M339D : October 4^{th}, 2024.

Advanced Derivatives Questions

1. Consider a European call option and a European put option on a nondividend-paying stock. You are given:

(i) The current price of the stock is 60.

(ii) The call option currently sells for 0.15 more than the put option.

(iii) Both the call option and put option will expire in 4 years.

(iv) Both the call option and put option have a strike price of 70.

Calculate the continuously compounded risk-free interest rate.

$r = ?$

(A) 0.039

(B) 0.049

(C) 0.059

(D) 0.069

(E) 0.079

Put-Call Parity.

$$\underbrace{V_c(0) - V_p(0)}_{= \text{(ii)}\ 0.15} = \underbrace{S(0)}_{=60} - \underbrace{PV_{0,T}(K)}_{=70e^{-r4}}$$

$$70e^{-4r} = 60 - 0.15 = 59.85$$

$$e^{-4r} = \frac{59.85}{70}$$

$$-4r = \ln\left(\frac{59.85}{70}\right)$$

$$r = -\frac{1}{4}\ln\left(\frac{59.85}{70}\right) = \underline{0.03916}$$

In general:

$$V_c(0) - V_p(0) = S(0) - Ke^{-rT}$$

$$Ke^{-rT} = S(0) - V_c(0) + V_p(0)$$

$$e^{-rT} = \frac{S(0) - V_c(0) + V_p(0)}{K}$$

$$-rT = \ln\left(\frac{S(0) - V_c(0) + V_p(0)}{K}\right)$$

$$\boxed{r = -\frac{1}{T}\ln\left(\frac{S(0) - V_c(0) + V_p(0)}{K}\right)}$$

implied interest rate

77. You are given:

i) The current price to buy one share of XYZ stock is 500.

ii) The stock does not pay dividends.

iii) The continuously compounded risk-free interest rate is 6%.

iv) A European call option on one share of XYZ stock with a strike price of *K* that expires in one year costs 66.59.

v) A European put option on one share of XYZ stock with a strike price of *K* that expires in one year costs 18.64.

Using put-call parity, calculate the strike price, *K*.

$\longrightarrow$: $V_c(0) - V_p(0) = S(0) - Ke^{-rT}$

(A) 449

$66.59 - 18.64 = 500 - Ke^{-0.06}$

(B) 452

$Ke^{-0.06} = 500 - 47.95 = 452.05$

(C) 480

$K = 452.05e^{0.06} = 480.0032$

(D) 559

(E) 582

78. The current price of a non-dividend paying stock is 40 and the continuously compounded risk-free interest rate is 8%. You are given that the price of a 35-strike call option is 3.35 higher than the price of a 40-strike call option, where both options expire in 3 months.

Calculate the amount by which the price of an otherwise equivalent 40-strike put option exceeds the price of an otherwise equivalent 35-strike put option.

$\longrightarrow$: $V_c(0, K_1=35) - V_p(0, K_1=35) = S(0) - 35e^{-0.08(0.25)}$

(A) 1.55

$V_c(0, K_2=40) - V_p(0, K_2=40) = S(0) - 40e^{-0.02}$ $-$

(B) 1.65

$3.35 + \left(V_p(0, K_2=40) - V_p(0, K_1=35)\right) = 5e^{-0.02}$

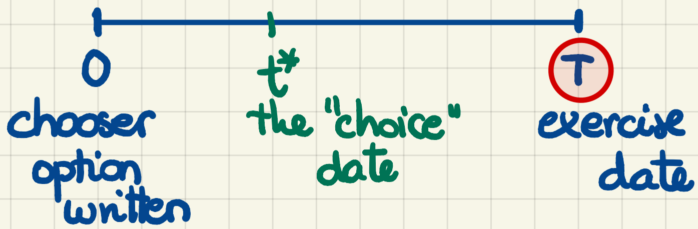
(C) 1.75

answer $= 5e^{-0.02} - 3.35 = 1.55$

(D) 3.25

(E) 3.35

Chooser Options (aka as·you·like·it options).



K… strike price

At time t^*, the chooser option's owner decides whether the option becomes a call or a put
(either way with strike K and exercise date T).

Assume that the owner is rational.

Idea #1: Try to sell it! 🙂 ↑

Idea #2: Choose whichever one is in the money.

Notation: $V_{CH}(t, t^*, T)$

valuation date: t

choice date: t^*

exercise date: T

$V_{c/p}(t,$ exercise date, strike price$)$

$$\Rightarrow V_{CH}(t^*, t^*, T) = \max\left(V_c(t^*, T, K), V_p(t^*, T, K)\right)$$