
STRIKE PRICE
EXCERCISE PRICE
LOT SIZE
BID
ASK
SPREAD

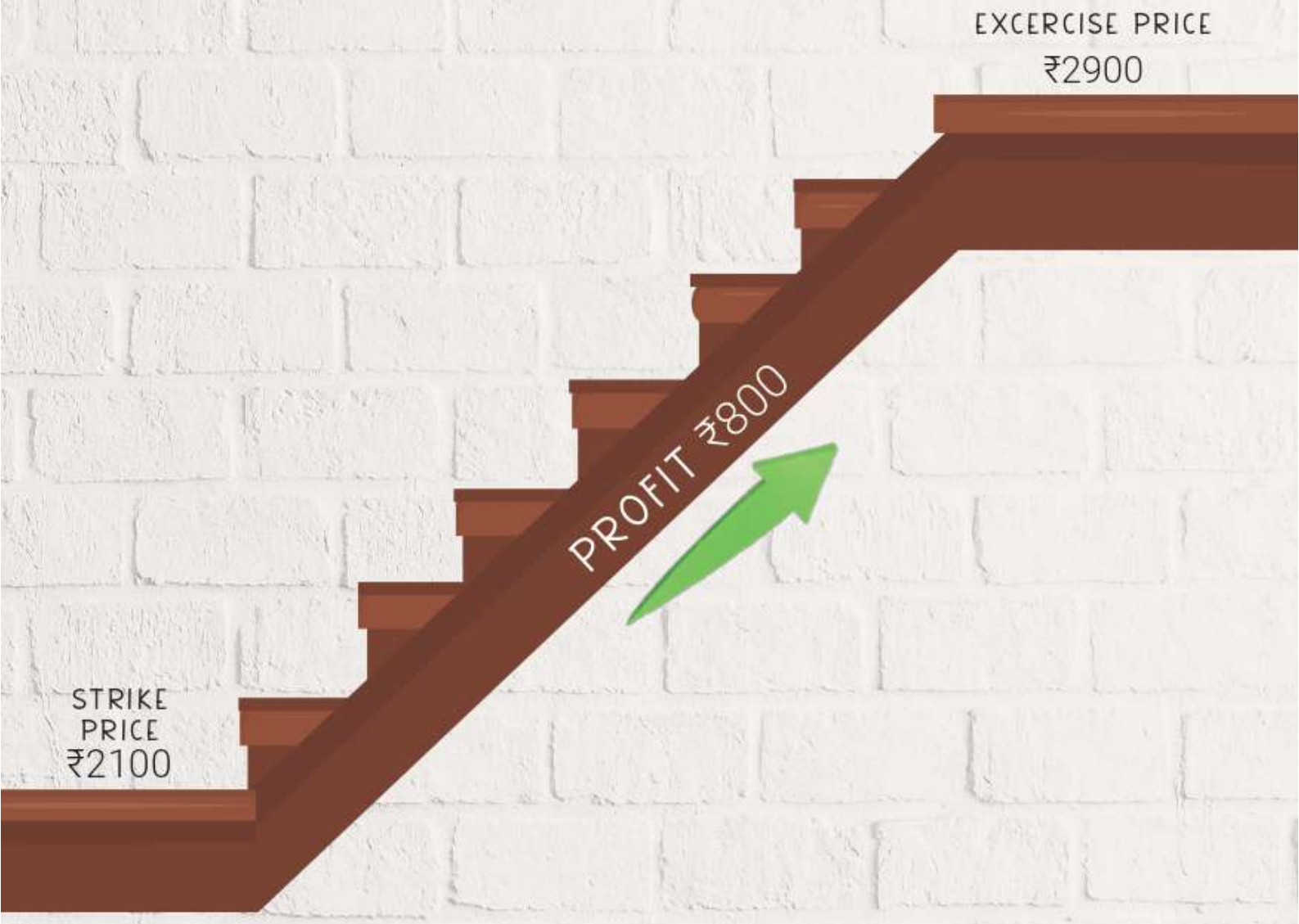
5.2 IMPORTANT TERMS TO UNDERSTAND OPTIONS CONTRACT

Let us begin with understanding some standard terms used in the Option Contracts.

STRIKE PRICE

STRIKE PRICE REFERS TO THE PRICE AT WHICH THE BUYER OR SELLER HAS THE RIGHT TO BUY OR SELL THE ASSET IN THE FUTURE AS PER THE CONTRACT. STRIKE PRICE IS THE PRICE THAT DETERMINES THE PROFIT OR LOSS ON THE POSITION.

