Financial Mathematics

MATH 5870/6870[1]
Fall 2021

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[1] Based on Robert L. McDonald's *Derivatives Markets*, 3rd Ed, Pearson, 2013.

Chapter 3. Insurance, Collars, and Other Strategies

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Options can be

1. Used to insure long positions (floors)
2. Used to insure short positions (caps)
3. Written against asset positions (selling insurance)
   Covered call writing
   Covered put writing

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Four positions

positions w.r.t. asset	put option	call option
long	purchased (floor)	written
short	written	purchased (cap)

Buying insurance	Selling insurance
floor = buying a put option	Covered put writing
cap = buying a call option	Covered call writing

We will work under the following setup

S&S index

index price today	\$1,000
6-month interest rate	2%
premium for 1000-strike 6-month call	\$93.809
premium for 1000-strike 6-month put	\$74.201

Insuring a long position – Floors

owning a home	owning a stock index
insuring the house	buying a put (floor)

Goal: to insure against a fall in the price of the underlying asset.

Example 3.1-1 Under the following scenario, compute the combined profit of insuring a long position via buying a put for the following S&R index.

index price today	\$1,000
6-month interest rate	2%
premium for 1000-strike 6-month put	\$74.201
index price at expiration	\$900

Solution.

$$\underbrace{\$900 - \$1,000 \times 1.02}_{\text{profit on S\&R index}} + \underbrace{\$1,000 - \$900 - \$74.201 \times 1.02}_{\text{profit on put}} = -\$95.68.$$

$\square$

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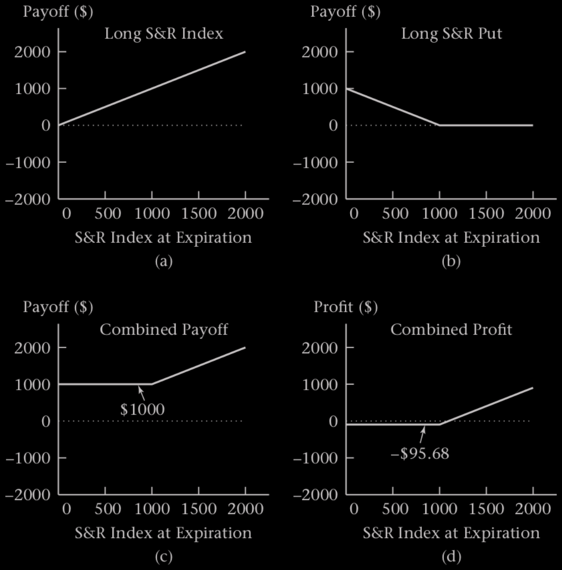
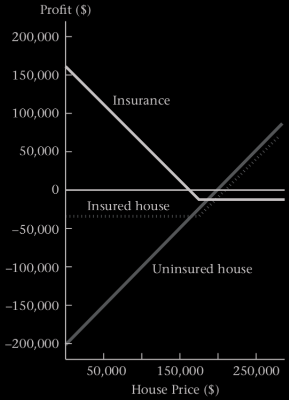

Payoff ($)
Long S&R Index
2000
1000
0
−1000
−2000
0
500
1000
1500
2000
S&R Index at Expiration
(a)
Payoff ($)
Long S&R Put
2000
1000
0
−1000
−2000
0
500
1000
1500
2000
S&R Index at Expiration
(b)
Payoff ($)
Combined Payoff
2000
1000
$1000
0
−1000
−2000
0
500
1000
1500
2000
S&R Index at Expiration
(c)
Profit ($)
Combined Profit
2000
1000
0
−$95.68
−1000
−2000
0
500
1000
1500
2000
S&R Index at Expiration
(d)



Profit ($)
200,000
150,000
100,000
50,000
0
−50,000
−100,000
−150,000
−200,000
Insurance
Insured house
Uninsured house
50,000
150,000
250,000
House Price ($)

Insuring a short position – Caps

If we have a short position in the S&R index, we experience a loss when the index rises.

We can insure a short position by purchasing a call option (cap) to protect against a higher price of repurchasing the index.

Example 3.1-2 Under the following scenario, compute the combined profit for insuring a short position via buying a call of the following S&R index.

index price today	\$1,000
6-month interest rate	2%
premium for 1000-strike 6-month call	\$93.809
index price at expiration	\$1,100

Solution.

$$\underbrace{\$1,000 \times 1.02}_{\text{future value of short S\&R index}} - \underbrace{\$93.809 \times 1.02}_{\text{FV of premium for call}} - \underbrace{\$1,000}_{\text{exercise the call option}} = -\$75.685.$$

$\square$

Example 3.1-2 Under the following scenario, compute the combined profit for insuring a short position via buying a call of the following S&R index.

index price today	\$1,000
6-month interest rate	2%
premium for 1000-strike 6-month call	\$93.809
index price at expiration	\$1,100

Solution.

