

Moneyiness and What a Premium Is Made Of

Paying for extrinsic value you don't understand is how premium melts in your hands.

Split every premium into intrinsic and extrinsic before you judge whether it's expensive.

TERMS

ITM: The strike already has value if exercised now: below stock price for a call, above it for a put.

ATM: The strike sits right at the current stock price, the dividing line between ITM and OTM.

OTM: Exercising makes no sense yet: above stock price for a call, below it for a put.

Intrinsic value: The real, already-earned part of a premium: $\max(\text{stock} - \text{strike}, 0)$ for a call.

Extrinsic value: Whatever is left after intrinsic: time plus fear (implied volatility). It melts as expiry nears.

BEFORE YOU ACT, CHECK

- ☐ Where does this strike sit: ITM, ATM, or OTM, and does that flip for a put?
- ☐ Can I split this premium into intrinsic and extrinsic right now?
- ☐ If it's OTM, do I know the entire premium is extrinsic and exposed to decay?
- ☐ What's inflating or deflating the extrinsic here: time remaining, or expected movement?

QUICK RECALL

1. Stock is above the strike on a call. Is that in-the-money or out-of-the-money?
In-the-money. A call is ITM when the stock price is above the strike, because it already has intrinsic value.
2. An option is out-of-the-money. How much of its premium is extrinsic value?
All of it. An OTM option has zero intrinsic value, so the entire premium is extrinsic and most exposed to decay.

NUMBERS

Intrinsic value (call)	$\max(\text{stock price} - \text{strike}, 0)$	Stock \$53, strike \$50: intrinsic = \$3. The call is \$3 ITM.
Extrinsic value	premium - intrinsic	Premium \$4, intrinsic \$3: extrinsic = \$1.
OTM premium split	100% extrinsic, zero intrinsic	Stock \$48, \$50 call at \$1.50: intrinsic \$0, extrinsic \$1.50, the whole premium.

THE TRAP

"Extrinsic melts, so selling options is free money."

Extrinsic value does decay as time passes and fear fades, and sellers collect it. But selling means taking on a defined obligation with real risk of its own. Getting paid for decay is compensation for risk, not a free lunch.

CARRY FORWARD

- Moneyiness: ITM has value now, ATM sits at the line, OTM does not yet, and the direction flips for puts.
- Premium equals intrinsic plus extrinsic. Intrinsic is real and floors at zero. Extrinsic is time and fear, and it melts.
- An OTM option is 100% extrinsic: it is the most exposed to decay.

Next: Module 1.6 Payoff Diagrams: draw what a long call and a long put look like at expiration.

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