For instance, if we have a call option strike price at ₹2100 and at the time of expiry the price is ₹2900, then the difference of ₹800, calculated from the strike, would be the payoff.
Had the strike price been ₹2500, then the payoff would have been ₹400 instead of ₹800



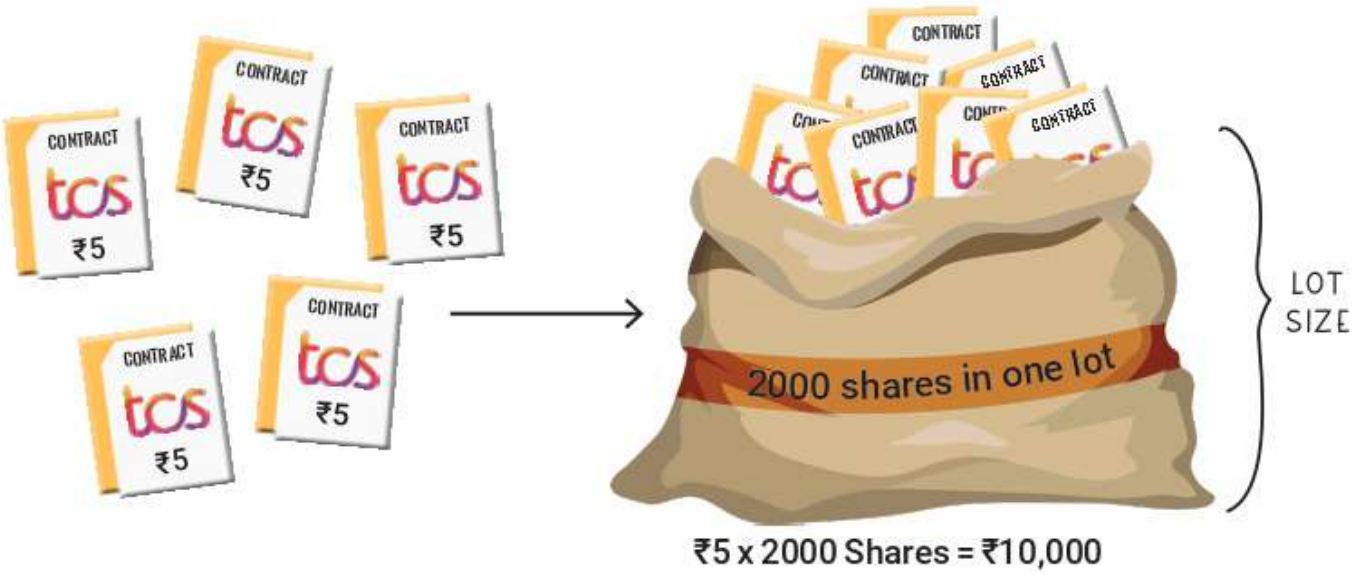
EXERCISE PRICE

Exercise price of an option is the price of the underlying asset on the expiry date of the contract. The difference between the exercise price and the strike price determines the profit or loss in an option contract.

EXPIRY

Expiry Date refers to the date till which the option contract is valid. The price of the underlying asset on this particular date forms the Exercise Price. In India, expiry for shares related options happens to be the last Thursday of each month.

LOT SIZE



₹5 x 2000 Shares = ₹10,000

Single option contracts cannot be purchased. They have to be bought and sold in lots. The number of contracts in each lot determines the Lot size.
So, if an option contract is worth ₹5 and has a lot of 2000 contracts, then each lot costs ₹10,000.

