



FIN 366: INVESTMENTS
DERIVATIVES
CRITICAL THINKING & CONCEPTUAL QUESTIONS

1. When you pay a premium to purchase a call, are you paying the dealer's BID or ASK?
2. When you pay a premium to purchase a put, are you paying the dealer's BID or ASK?
3. Why might an investor hold a call or put with no intention of ever exercising?
4. What is a *protective put* and when might an investor use this?
5. In what ways do calls and puts offer benefits over holding stocks directly? In what ways might holding equities directly be better?
6. You purchase a security for \$10 that gives you the right to purchase a stock for \$340 on December 31st. On December 31st, the shares are trading at \$351. What type of security is this? Would you exercise? What if the shares were trading at \$328 on December 31st?
7. You purchase a security for \$8 that gives you the right to sell a stock for \$286 on December 31st. On December 31st, the shares are trading at \$321. What type of security is this? Would you exercise? What if the shares were trading at \$225 on December 31st?
8. If you paid \$10 for a call option last month with an exercise at \$100 and the stock trades at \$101 on the expiration date, why *should* you exercise even though your profit is negative?
9. What is the primary difference between calls/puts and forwards/futures?
10. How might forwards and futures "lock you into a loss" while buying calls and puts do not?
11. **CHALLENGE** **American options** allow the holder of the option to exercise at any time *before* the expiration date. **European options** allow the holder of the option to exercise only *on* the expiration date. If two options are identical except one is American-style and the other is European-style, which should be more valuable? (Note that the names do not necessarily require that the security be from America or from Europe.)
12. **CHALLENGE** An option is "**in the money**" when the exercise of the option would immediately produce a positive cash flow. For example, a call with an exercise price of \$100 when the stock is trading at \$110 is in the money. In perfectly efficient markets, what do we expect the minimum premium of such an option to be if we could immediately exercise and make \$10? Why?
13. **CHALLENGE** An "**out of the money**" option is when exercise of the option would immediately produce a negative cash flow. Do we expect the premiums on out of the money options on a stock to increase or decrease as the time to expiration increase? What about for in the money options?