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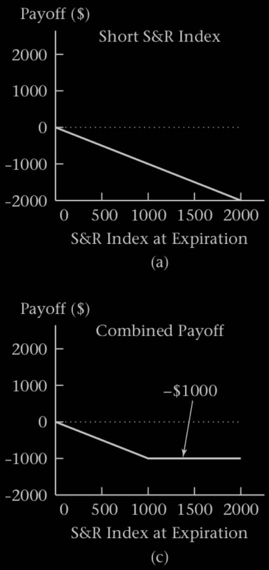
Payoff ($)
Short S&R Index
2000
1000
0
−1000
−2000
0
500
1000
1500
2000
S&R Index at Expiration
(a)
Payoff ($)
Long S&R Call
2000
1000
0
−1000
−2000
0
500
1000
1500
2000
S&R Index at Expiration
(b)
Payoff ($)
Combined Payoff
–$1000
2000
1000
0
−1000
−2000
0
500
1000
1500
2000
S&R Index at Expiration
(c)
Profit ($)
Combined Profit
–$75.68
2000
1000
0
−1000
−2000
0
500
1000
1500
2000
S&R Index at Expiration
(d)

Selling insurance

For every insurance buyer there must be an insurance seller

Strategies used to sell insurance

- **Covered writing** (**option overwriting** or **selling a covered call**) is writing an option when there is a corresponding long position in the underlying asset.

- **Naked writing** is writing an option when the writer does not have a position in the asset.

Selling insurance

For every insurance buyer there must be an insurance seller

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- Covered writing (option overwriting or selling a covered call) is writing an option when there is a corresponding long position in the underlying asset.
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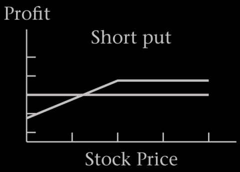
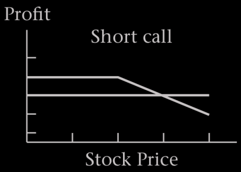
Covered call writing

Long position of the asset + Sell a call option $\sim$



Covered put writing

Short position of the asset + Sell a put option $\sim$



Covered call writing

Example 3.1-3 Under the following scenario, compute the combined profit for writing a covered call for S&R index.

index price today	\$1,000
6-month interest rate	2%
premium for 1000-strike 6-month call	\$93.809
index price at expiration	\$1,100

Solution.

$$\underbrace{\$1,100 - \$1,000 \times 1.02}_{\text{profit on S\&R index}} + \underbrace{\$1,000 - \$1,100 + \$93.809 \times 1.02}_{\text{profit on written call}} = \$75.68.$$

$\square$

Covered call writing

Example 3.1-3 Under the following scenario, compute the combined profit for writing a covered call for S&R index.

index price today	\$1,000
6-month interest rate	2%
premium for 1000-strike 6-month call	\$93.809
index price at expiration	\$1,100

Solution.

$$\underbrace{\$1,100 - \$1,000 \times 1.02}_{\text{profit on S\&R index}} + \underbrace{\$1,000 - \$1,100 + \$93.809 \times 1.02}_{\text{profit on written call}} = \$75.68.$$

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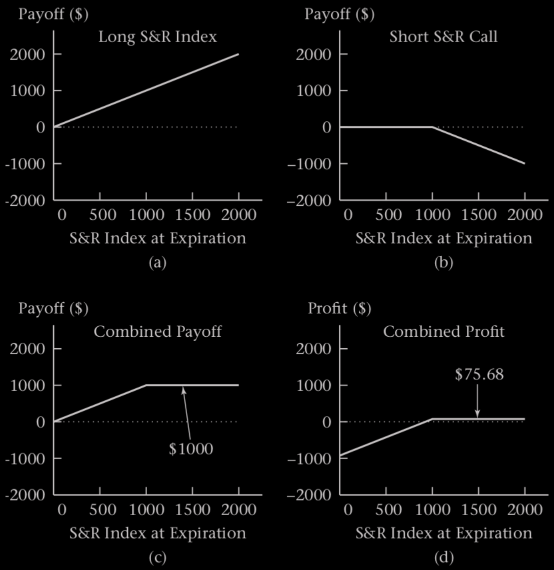
Payoff ($)
Long S&R Index
2000
1000
0
-1000
-2000
0
500
1000
1500
2000
S&R Index at Expiration
(a)
Payoff ($)
Short S&R Call
2000
1000
0
−1000
−2000
0
500
1000
1500
2000
S&R Index at Expiration
(b)
Payoff ($)
Combined Payoff
2000
1000
0
-1000
-2000
$1000
0
500
1000
1500
2000
S&R Index at Expiration
(c)
Profit ($)
Combined Profit
2000
1000
0
−1000
−2000
$75.68
0
500
1000
1500
2000
S&R Index at Expiration
(d)

Covered put writing

Example 3.1-4 Under the following scenario, compute the combined profit for writing a covered put for S&R index.

index price today	\$1,000
6-month interest rate	2%
premium for 1000-strike 6-month put	\$74.201
index price at expiration	\$900

Solution.

$$\underbrace{\$1,000 \times 1.02 - \$900}_{\text{profit on selling S\&R index}} + \underbrace{\$900 - \$1,000 + \$74.201 \times 1.02}_{\text{profit on written put}} = \$95.685.$$

