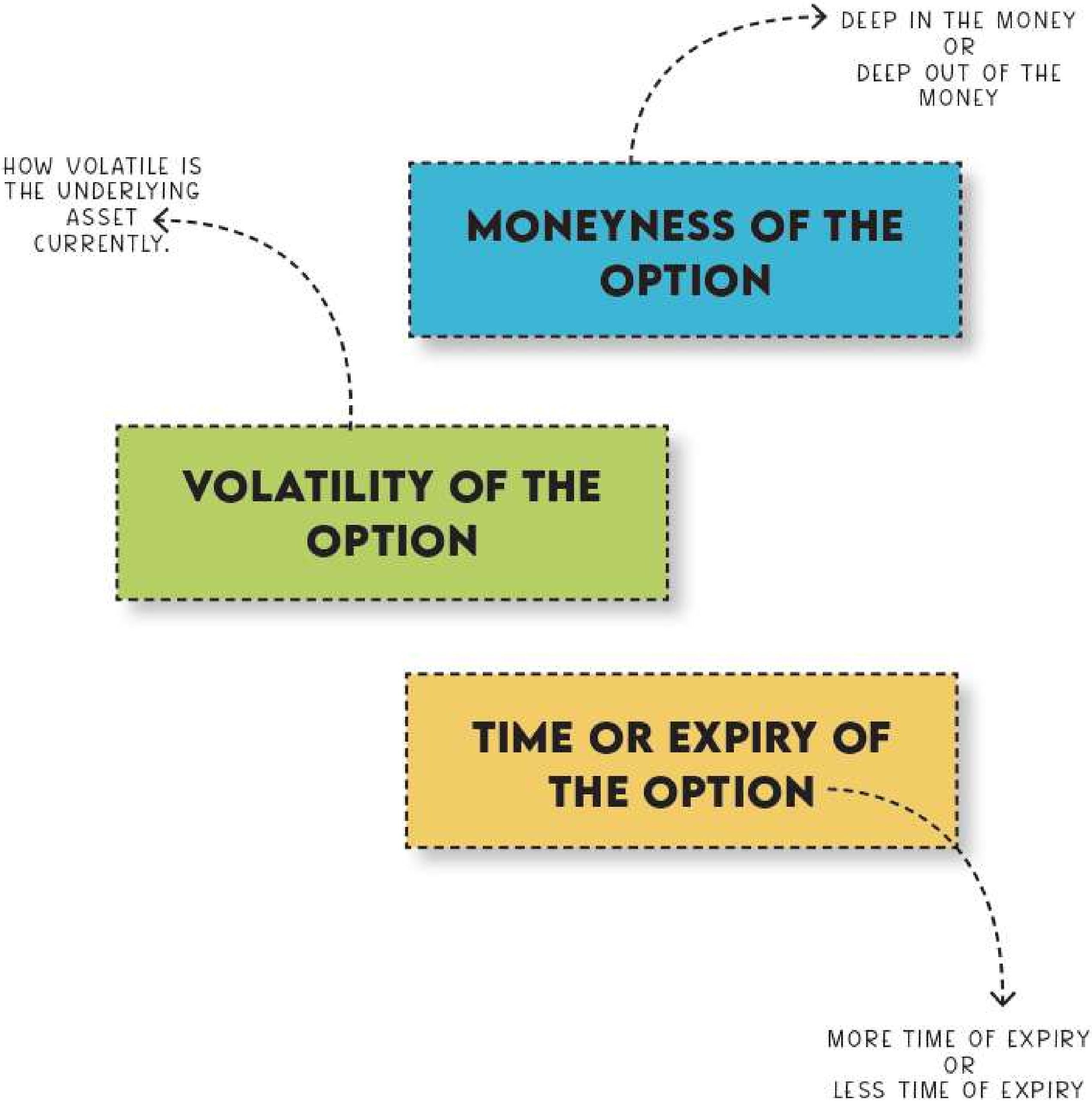
9.3 FACTORS AFFECTING THE PRICE OR VALUE OF AN OPTION

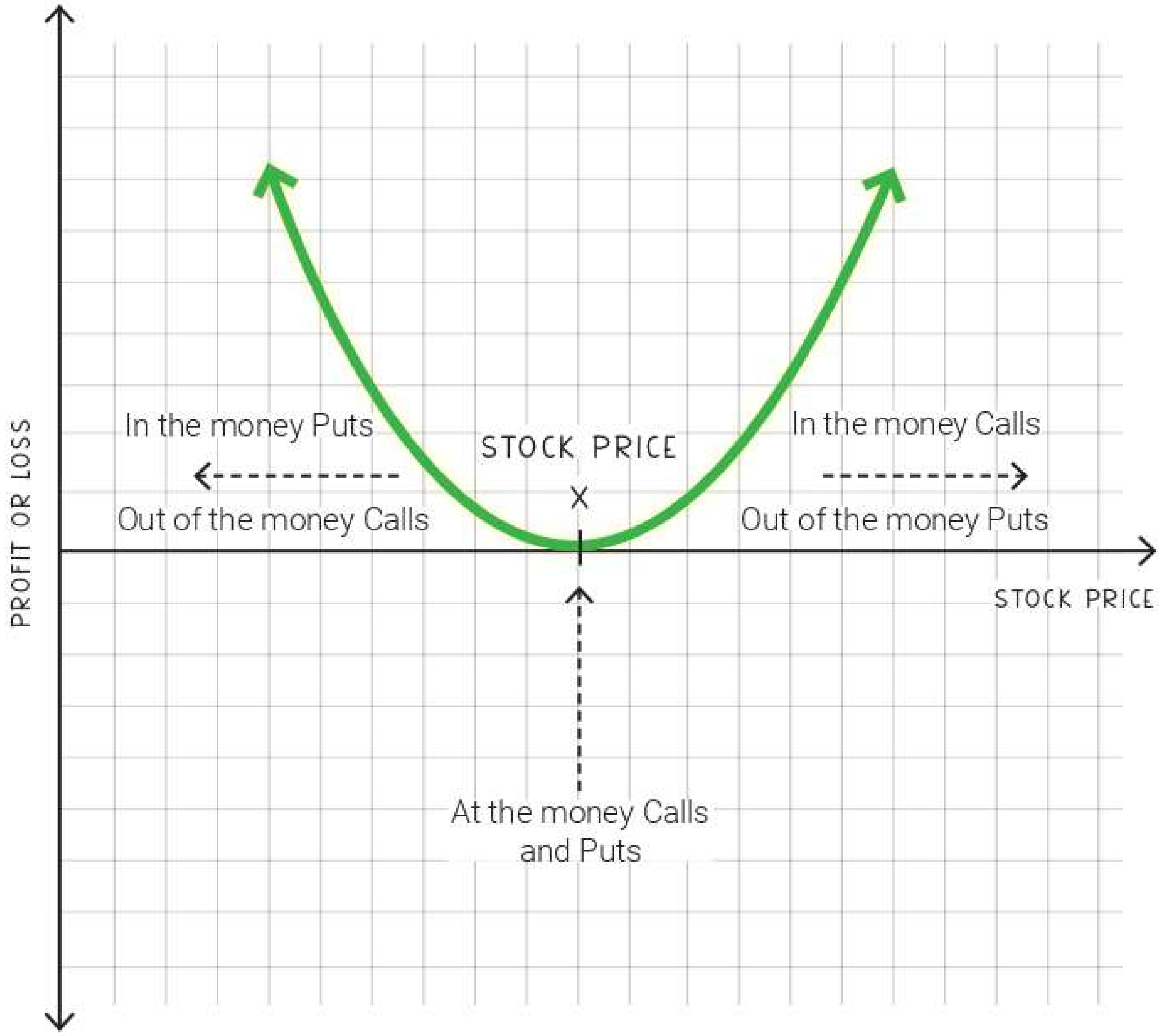
Explainer Video

Now that we understand the very basics of premium amount, lets go ahead and understand some factors that affect the price of the option.



MONEYNESS OF THE OPTION

As the option goes deep in the money, the option price increases. And as we go deep out of the money, the option price decreases.



As discussed earlier, the price of the option has intrinsic value as one of its components. So, as we go deep into the money, the option price increases with the increase in in-built profits. While as we go deep out of the money, the in-built profits are zero and so the option price decreases.

