SNS College of Technology

Coimbatore - 35

23BAE703 – Derivatives and Risk Management

Unit III – Options Contract

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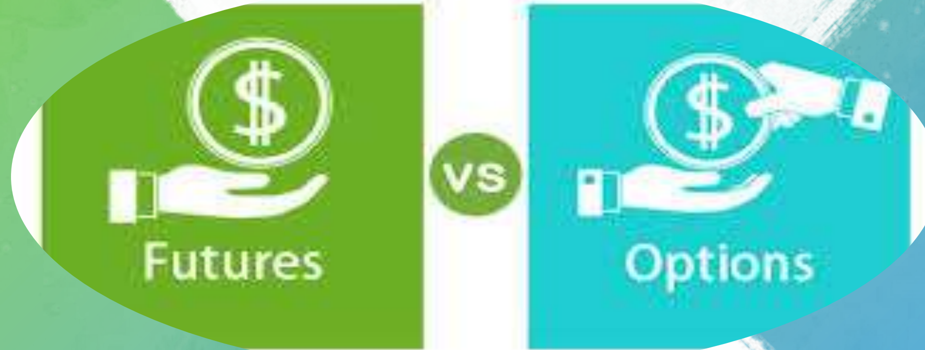
Redesigning Common Mind & Business Towards Excellence

Build an Entrepreneurial Mindset Through Our Design Thinking FrameWork

Can you Guess the Topic!!



Difference Between Futures and Options Contract

Recap

- ✓ Why Option Pricing Model
- ✓ Option Pricing
- ✓ How Option Pricing Changes over time?
- ✓ Option Pricing Model
- ✓ Types

Agenda for Discussion

- ✓ Why to study the difference?
- ✓ Difference between Futures and Options
- ✓ How to profit from Futures Vs Options?

Why to study the difference?

Pay Premium

High
% of
Deal Value

Entry
to
Options

Entry
to
Futures

Pay a
"Margin"

% of Deal
Value

Differences between Futures and Options

Futures	Options
• Exchange traded, novation	• Same as futures
• Exchange defines the product	• Same as futures
• Price is zero	• Strike price is fixed, price moves
• Linear payoff	• Price is always positive

Differences between Futures and Options

FUTURES	OPTIONS
Futures contracts have the buyer obligated to honor the contract	In options contract, there is no obligation on the buyer to buy or sell
Contract seller has the obligation to sell/buy, if buyer excercises right	Contract seller has the obligation to sell/buy, if buyer excercises right
Require higher margin payment than Options	Require lower margin payment than Futures
Preferred by speculators and arbitrageurs	Preferred by Hedger
Unlimited profit, loss potential	Unlimited profit, limted loss potential

Differences between Futures and Options

FUTURES CONTRACTS
V/S
OPTIONS CONTRACTS

FUTURES	OPTIONS
Buyer obligated to honour contract.	No obligation on buyer to actually buy or sell.
Contract seller has obligation to sell/buy if buyer exercises right.	Contract seller has obligation to sell/buy if buyer exercises right.
Requires higher margin payment than Options.	Requires lower margin payment than Futures.
Preferred by speculators and arbitrageurs.	Preferred by hedger.
Unlimited profit, loss potential.	Unlimited profit, limited loss potential.

How to Profit from Futures Vs Options

FUTURES	OPTIONS
Futures Contract is an agreement to buy or sell specified quantity of the underlying assets at a price agreed upon by the buyer and seller, on or before a specified time. Both the buyer and seller are obliged to buy/sell the underlying asset.	In options the buyer enjoys the right and not the obligation, to buy or sell the underlying asset.
Unlimited upside and downside for both buyer and seller	Limited downside (to the extent of premium paid) for buyer and unlimited upside. For seller (writer) of the option, profits are limited whereas losses can be unlimited.
Futures contracts prices are affected mainly by the prices of the underlying asset.	Prices of options are however, affected by (a) prices of the underlying asset, b) time remaining for expiry of the contact and c) volatility of the underlying asset.

How to Profit from Futures vs Options

How to Profit from Futures Vs Options

How to Profit from Futures and Options

What is Derivative Market

Trade Futures & Options

There are Some Fundamental Differences Between Futures and Options Contracts

- Compare to futures, the buyer of the option has a choice of not to complete the deal and would only deal if the price is favourable to him.
- The option buyer hence is being protected from unfavourable market movements. Therefore, the risk of loss is carried by the option seller.

Assessment

- How can options, futures, and forward contracts be used to devise simple hedging strategies?

a, Options are often used by firms to limit their downside risk. For example, if you own an asset and have the option to sell it at the current price, then you have effectively insured yourself against loss.

b. Futures contracts are agreements made today to buy or sell an asset in the future. The price is fixed today, but the final payment does not occur until the delivery date. Futures contracts are highly standardized and are traded on organized exchanges. Commodity futures allow firms to fix the future price that they pay for a wide range of agricultural commodities, metals, and oil. Financial futures help firms to protect themselves against unforeseen movements in interest rates, exchange rates, and stock prices.

c. Forward contracts are equivalent to tailor-made futures contracts. For example, firms often enter into forward agreements with a bank to buy or sell foreign exchange or to fix the interest rate on a loan to be made in the future.

A. a B. b C. c D. All the three statements are correct

All the three statements are correct

Summary

- Why to study the difference?
- Difference between Futures and Options
- How to profit from Futures Vs Options?

References

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Thanks!

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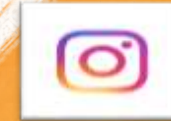
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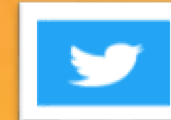
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