□

Covered put writing

Example 3.1-4 Under the following scenario, compute the combined profit for writing a covered put for S&R index.

index price today	\$1,000
6-month interest rate	2%
premium for 1000-strike 6-month put	\$74.201
index price at expiration	\$900

Solution.

$$\underbrace{\$1,000 \times 1.02 - \$900}_{\text{profit on selling S\&R index}} + \underbrace{\$900 - \$1,000 + \$74.201 \times 1.02}_{\text{profit on written put}} = \$95.685.$$

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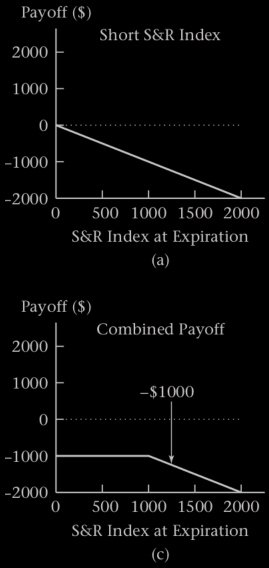

Payoff ($)
Short S&R Index
2000
1000
0
−1000
−2000
0
500
1000
1500
2000
S&R Index at Expiration
(a)
Payoff ($)
Short S&R Put
S&R Index at Expiration
(b)
Payoff ($)
Combined Payoff
−$1000
S&R Index at Expiration
(c)
Profit ($)
Combined Profit
$95.68
S&R Index at Expiration
(d)

It is possible to <u>mimic a long forward position</u> on an asset by

buying a call + selling a put,

with each option having the same strike price and expiration time.

||

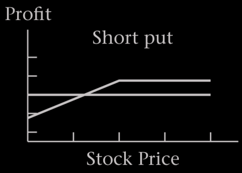
A synthetic forward

Example 3.2-1 Working with the S&R index. Suppose that

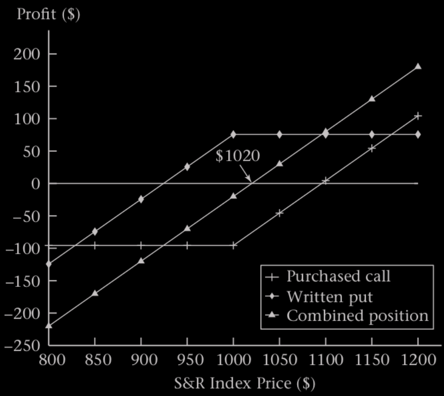
6-month interest rate	2%
premium for 1000-strike 6-month call	\$93.809
premium for 1000-strike 6-month put	\$74.201

Draw profit digram for the combined position of a purchased call with a written put, namely,

+



Solution.



Profit ($)
200
150
100
50
0
–50
–100
–150
–200
–250
$1020
Purchased call
Written put
Combined position
800 850 900 950 1000 1050 1100 1150 1200
S&R Index Price ($)

□

A synthetic long forward contract

We pay the net option premium

We pay the strike price

The actual forward

We pay zero premium

We pay the forward price

Basic Assumption

The net cost of buying the index using options

must equal

the net cost of buying the index using a forward contract.

NO ARBITRAGE!

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NO ARBITRAGE!

The Put-Call parity equation

$$\mathrm{Call}(K, T) - \mathrm{Put}(K, T) = \mathrm{PV}\left(F_{0,T} - K\right)$$

- K: strike price
- T: expiration date
- $\mathrm{Call}(\cdot, \circ)$: the premium for call.
- $\mathrm{Put}(\cdot, \circ)$: the premium for put.
- $F_{0,T}$: the forward price at time T if one enters at time 0 into a long forward position.
- $\mathrm{PV}(\cdot)$: the present value function.

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- $\mathrm{PV}(\cdot)$: the present value function.

Example 3.2-2 Check Example 3.2-1 to see if the put-call parity equation is satisfied.

Solution. We need to check:

$$\$93.809 - \$74.201 \stackrel{?}{=} \mathrm{PV}(\$1,000 \times 1.02 - \$1,000)$$

Clearly, LHS $= \$19.61$. On the other hand, the RHS is equal to

$$\begin{aligned}
\mathrm{PV}(\$1,000 \times 1.02 - \$1,000) &= \mathrm{PV}\left(1,000 \times (1.02 - 1)\right) \\
&= \mathrm{PV}\left(1,000 \times 0.02\right) \\
&= \frac{1,000 \times 0.02}{1.02} \\
&= \$19.61.
\end{aligned}$$

Hence, the put-call parity equation is satisfied. $\square$

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Hence, the put-call parity equation is satisfied. $\square$

$$\mathrm{Call}(K, T) - \mathrm{Put}(K, T) = \mathrm{PV}\left(F_{0,T} - K\right)$$

$$\Updownarrow$$

$$\mathrm{PV}\left(F_{0,T}\right) + \mathrm{Put}(K, T) = \mathrm{Call}(K, T) + \mathrm{PV}\left(K\right)$$