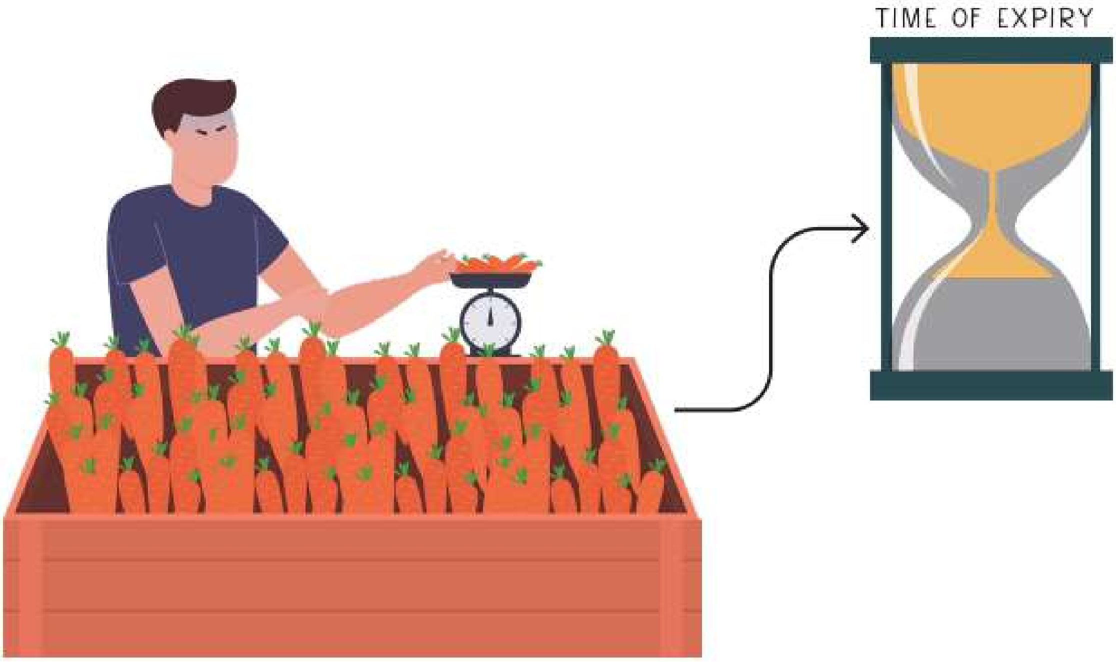
VOLATILITY OF THE OPTION

As uncertainties in the market increase, the price movement and therefore volatility goes up.
In such circumstances, the risk for the seller of the option increases. Therefore, the seller wants an additional premium to sell the contract as they may have large losses later.

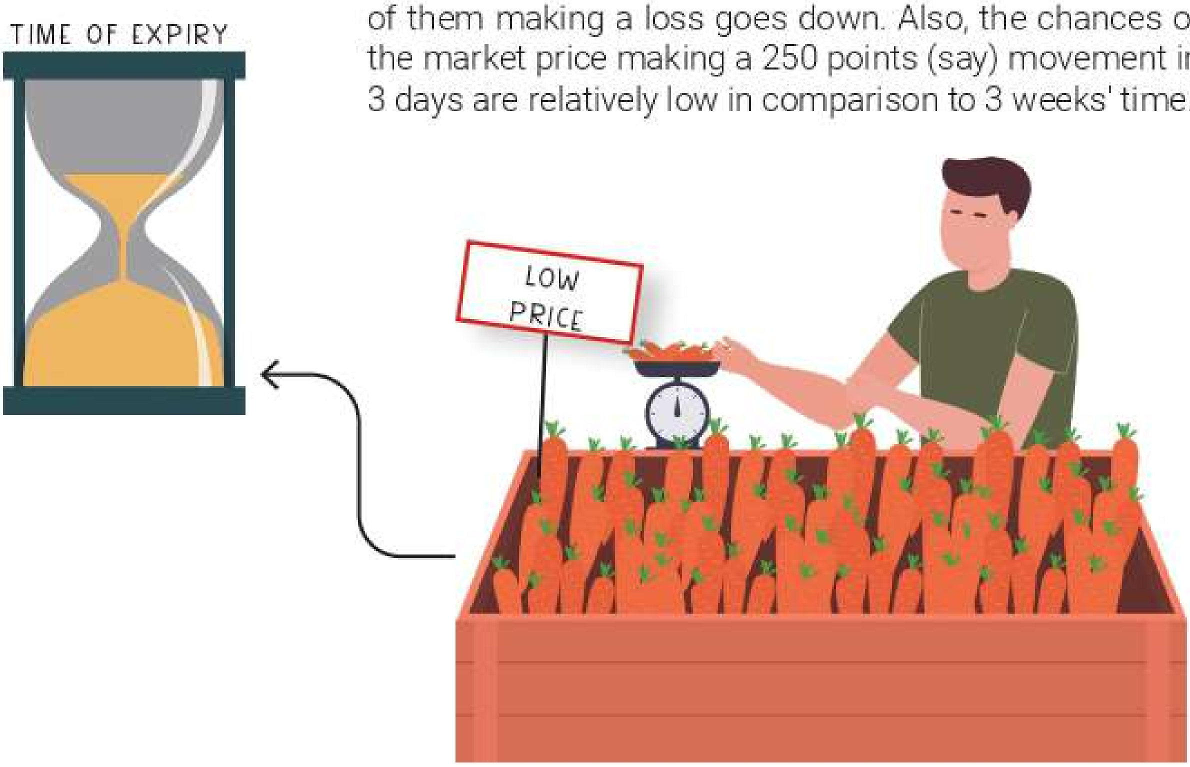
On the other hand, as the volatility in the market is low, the chances of seller making losses is also low. Therefore, the seller would sell the option at lower price too.

