

Financial Mathematics

MATH 5870/6870¹
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¹Based on Robert L. McDonald's *Derivatives Markets*, 3rd Ed, Pearson, 2013.

Chapter 2. An Introduction to Forwards and Options

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§ 2.1 Forward contracts

§ 2.2 Call options

§ 2.3 Put options

§ 2.4 Summary of forward and option positions

§ 2.5 Problems

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Six positions

$$\{\text{long, short}\} \times \{\text{forward, call, put}\}$$

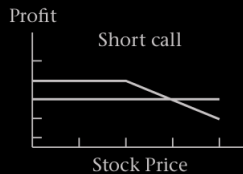
Maximum possible profit and loss at maturity for
 $\{\text{long, short}\} \times \{\text{forward, call, put}\}$

Position	Maximum Loss	Maximum Gain
Long forward	−Forward price	Unlimited
Short forward	Unlimited	Forward price
Long call	−FV(<i>premium</i>)	Unlimited
Short call	Unlimited	FV(<i>premium</i>)
Long put	−FV(<i>premium</i>)	Strike price − FV(<i>premium</i>)
Short put	FV(<i>premium</i>) − Strike price	FV(<i>premium</i>)

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⁵ $FV(\cdot)$ denotes the function that returns the future value.

Profit diagrams for
 $\{\text{long}, \text{short}\} \times \{\text{forward}, \text{call}, \text{put}\}$



Summary of positions for
 $\{\text{long, short}\} \times \{\text{forward, call, put}\}$

Derivative Position	Position with Respect to Underlying Asset	Asset Price Contingency	Strategy
Long forward	Long (buy)	Always	Guaranteed purchase price
Short forward	Short (sell)	Always	Guaranteed sale price
Long call	Long (buy)	$> \text{Strike}$	Insures against high price
Short call	Short (sell)	$> \text{Strike}$	Sells insurance against high price
Long put	Short (sell)	$< \text{Strike}$	Insures against low price
Short put	Long (buy)	$< \text{Strike}$	Sells insurance against low price