PREMIUM

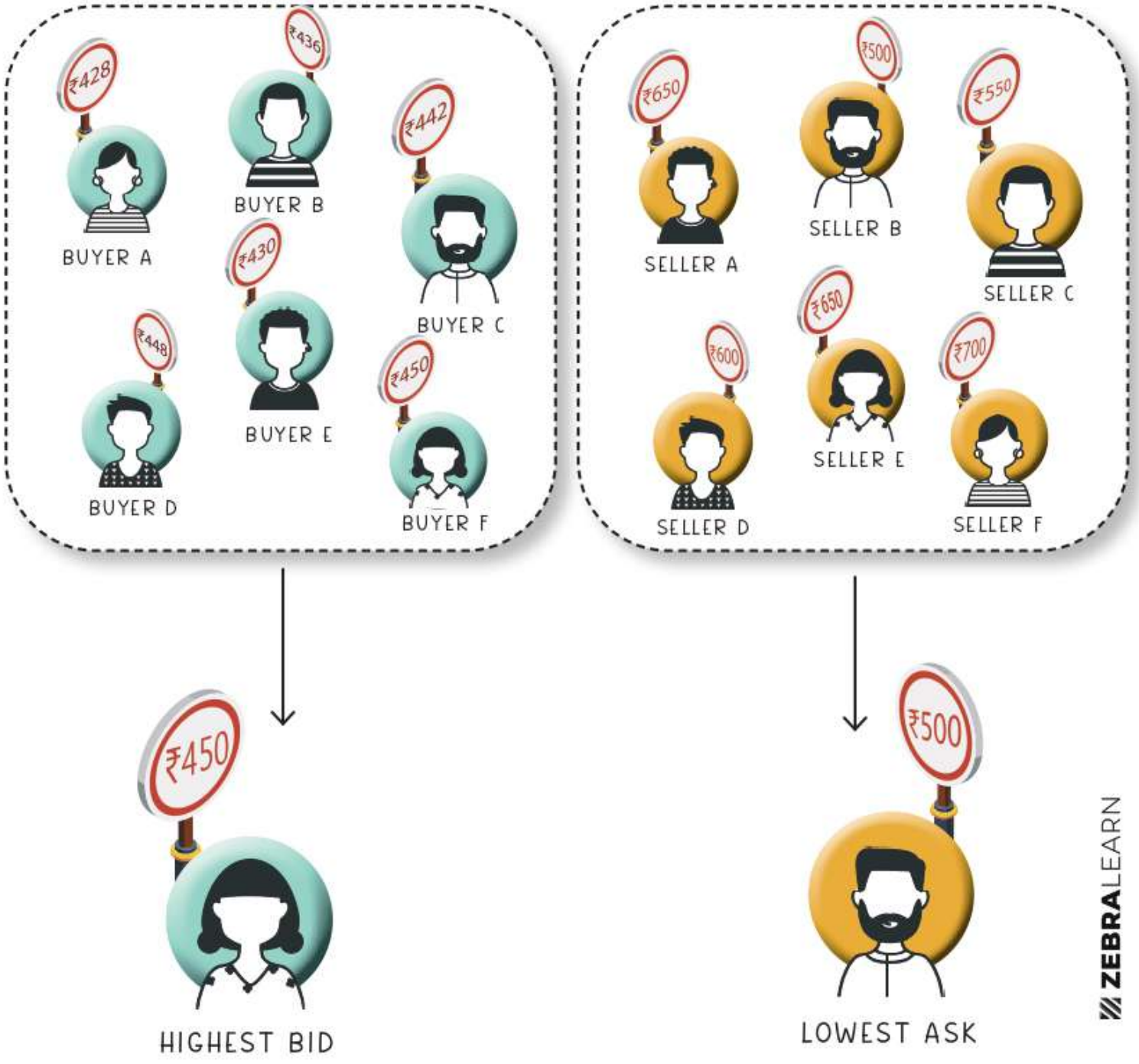
The premium is the price that the buyer pays to enter the contract.Premium is the cost of the option or the right that the buyer is purchasing. Premium paid determines the profitability of any option strategy. We will learn more about these when we discuss payoff charts.

BID

Similar to Futures, options are also sold in Auction model. The highest that a buyer is willing to pay, is called the Bid Price in the market. Any seller wanting to sell immediately will have to sell at this price.