Buying the index and buying the put

generate the same payoff as

buying the call and buying a zero-coupon bond (i.e. lending) $\mathrm{PV}(K)$

$$\text{Call}(K,T) - \text{Put}(K,T) = \text{PV}\left(F_{0,T} - K\right)$$

$$\Updownarrow$$

$$\text{PV}\left(F_{0,T}\right) - \text{Call}(K,T) = \text{PV}\left(K\right) - \text{Put}(K,T)$$

Writing a covered call

has the same profit as

lending PV(K) and selling a put

$$\mathrm{Call}(K, T) - \mathrm{Put}(K, T) = \mathrm{PV}\left(F_{0,T}\right) - \mathrm{PV}\left(K\right)$$

Revisit four positions in Section 3.1

Position	Meaning	equivalent to
Inuring a long position (floors)		
Inuring a short position (caps)		
Covered call writing		
Covered put writing		

$$\mathrm{Call}(K, T) - \mathrm{Put}(K, T) = \mathrm{PV}\left(F_{0,T}\right) - \mathrm{PV}\left(K\right)$$

Revisit four positions in Section 3.1

Position	Meaning	equivalent to
Inuring a long position (floors)	Index + Put	
Inuring a short position (caps)		
Covered call writing		
Covered put writing		

$$\mathrm{Call}(K,T) - \mathrm{Put}(K,T) = \mathrm{PV}\,(F_{0,T}) - \mathrm{PV}\,(K)$$

Revisit four positions in Section 3.1

Position	Meaning	equivalent to
Inuring a long position (floors)	Index + Put	Bound + Call
Inuring a short position (caps)		
Covered call writing		
Covered put writing		

$$\text{Call}(K,T) - \text{Put}(K,T) = \text{PV}\left(F_{0,T}\right) - \text{PV}\left(K\right)$$

Revisit four positions in Section 3.1

Position	Meaning	equivalent to
Inuring a long position (floors)	Index + Put	Bound + Call
Inuring a short position (caps)	−Index + Call	
Covered call writing		
Covered put writing		

$$\mathrm{Call}(K,T) - \mathrm{Put}(K,T) = \mathrm{PV}\left(F_{0,T}\right) - \mathrm{PV}\left(K\right)$$

Revisit four positions in Section 3.1

Position	Meaning	equivalent to
Inuring a long position (floors)	Index + Put	Bound + Call
Inuring a short position (caps)	−Index + Call	−Bound + Put
Covered call writing		
Covered put writing		

$$\mathrm{Call}(K, T) - \mathrm{Put}(K, T) = \mathrm{PV}\left(F_{0,T}\right) - \mathrm{PV}\left(K\right)$$

Revisit four positions in Section 3.1

Position	Meaning	equivalent to
Inuring a long position (floors)	Index + Put	Bound + Call
Inuring a short position (caps)	−Index + Call	−Bound + Put
Covered call writing	Index − Call	
Covered put writing		

$$\mathrm{Call}(K, T) - \mathrm{Put}(K, T) = \mathrm{PV}\left(F_{0,T}\right) - \mathrm{PV}\left(K\right)$$

Revisit four positions in Section 3.1

Position	Meaning	equivalent to
Inuring a long position (floors)	Index + Put	Bound + Call
Inuring a short position (caps)	−Index + Call	−Bound + Put
Covered call writing	Index − Call	Bound − Put
Covered put writing		

$$\mathrm{Call}(K,T) - \mathrm{Put}(K,T) = \mathrm{PV}\left(F_{0,T}\right) - \mathrm{PV}\left(K\right)$$

Revisit four positions in Section 3.1

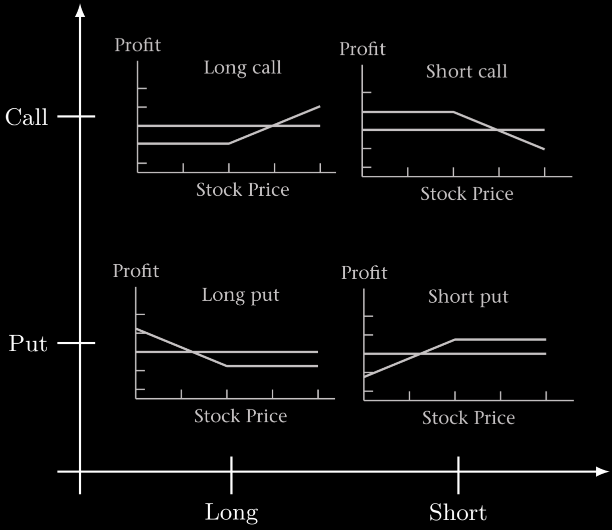
Position	Meaning	equivalent to
Inuring a long position (floors)	Index + Put	Bound + Call
Inuring a short position (caps)	−Index + Call	−Bound + Put
Covered call writing	Index − Call	Bound − Put
Covered put writing	−Index − Put	

