Don't understand? Think like a 7-year old!

The dictionary defines an option as a "choice", precisely that which a regulated stock option gives to its holder. For example, the owner of a call has the *choice* to purchase a stock for a specific price within a specific period of time. Compare this to a corn flakes coupon: You buy the Sunday paper for $1.50 (= premium) and clip a coupon (= call option) which gives you the *choice* to buy a box of corn flakes (= underlying security) for $2.00 (= strike price) any time before November 30th (= expiration date). Naturally you'll only use your coupon (= exercise), if you can purchase corn flakes more cheaply with the voucher than without, considering the cost of the coupon ($1.50), as well as the cost of the cereal ($2.00). Thus, if corn flakes are selling for more than $3.50 (= breakeven), you'll use your coupon. This is obvious to any diligent shopper and even my 7-year old nephew Justin.

Yet, many of my students are confounded and so I have developed a surefire method to calculate the breakeven, maximum gain and maximum loss of each option strategy using four steps: Assign plusses and minuses, add premiums, add in one strike price, then add in the remaining strike price. I am often forced to spend 4-6 hours on this topic and am inevitably frustrated by a sea of blank faces. Unsure if my teaching skills are at fault or my students are just dense, I decided to experiment: Already in pajamas and ready for bed, I taught options to Justin. Fifteen minutes later as he was summoned by his mother, Justin had already solved every problem posed!

So, it isn't my fault after all! I <u>can</u> teach. Nevertheless I doubt that my students are collectively stupid and instead suffer from the adult tendency to out-think even the simplest concepts. Justin suffers no such affliction. Nowadays I no longer ask that my students "Keep it Simple, Stupid" and alternatively suggest that they "think like a 7-year old." Often, inclined to take offense at this paternalistic instruction, my students should instead accept this as a compliment of the highest caliber—after all, this 7-year old is <u>my</u> nephew!