the indexes, which have a contract multiplier of 1 (rather than 100) for the standard FLEX contract.

How to decide which option to trade? It comes down to your directional bias and how much risk you're comfortable taking on.

If you think the S&P 500® is overvalued and ripe for a fall, but you don't think it will happen in the next few days, consider trading index options that expire further out. If volatility is relatively low and the market is calm, you may want to consider trading slightly out-of-the-money weekly options that expire within a few days. For example, if you buy a call and the index moves higher before expiration, you could make a small profit. If the index moves lower, your loss would be the premium you paid.

**You can choose AM- or PM-settled contracts; standard, weekly or month-end expirations; and expirations every trading day, 5 days a week.**

### S&P 500 Product Comparison

	CONTRACT SIZE	CONTRACT MULTIPLIER	APPROX. NOTIONAL VALUE (IF S&P 500 IS AT \$5,500)	SETTLEMENT	TRADING HOURS
<b>S&amp;P 500 Index Options (SPX)</b>	1	100	\$550,000	AM for standard contracts; 3rd Friday.	Global trading hours available**. Trading starts at 8:15 p.m. to 9:25 a.m. ET through 4:15 p.m. to 5:00 p.m. ET.
<b>SPX Weekly Options (SPXW)</b>	1	100	\$550,000	PM; every trading day of the week, 3rd Friday, last trading day of the month (for end-of-month also).	
<b>Mini-SPX Index Options (XSP)</b>	1/10th of SPX	10	\$55,000	PM; every trading day of the week, 3rd Friday, last trading day of the month.	
<b>Nanos S&amp;P 500 Index Options (NANOS)</b>	1/100th of XSP	1	\$550	PM; Monday, Wednesday, Friday.	Regular trading hours.

**Click here to compare Russell 2000 products**



## 5 Last But Not Least: Diversification and Volatility

An index option gives you exposure to an entire index.

For example, if you're trading an S&P 500® option, you're basing your trading strategies on which way you think the entire market will move instead of making decisions on individual stocks. This may reduce the number of transactions and decisions you have to make.

Individual stocks are exposed to company-specific risks such as management changes, weak earnings reports and scandals. If one S&P 500 company's stock drops significantly, the index won't be as impacted as that one stock. This generally makes the index less volatile than individual stocks.

**Know your options. The potential benefits of index options—including flexibility, cash settlement, no chance of early assignment and tax advantages—make them an alluring asset to add to your trading arsenal. However, because the equity market is always in flux, be sure you understand the product you're trading, know when to take profits and always think about what could go wrong.**



\*Under section 1256 of the IRS tax code, profit and loss on transactions in certain exchange-traded options, including SPX options, are entitled to be taxed at a rate equal to 60% long-term and 40% short-term capital gain or loss, provided that the investor involved and the strategy employed satisfy the criteria of the tax code. Investors should consult with their tax advisors to determine how the profit and loss on any particular option strategy will be taxed. Tax laws and regulations change from time to time and may be subject to varying interpretations.

\*\*Global Trading Hours (GTH). The trading hours for options on the SPX, SPXW (SPX Weeklys and SPX End-of-Month) and XSP (Mini-SPX) begin at 8:15 p.m. Eastern time and end at 9:25 a.m. Eastern time. Please visit the Hours & Holidays page for more details.

Options involve risks and are not suitable for all investors. Before trading options, you should discuss with your broker whether trading options is right for you and review the Characteristics and Risks of Standardized Options (or Options Disclosure Document) regarding risks associated with trading options.

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