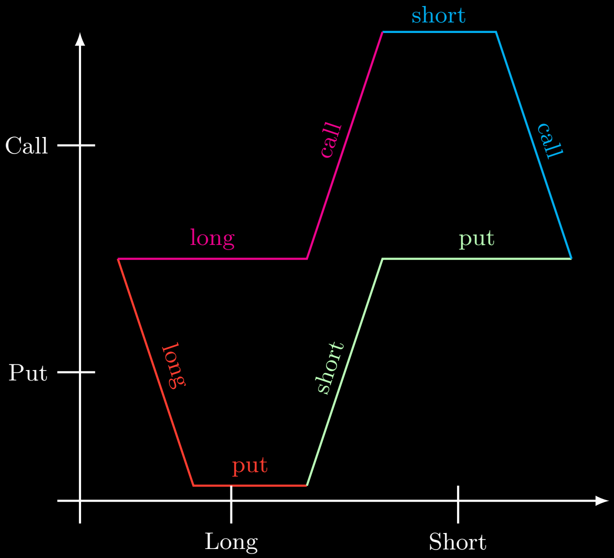
$$\text{Call}(K,T) - \text{Put}(K,T) = \text{PV}\left(F_{0,T}\right) - \text{PV}\left(K\right)$$

Revisit four positions in Section 3.1

Position	Meaning	equivalent to
Inuring a long position (floors)	Index + Put	Bound + Call
Inuring a short position (caps)	−Index + Call	−Bound + Put
Covered call writing	Index − Call	Bound − Put
Covered put writing	−Index − Put	− Bound − Call

By combining two or more options, we find many well-known strategies.




short
call
call
long
put
Call
long
short
Put
put
Long
Short

An option spread is a position consisting of only calls or only puts, in which some options are purchased and some written.

- Bull and bear spreads
- Box spreads
- Ratio spreads
- Collars

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Example for this section

Black-Scholes option prices

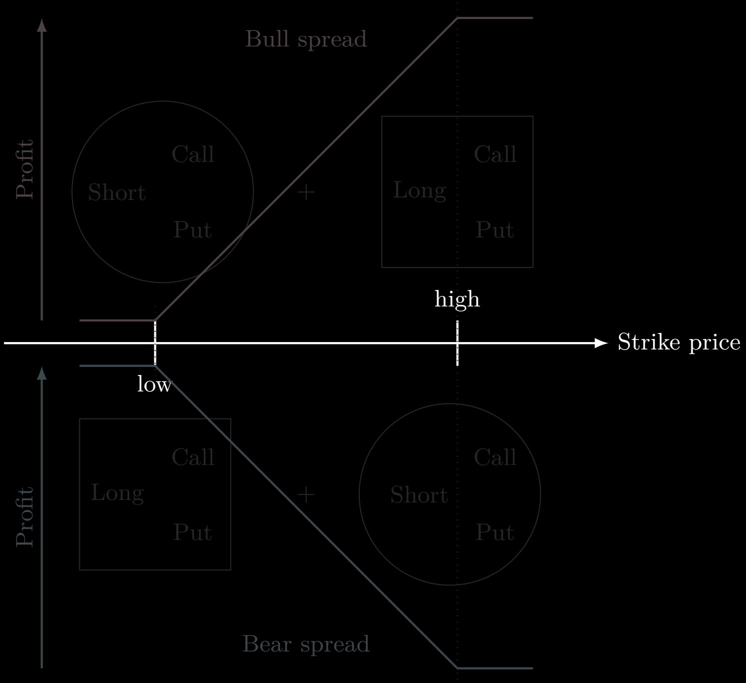
$$\begin{aligned} \text{Stock price} &= \$40 \\ \text{Volatility} &= 30\% \\ \text{Effective annual risk-free rate} &= 8.33\% \\ \text{Dividend yield} &= \$0 \\ \text{Expriation days} &= 91 \text{ days} \end{aligned}$$

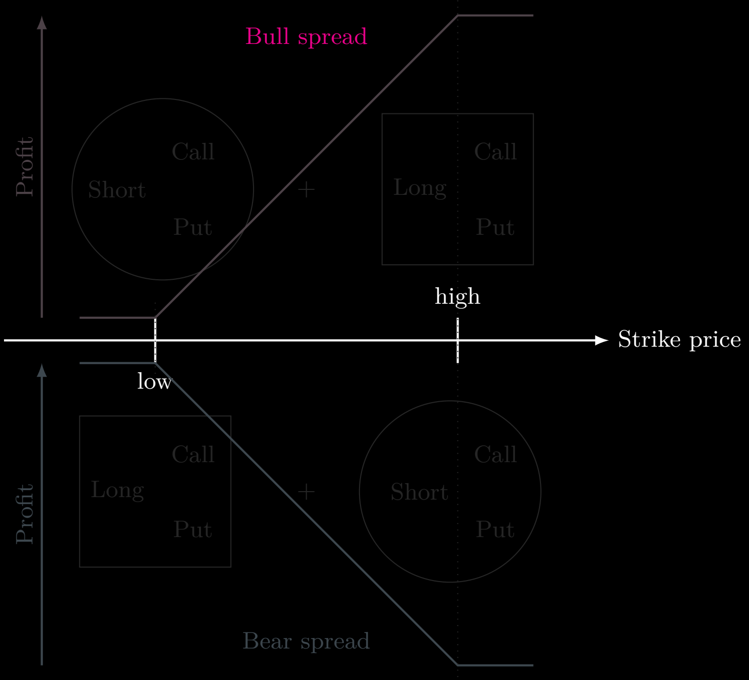
Strike	Call	Put
35	6.13	0.44
40	2.78	1.99
45	0.97	5.08

Bull and bear spreads

A position in which you buy a call and sell an otherwise identical call with a higher strike price is an example of a bull spread. Bull spreads can also be constructed using puts.