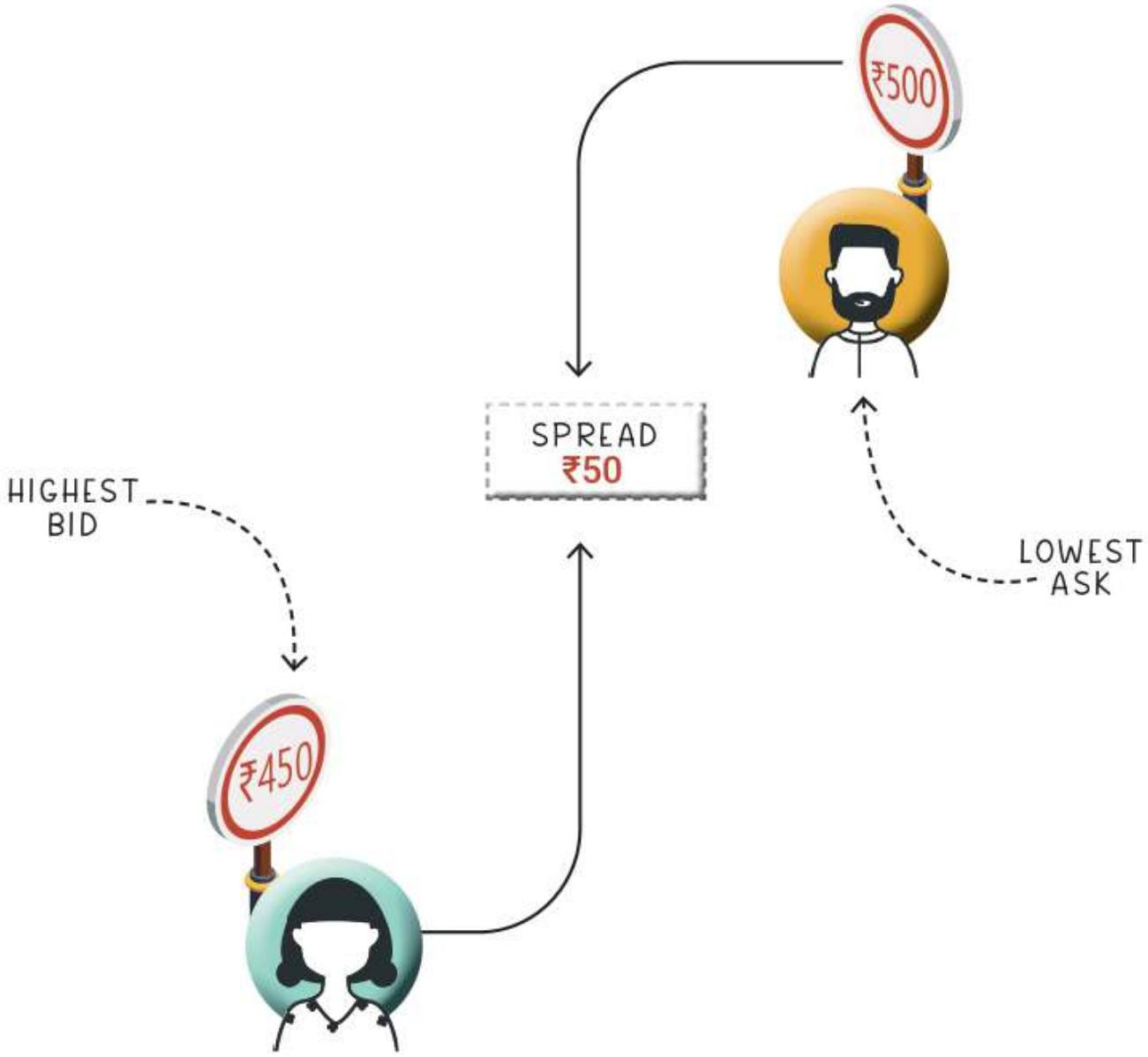
ASK

Ask Price is the lowest price at which a seller is ready to sell the option contract. A buyer looking to buy immediately will have to pay the Ask Price.



BID-ASK SPREAD

The spread is the difference between the bid and ask price of an asset. The buyers want to buy at the lowest and the sellers what to sell at the highest possible price. This is why there is a spread between the two.

