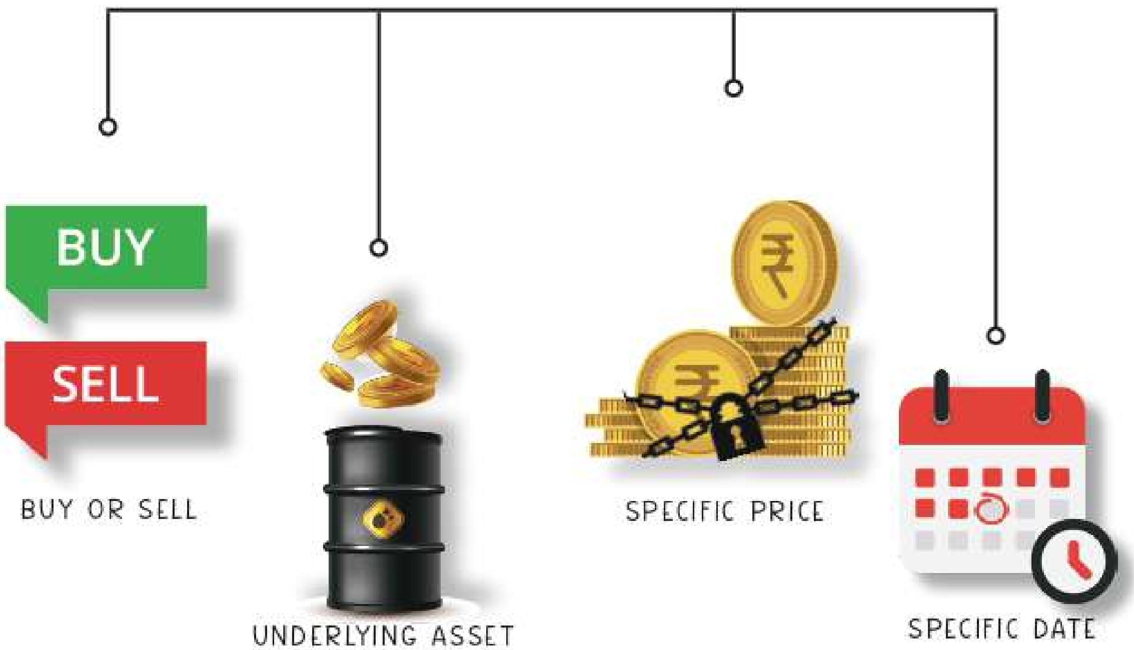
CHAPTER 5

FUNDAMENTALS OF OPTIONS CONTRACTS

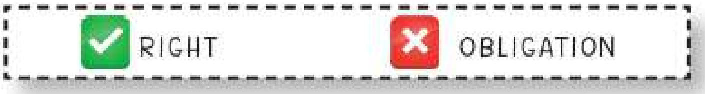
5.1 Introduction
5.2 Important terms to understand Options Contract
5.3 What does an options contract quotation look like ?
5.4 How does an options contract work?
5.5 Moneyness of options contract
5.6 Option payoffs

5.1 INTRODUCTION

> “OPTION CONTRACTS ARE DERIVATIVE CONTRACTS THAT GIVE THE BUYER A RIGHT BUT NOT A COMPULSORY OBLIGATION TO BUY OR SELL AN ASSET AT A SPECIFIC PRICE ON A SPECIFIC DATE.”

