

The leverage that cuts both ways

OPTIONS LEVERAGE

An option controls the movement of far more underlying than its premium costs, so a small underlying move produces a large percentage move in the option - leverage, and like all leverage it cuts both ways. The percentage swings that make options attractive make them ruinous: an option can lose most of its value on a modest adverse underlying move, and the leverage that promised amplification delivers it symmetrically, on the downside first.

Options are leveraged - a premium controls far more underlying than it costs - and this lesson prices that leverage honestly, because it is the feature options are marketed on and the mechanism by which they most often destroy retail capital.

How the leverage works

Small premium, large exposure: an option's premium is a fraction of the underlying it references, so its percentage moves are far larger than the underlying's - a modest underlying move is a large percentage swing in the option. Symmetric by nature: the leverage amplifies losses exactly as it amplifies gains - an option can lose half its value on a small adverse move, and the percentage that thrills on the way up devastates on the way down. Compounded by decay: the leverage sits on top of the decay carry (lesson 4), so an option can lose to the underlying moving against it and to time passing at once - two erosions the leverage magnifies.

The framing the marketing omits

Options are sold on the upside of their leverage - the small premium that could multiply - and the honest framing is the crypto volatility lesson's: leverage is priced risk, not free amplification. The large percentage gains are matched by large percentage losses, delivered more often, because the option must overcome the premium, the spread and the decay before the leverage works in the buyer's favour at all. The leverage is real, and it is symmetric, and the retail buyer who sees only the amplified upside has seen half the instrument - the half the marketing shows.

Sizing for the leverage

Because the leverage is real, an options position's risk is not its premium's smallness but its exposure's largeness relative to it - which is why module 4 sizes options by maximum loss, and why the small premium is a dangerous anchor: it looks like a small position and behaves like a leveraged one. A reader who sizes by the premium ('it's only a small premium') has mis-sized by the leverage factor, and a portfolio of small premiums can carry large, correlated leveraged exposure. The leverage that cuts both ways must be sized for on its exposure, not its cost - the honest response to an instrument whose smallness of premium disguises its largeness of risk.

Check your understanding

1. Why is options leverage 'priced risk, not free amplification'?

- a. Leverage only helps the buyer
- b. The leverage amplifies losses exactly as it amplifies gains - and delivers them more often, because the option must overcome premium, spread and decay before working in the buyer's favour
- c. Leverage is free in options

Answer: b. The crypto volatility framing, in options: symmetric leverage, shown by the marketing only on the upside. The retail buyer who sees only the amplified gain has seen half the instrument.

2. Why is a small premium a dangerous anchor for sizing?

- a. Small premiums are cheap
- b. It looks like a small position and behaves like a leveraged one - sizing by the premium mis-sizes by the leverage factor, so module 4 sizes options by maximum loss instead
- c. Premiums change too fast

Answer: b. The premium's smallness disguises the exposure's largeness. A portfolio of small premiums can carry large correlated leveraged exposure - sized for on exposure, not cost.