19BAE710-FINANCIAL DERIVATIVES

Exchange-Traded Options (ETOs)

1. Definition:

- Exchange-Traded Options are standardized financial contracts that grant the holder the right (but not the obligation) to buy or sell an underlying asset at a predetermined price (strike price) on or before a specified expiration date.

2. Key Components:

- Underlying Asset: This is what the option derives its value from. It could be a stock, an index, a currency pair, or a commodity.
- Strike Price: The price at which the option allows you to buy (for a call option) or sell (for a put option) the underlying asset.
- Expiration Date: The date at which the option contract expires. After this date, the option becomes worthless.
- Option Premium: The price paid to acquire the option. It represents the cost of the contract.

3. Types of Options:

- Call Options: Give the holder the right to buy the underlying asset at the strike price before or on the expiration date.
- Put Options: Give the holder the right to sell the underlying asset at the strike price before or on the expiration date.

4. Trading on Exchanges:

- ETOs are bought and sold on organized exchanges such as the Chicago Board Options Exchange (CBOE) in the United States. These exchanges facilitate liquidity, transparency, and standardized contracts.

5. Option Buyers and Sellers:

- Buyers (Holders): Pay a premium to acquire the right but are not obligated to exercise it.
- Sellers (Writers): Receive the premium but may be obligated to fulfill the terms of the option if the buyer decides to exercise it.

6. Option Strategies:

- Traders and investors can use various strategies involving multiple options to hedge, speculate, or generate income. Common strategies include straddles, strangles, spreads, and covered calls.

7. Risk and Reward:

- Limited Risk: For option buyers, the risk is limited to the premium paid. Sellers, on the other hand, face unlimited risk if the market moves against them.

- Limited Reward: The profit potential for option buyers is theoretically unlimited, while sellers' potential profit is capped at the premium received.

8. Hedging and Speculation:

- ETOs serve as valuable tools for risk management (hedging) and speculation. Investors can protect their portfolios from adverse market movements or take advantage of anticipated price changes.

9. Market Factors:

- Option prices are influenced by factors like the price of the underlying asset, volatility, time to expiration, and interest rates.

10. Regulatory Framework:

- ETOs are subject to regulatory oversight to ensure fair and transparent trading practices. Regulatory bodies vary by region.