READING 6

OPTIONS STRATEGIES

EXAM FOCUS

The primary focus of this topic area is on the ways in which derivative contracts (instruments whose values derive from the economic performance of underlying securities, currencies, or other instruments or factors) may be used to hedge, or change the degree of exposure to, existing positions (for example a holding of a stock, or the exposure to a foreign currency caused by the ownership of an asset or liability in that currency). We will also see how derivatives, particularly options, can be used to obtain exposures to instruments and factors that cannot be obtained directly from the instruments and factors themselves (strategies such as straddles and spreads, for instance).

Reading 6 deals with options, mainly focusing on options on individual stocks, although the principles apply equally well to options on any other instruments. Reading 7 looks at the principles and uses of futures and forward contracts, while Reading 8 is concerned with currency management, beginning with the various approaches to currency along the passive-active spectrum, moving on to active currency strategies (including volatility trading via options), before considering currency hedging using futures and forwards (mainly the latter), and options.

The sequence of topics in our coverage of Reading 6 differs from the LOS order. We start by looking at the payoffs and profits associated with holding option positions to expiration. Since value at expiration is purely reflective of intrinsic value, the calculations involved are simple (but highly examinable, so worth getting clear before the complicating issue of time value is addressed). Only then do we move on to the more theory-heavy areas associated with time value—the option "Greeks" and strategies derived from them.

MODULE 6.1: OPTIONS BASICS—VALUE AT EXPIRATION AND PROFIT AT EXPIRATION

Video covering this content is available online.

PROFESSOR'S NOTE

Options have already been met at the previous levels, of course, so the material in this first module is largely revision. However, we recommend that you don't skip it, since it is vital to everything that follows.

In particular, distinguishing between option value and profit (respectively pre- and post-initial premium), and the graphical representation of how they vary with differing values of the underlying