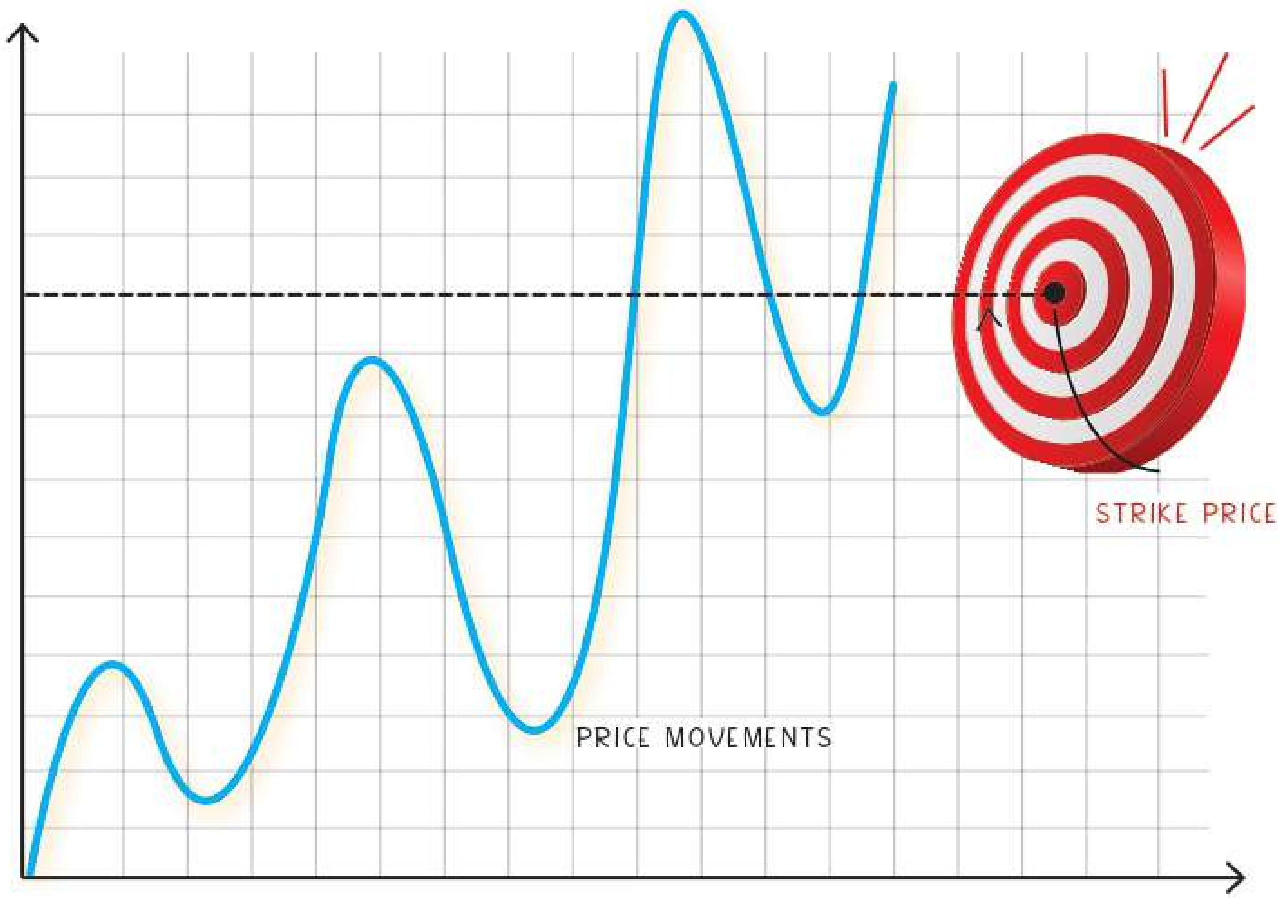


For example, lets say it gives the buyer the right to buy an asset for ₹110 on expiry. Now if on expiry the price is ₹115, the buyer of the option can exercise it and still buy the asset at ₹110 and profit by ₹5. If the market price on expiry is ₹100, then they can let the option expire and not exercise the same. We will see how this works exactly in this chapter.



An important thing to note here is that Option Contracts, as the name suggests, give an option to buy or sell the underlying asset. The buyer of the contract may or may not exercise this right to buy or sell the underlying asset even at the date of expiry of the contract.

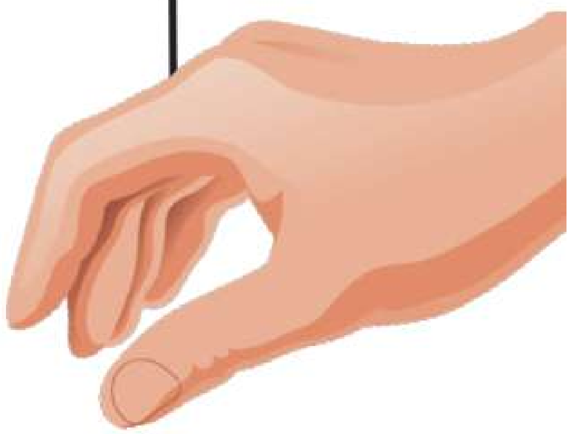
Option contracts are created around different strike prices. Strike Price refers to the price at which, as per the contract, the asset can be bought or sold on expiry. In the previous example, the strike price was Rs. 110. Strike price is extremely important to understand options as it changes the entire strategy, price of option and its pay-off.



Do not get overwhelmed if you do not understand options right away. It takes time to understand the same. By the end of this chapter, you will understand them and how they work in great detail.

Options contracts are of two types, as mentioned earlier, call options, and put options, and we would be understanding the Payoffs and payoff charts of both, call options and put, in-depth shortly.

TWO TYPES OF OPTIONS



CALL OPTION

In the Call Option, the buyer has the option/right - but not the obligation, to purchase the underlying asset at a fixed price. Here, the buyer profits when the price of the underlying asset goes up.

PUT OPTION

In the Put Option, the buyer has the option/right - but not the obligation, to sell the underlying asset at a fixed price. Here, the buyer of the Put option profits when the price of underlying asset goes down.

To enter into such a contract where the buyer of the option has the right but not the obligation to buy or sell an asset at a specific price, the buyer needs to pay a certain amount to the seller. This amount is called Options Premium or the cost of the option. After paying the option premium, the buyer of the option is not required to pay anything further in any circumstance i.e. they have limited their losses.

Both the call option buyer and put option buyer are supposed to pay this premium while entering the contract.

The premium amount is the risk taken by the Options buyer to enter into a contract where they get the right but not the obligation to buy or sell. In theory this might look like a very good position to be in with limited losses and unlimited profits, but in reality, it has to be really understood well to profit from these. We will understand the profitability under different circumstances when we learn about Option payoff charts.