TIME OR EXPIRY OF THE OPTION

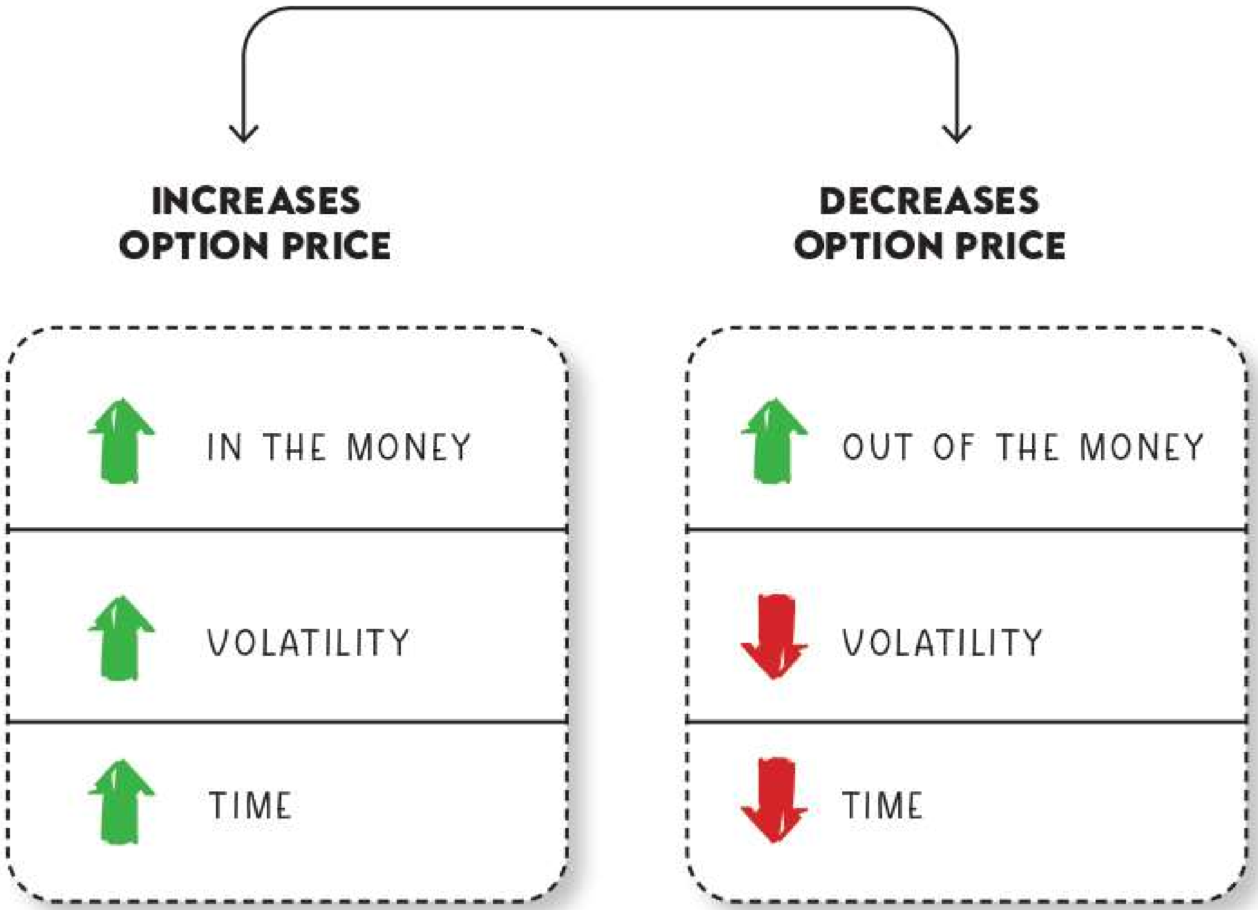
As the time to expiry of the option contract increases, the risk for the option seller also increases. It allows more time for the underlying asset and cause larger losses to the seller. As a result,as the risk increases so does the price or the premium of the option.



Similarly, as the time to expiry decreases, the seller is willing to sell at a lower rate. This is because he chances of them making a loss goes down. Also, the chances of the market price making a 250 points (say) movement in 3 days are relatively low in comparison to 3 weeks' time.



SUMMING UP THE FACTORS AFFECTING THE PRICE OF THE OPTION:



Essentially, with an increase in risk for the seller, the premium increases and with a decrease in the risk, the premium decreases.