The opposite of a bull spread is a bear spread.


Bull spread
Profit
Short
Call
Put
+
Long
Call
Put
high
Strike price
low
Profit
Long
Call
Put
+
Short
Call
Put
Bear spread


Bull spread
Profit
Call
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high
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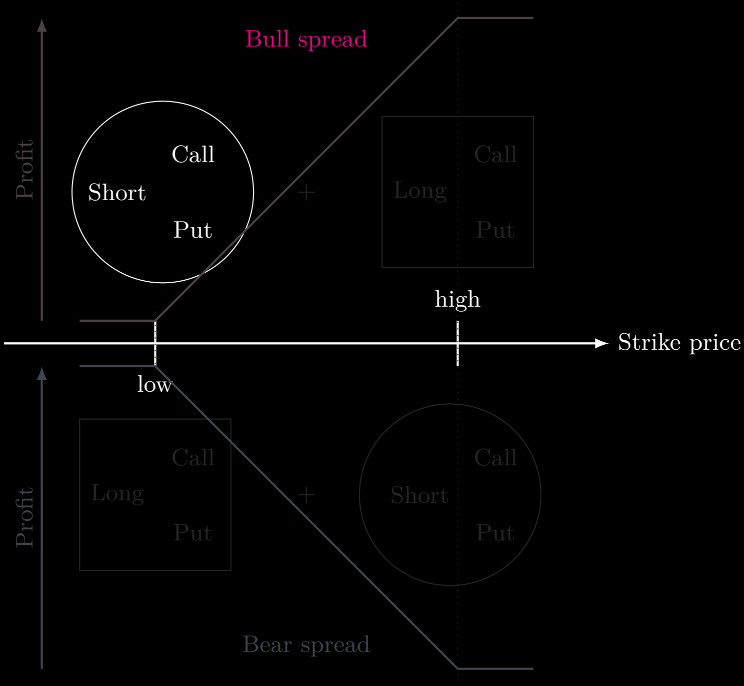
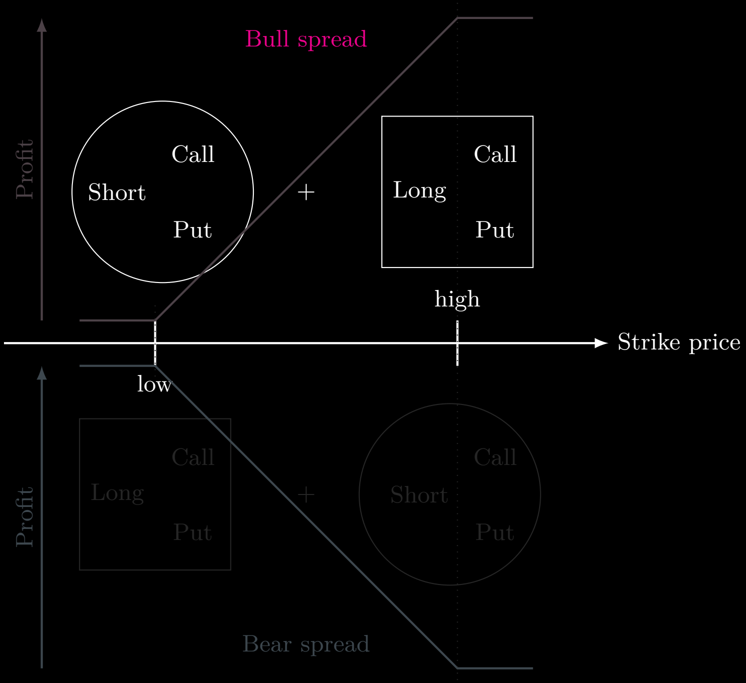
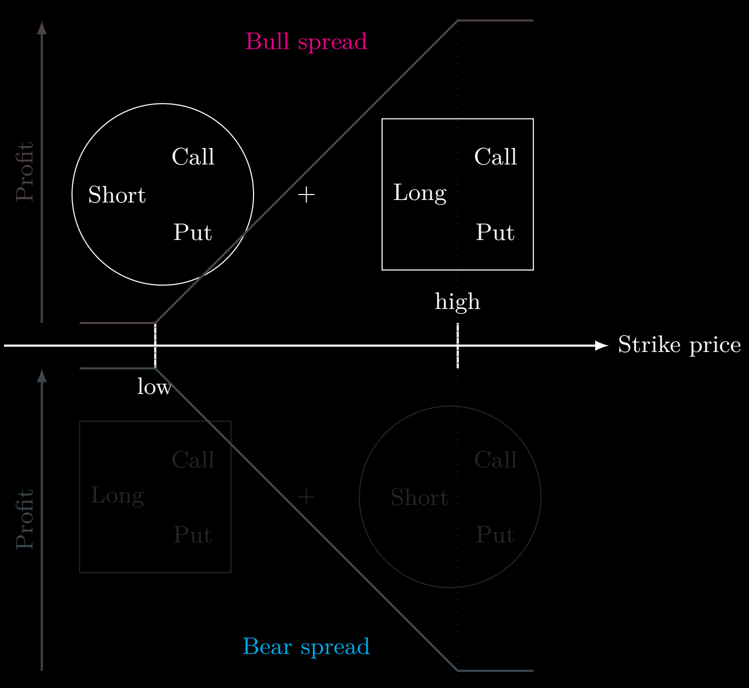
Profit
Call
Long
Put
+
Call
Short
Put
Bear spread



