

Options Contracts, Trading Strategies, and Stock Market Effects

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Derivatives include options and futures, which form a big part of financial markets. Derivative securities derive their prices from other securities and hence become powerful tools for speculation and hedging. The history of trading options began in 1973 with the listing of call options by the Chicago Board Options Exchange. Options contract trading is now done in various avenues, such as stock indexes, agricultural commodities, interest rates and foreign exchange.

The Option Contract

A call option offers the holder the right to buy an asset at a specific specified exercise price on or before a specified period or date. If the call option is unexercised before its expiration, it becomes worthless. Thus, when the price of the stock exceeds that of the strike price at the end of the contract, then the call option worth will equate to the variance obtained by subtracting the exercise price from the price of the stock (Bodie et al., 512). The net gain from the call option is thus the initial price paid to buy the option subtracted from the value of the call option.

A put option gives one party the right to sell a specified number of assets at a predetermined price and before a specified future expiration date. The party with the right is thus required to pay a premium to the buyer. The profits on put options rise when the price of the underlying asset falls. Execution is done when the strike price is higher than the value of the asset. The value of the put option is equal to the maximum exercise price minus the stock price. Premium represents the amount of compensation the buyer stands to pay to exercise the option when it is desirable. Premium is thus the purchase price of an option.

An option is described as being in the money if the stock prices are higher than the exercise price for call options and the asset price is lower than the strike price for put options. In this case, the option produces positive cash flow. Further, an option is described as out of money if the strike price exceeds the asset value. When the asset value is higher than the strike price, a put option is described as out of money. Also, a derivative is described as being at the money if the price of the underlying asset equates to the strike price (Bodie et al., 514).

Other Listed Options

Trading of several other options apart from stocks is common. Such options include market index options, futures prices for agricultural products and foreign currency. Index options fall under a call or

put options based on the stock market index. They are traded on broad-based indexes and industry-specific indexes. Additionally, options trade on foreign exchange indexes such as the Chicago Mercantile Exchange. Index options use the cash settlement procedure. The payoff for an index option becomes equivalent to the strike price minus the value of the index. (Bodie et al., 515)

Futures options are agreements between sellers and buyers to trade an asset at a certain future date and a specific exercise price. The net proceeds from the options equate to the value obtained by subtracting the exercise price from the current price of the security. The options from foreign currency give the right to buy or sell a predetermined amount of foreign money for a predetermined number of United States dollars. The quotation of options is done using cents per unit of foreign currency. The distinction arising from currency options and currency futures options is that currency options offer payoffs determined by the difference between the exercise price and the rate of exchange in a given period. Further, interest rate options on treasury notes, treasury bills, government bonds and treasury bonds are also common.

Options Trading

Options can be traded on over-the-counter markets. The main advantage of the OTC market is that the terms of a contract are tailored to meet the traders' particular specifications. The high cost of creating an OTC market forms the main limitation of OTC Markets. Modern option trading is done on organized exchanges which allow for standardization of the options. The standardization of the listed options allows the actors of the market to trade a restricted and identical amount of derivatives. Standardization of options escalates the scope of options trading and reduces transaction costs, thus creating an efficient, competitive market. Exchanges facilitate ease of trading.

The American-style options allow its party to practice his duty to buy a call option as well as sell a put option and the security before or during the expiry date. The American options are thus more valuable than the European options because they allow for leeway. However, the European style options only allow on the date of expiry. The Options Clearing Corporation is the clearinghouse for options contract transactions. The corporation guarantees smooth contract performance. Option writers have to give a margin to guarantee their possibility of keeping the contract obligations. The margin depends on the amount of money of the option and whether the asset is held in the portfolio.

Options Versus Stock Investments

Compared to a single investment in stock, options offer leverage. The values of options respond more proportionately to changes in the price of the stock. Therefore, call options become a leveraged investment in the stock. Secondly, options offer a good insurance value. Financiers who wish to modify their exposure to risks and uncertainties in innovative means may use options. They provide a rate of return better than that of stock alone (Bodie et al., 519).

Option Strategies

Put, and call options can be combined with various exercise prices to give a distinct payoff pattern. Purchasing a protective put option guarantees the buyer no losses since the buyer receives a payoff identical to the strike price of the option, even if the stock price declines below the exercise price. The profit of the protective put is only negative when the stock price is zero and increases with an increase in stock price. Protective put thus offers insurance against a decline in stock price and limits losses.

Further, covered calls involve a simultaneous purchase of a portion of stock as well as a call option sale on the same asset. The contract option is thus enclosed since there is a chance of delivering the stock using the portion of stock held in the portfolio. Naked option writing is the act of selling an option before a person offsets the position of the stock. The proceeds from a covered option are given by the stock's price minus the payoff of the call. A straddle is also another option strategy. A straddle involves the purchase of a put and a call option obtained from the stock having a similar strike price and date of expiration. Straddles become valuable option strategies, especially for traders holding to the notion that there is stock movement as price changes, but they are indeterminate about the course of the movement. The straddles capitalize on the volatility of the stock. Straddles have variations called strips and straps. A strip involves two puts and one call on a stock, while a strap represents two calls and one put (Bodie et al., 522).

Moreover, a spread involves a mixture of several call options of puts obtained on the same stock but with different strike prices and expiry dates. A currency spread is the buying of an option and concurrent selling of another having a dissimilar exercise price. Further, time spread, on the other hand, refers to options simultaneous selling and buying having different expiry dates. Investors who use spreads believe that one option is overpriced compared to another. Further, collars enclose a portfolio between two bounds.

Option Like Securities

Most traded securities symbolize option attributes embedded in them. Callable bonds have no call provisions and require the sale of the straight bond to an investor. Firms include a coupon rate to offer higher compensation to the investor. Convertible Securities transfer options to the owner of the underlying asset to exchange each security with a static amount of shares belonging to a shared stock without considering prices offered by the market. Warrants form options offered by firms that have a fixed number of shares and generate cash for the company when a holder of the share makes payment of the strike price. Other arrangements include collateralized loans, leveraged equity, and risky debt, which provides an inherent to the borrower of a collateral loan or call option (Bodie et al. 529).

Exotic Options

There has been tremendous innovation in the derivative markets. They have uncommon terms different from the previous ones. Some of these exotic options include Asian Options which have payoffs determined on the average value of the stock during the lifespan of the option. In addition, currency-translated options involve the asset or strike price controlled in a foreign currency. Digital options have their payoffs fixed and determined by satisfying the price and asset conditions (Bodie et al. 535).

Work Cited

Bodie, Zvi, Alex Kane, and Alan J. Marcus. *Essentials of Investments 10th Edition*. McGraw-Hill, 2012.