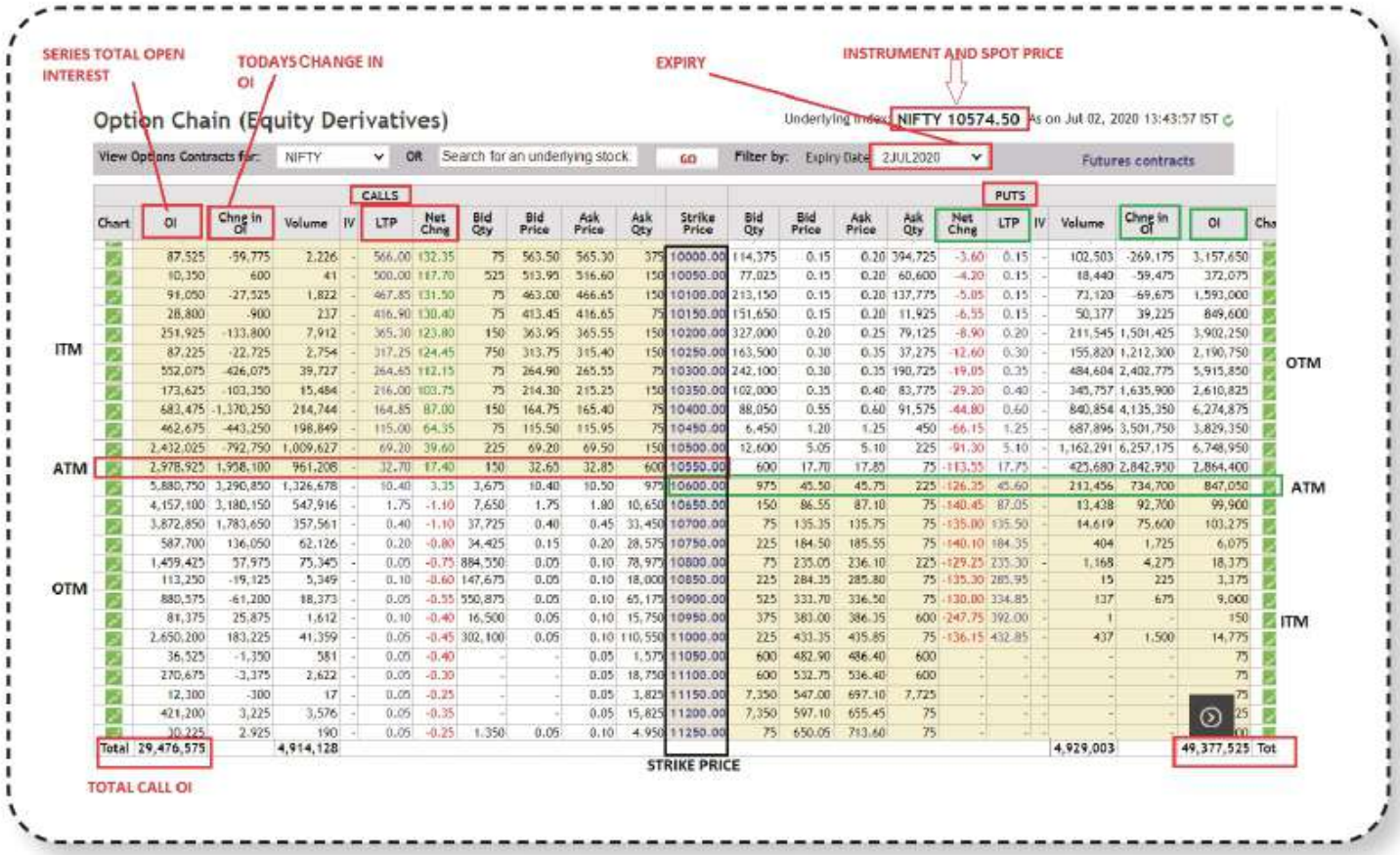


Bid-Ask spread can be low or high depending on the liquidity of the market. If the market is liquid i.e. it has lot of buyers and sellers, then the bid-ask spread would be thin i.e. low. If there are limited number of buyers and sellers, then the bid-ask spread would be high. Bid-ask spread adds to transaction costs when executing any strategy.

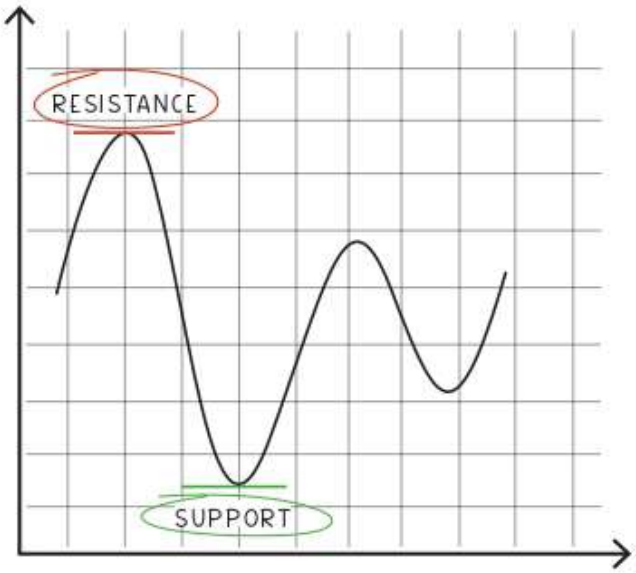
OPEN INTEREST

Open Interest refers to the total number of options that currently exist in the market at different strike prices for any particular underlying asset.