Bull spread
Profit
Call
Short
Put
+
Call
Long
Put
high
Strike price
low
Profit
Call
Long
Put
+
Call
Short
Put
Bear spread



Bull spread
Profit
Call
Short
Put
+
Call
Long
Put
high
Strike price
low
Profit
Call
Long
Put
+
Call
Short
Put
Bear spread


Bull spread
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+
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Short
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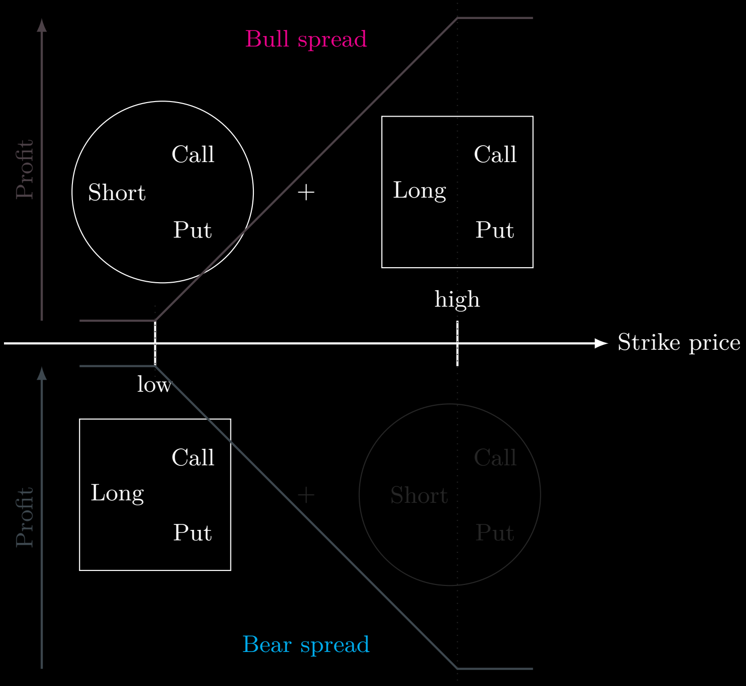
Bear spread


Bull spread
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+
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Short
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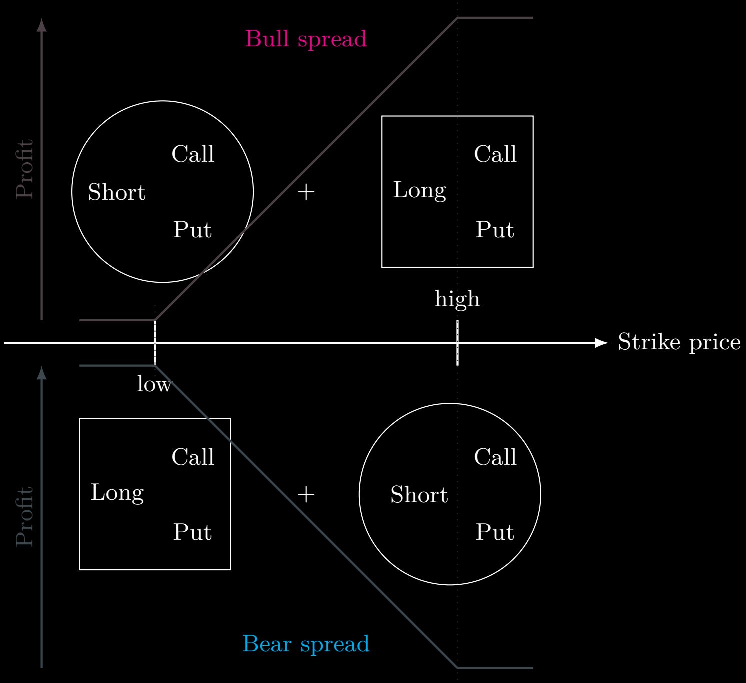
Bear spread


