

What are the advantages and drawbacks of options?

Learning about this instrument's advantages and drawbacks will enable you to make an informed decision.

Options are considered to be one of the most versatile financial instruments available in the stock market today. They provide the buyer the right, but not the obligation to exercise the contract. Before trading in this instrument however, it would be wise to go through its benefits and drawbacks.

Let us have a look at some **advantages**.

Leverage

Options allow you to trade on margin. This means that you can invest in a large number of stocks by paying for only a fraction of them. This enables you to earn more profit if the price moves in the expected direction.

Hedging

Options can be used to hedge against the risks involved in your holdings. If, for instance, you hold 100 shares of ABC company, and you believe that its price might fall in the near future, you can buy put options in order to safeguard your current position.

Profit potential

Options give you the opportunity to earn in almost any market condition. Investors can make as much profit from a falling market as from the market's upward movement.

While options provide good opportunities to make profit with a low investment, there are certain **drawbacks** that keep many investors away from this type of trading too.

Lower liquidity

Options are traded at different prices with different expiry dates. However, some contracts have a very low liquidity. There is a strong possibility of an uninitiated trader being stranded with an options contract that no one is willing to buy, resulting in losses.

Complex

Options are quite difficult to understand, especially for beginners. The complicated nature of this instrument, along with the fluctuations in the stock price makes it a very risky instrument for amateurs.

Time-bound

Stocks can be held for a long time, even decades. However, options contracts have an expiry date. Hence, they may not be suitable for long-term investment needs.