For example, TCS will have different number of call options and put options at different strike prices. This is called Open Interest at different strike prices.



Traders have trading strategies purely looking at the Open Interest at different levels too. Too high open interest for call option often denotes Resistance at that strike price and too high open interest for Put at a price denotes support levels in general.



BREAK EVEN POINT

The price at which you make no profit no loss as a buyer or seller of option contract is called the Break-even price. So, if you have purchased a call option, the exercise price must be higher than the Break-even point to make a profit.

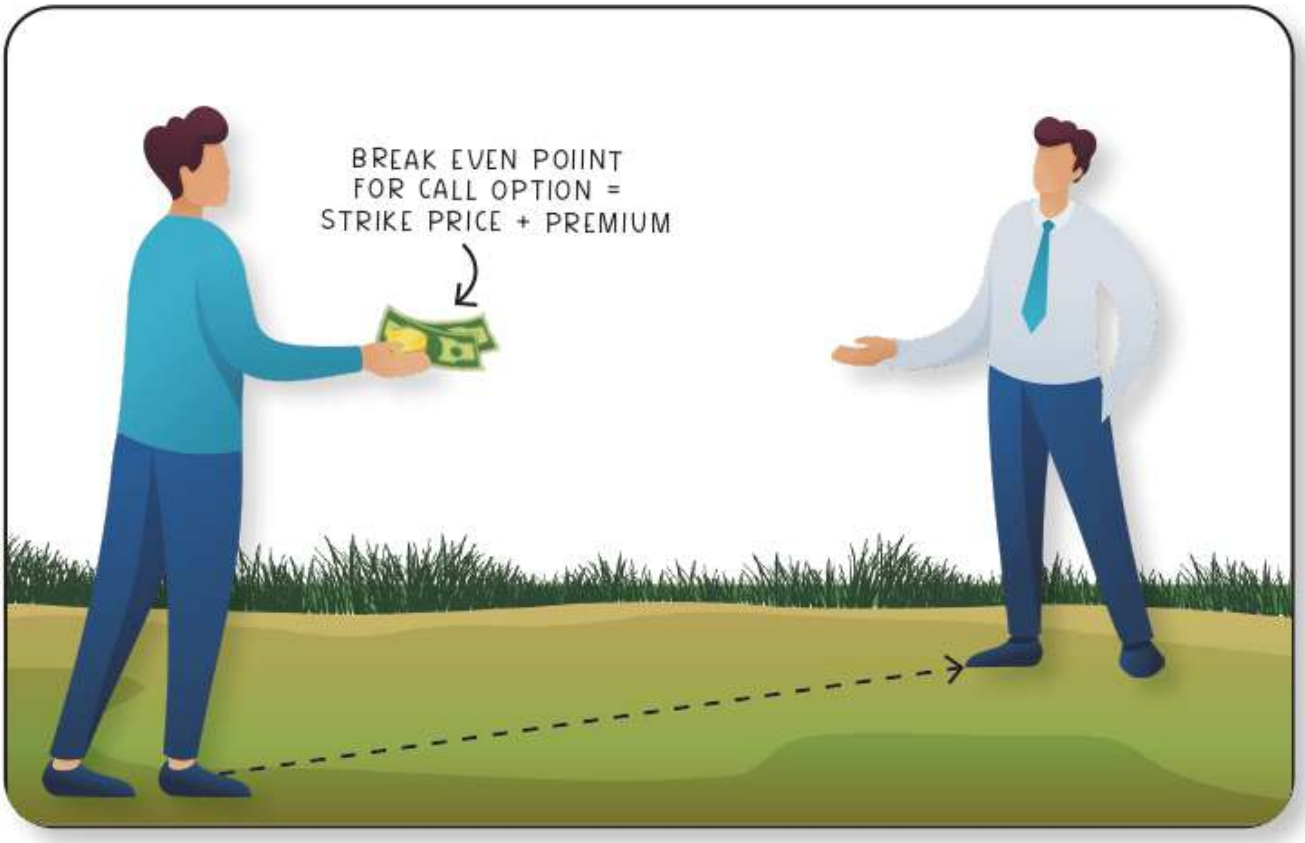
For instance,

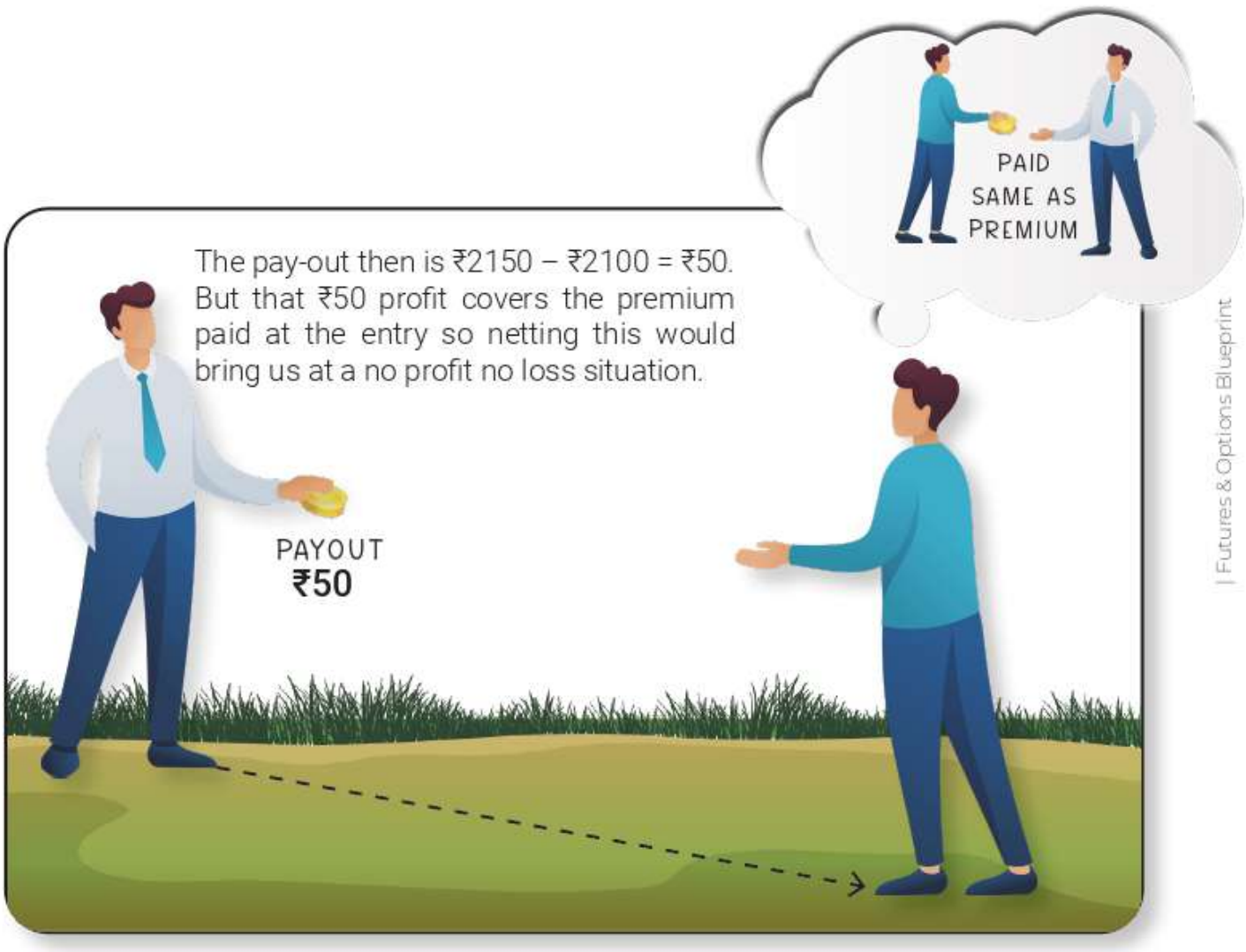
let us say the strike of a call option is ₹2100, the premium being ₹50 and exercise price is ₹2150 at the expiry date.

₹2100
STRIKE PRICE

₹50
PREMIUM

₹2150
EXERCISE PRICE





BREAK EVEN POINT

CALL OPTION

STRIKE PRICE + PREMIUM

PUT OPTION

STRIKE PRICE - PREMIUM