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Option Early Exercise and Assignment

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As with all investments, your capital is at risk

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Content

- Option Risk Management
- Call Option Early Exercise
- Put Option Early Exercise
- Actual Examples

Option Risk Management

- A successful trading system requires you to have an efficient and robust risk management system
- Part of risk management is to know when you should exercise your call and put options early to maximize your returns – also, to know when you are likely to get assigned to minimize your risk
- In this webinar, we will go over the most common scenarios for early exercise of a call and put option

Understanding Early Exercise of Options

When you exercise an option early:

- Your option contracts will convert into stock holding
- You will use the optionality benefit
- So, it is critical to make a cost-benefit analysis

When To Exercise A Call Option

- A common scenario to exercise a call option is right before ex-dividend date

Why?

- A stockholder is entitled to a dividend
- An Option contract is not entitled to a regular dividend because it is a contract between external third parties
- To receive the dividend the option holder, who bought the option, you must decide if it makes economic sense to exercise and convert the option into stock

What You Need To Consider Prior To Early Exercise

- Before exercising a call option for a dividend, you need to analyze if it is worth it

Factors to Consider:

- Call Option is deep in the money (the option and stock move 1 to 1)
- No more time premium in the option (if there is time premium, it is always better to sell then to exercise - you do not want to lose out on extra option premium)
- The dividend amount must be large enough to make economic sense
- What is your risk after you exercise (you lose the optionality)

When To Exercise A Put Option

- A common scenario to exercise a put is when the interest rate that you can earn on short stock makes economic sense to exercise your put option

Why?

- Short stock position results in net cash proceeds in your account (amount you sold the shares)
- Net proceeds earn interest in an interest-bearing account
- Long Put option does not earn interest because it is a debit
- Debit is a cost of carry and opportunity cost to carry position

What You Need To Consider Prior To Early Exercise

- Before exercising a put option for interest, you need to analyze if it is worth it

Factors to Consider:

- Put Option is deep in the money (the option and stock move 1 to 1 inversely)
- No more time premium in the option (if there is time premium, it is always better to sell then to exercise - you do not want to lose out on extra option premium)
- The interest amount you expect must be large enough to make economic sense
- What is your risk after you exercise (you lose the optionality)

Other Early Exercise Scenarios

We will focus on the 2 most common scenarios but there could be more reasons to exercise an option early such as:

- Hard-to-borrow situations
- Corporate Actions
- Special Deals

In Summary

As part of your risk management system, you may want to evaluate early exercise candidates to help:

- Maximize Profits
- Mitigate Risk

Next, we will focus an actual real-life examples