Bull spread
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high
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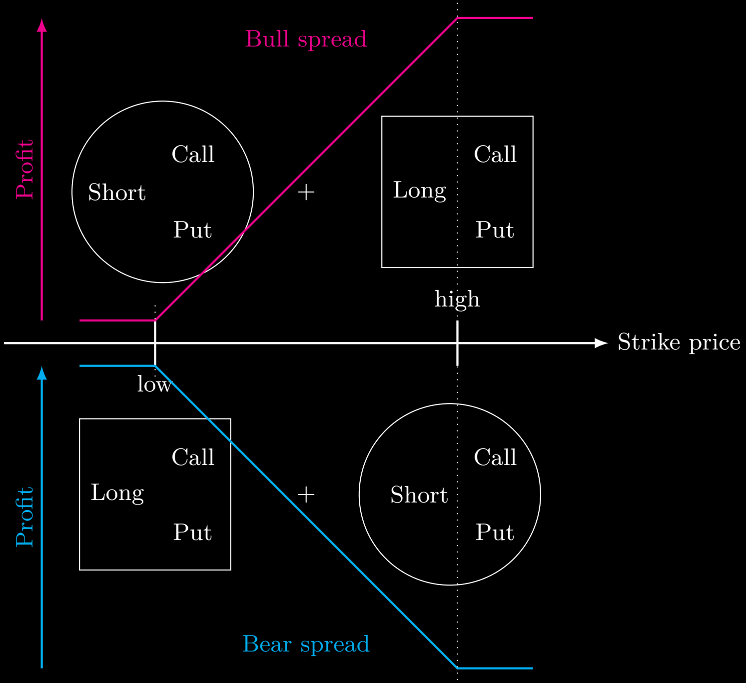
Long
Call
Put
+
Short
Call
Put
Bear spread


Bull spread
Profit
Short
Call
Put
+
Long
Call
Put
high
Strike price
low
Profit
Long
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Put
+
Short
Call
Put
Bear spread

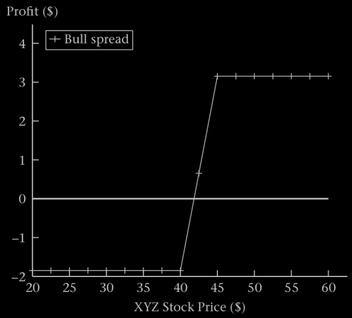
Example 3.3-1 Draw profit diagram for a 40-45 bull spread, namely, buying a 40-strike call and selling a 45-strike call.

Solution.

□

Example 3.3-1 Draw profit diagram for a 40-45 bull spread, namely, buying a 40-strike call and selling a 45-strike call.

Solution.



$\square$

Box spreads

A **box spread** is accomplished by using options to create a synthetic long forward at one price and a synthetic short forward at a different price.

This strategy guarantees a cash flow in the future.

Hence, it is an option spread that is purely a means of borrowing or lending money. It is costly but has no stock price risk.

Example 3.3-2 Suppose we simultaneously enter into the following two transactions:

1. Buy a 40-strike call and sell a 40-strike put.
2. Sell a 45-strike call and buy a 45-strike put.

Explain why there is no free lunch. Draw the profit diagram.

Solution. Check book 74. □

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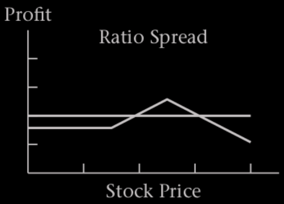
Solution. Check book 74. □

Ratio spreads

A **ratio spread** is constructed by buying m options at one strike and selling n options at a different strike, with all options having the same type (call or put), same time to maturity, and same underlying asset.



Example 3.3-3 (Problem 3.15) Compute profit diagrams for the following ratio spreads:

a Buy 950-strike call, sell two 1050-strike calls.

b Buy two 950-strike calls, sell three 1050-strike calls.

c Consider buying n 950-strike calls and selling m 1050-strike calls so that the premium of the position is zero. Considering your analysis in (a) and (b), what can you say about n/m? What exact ratio gives you a zero premium?

Solution. Homework. □

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Solution. Homework. □

Collars

A **collar** is the purchase of a put option and the sale of a call option with a higher strike price, with both options having the same underlying asset and having the same expiration date.

If the position is reversed, i.e., sale of a put and purchase of a call, the collar is written.

The **collar width** is the difference between the call and put strikes.

Example 3.3-4 Draw the profit diagram for a purchased collar:

selling a 45-strike call + buying a 40-strike put.

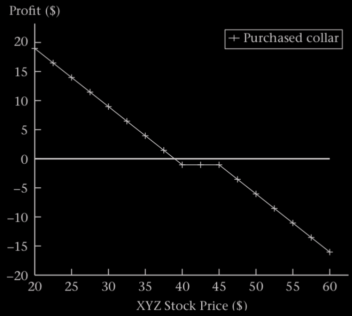
Solution.

□

Example 3.3-4 Draw the profit diagram for a purchased collar:

selling a 45-strike call + buying a 40-strike put.

Solution.



□

It is possible to find strike prices for the put and call such that the two premiums exactly offset one another. This position is called a **zero-cost collar**.

Example 3.3-5 Consider XYZ:

Strike	Call	Put
35	6.13	0.44
40	2.78	1.99
41.72	1.99	—
45	0.97	5.08

Show that the following gives a zero-cost collar

buying XYZ at \$40 + buying a 40-strike put + selling a 41.72-strike call

Draw the profit diagram.

Solution. Check book p. 77. $\square$

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Draw the profit diagram.

Solution. Check book p. 77. □