Reading 69

FORWARD COMMITMENT AND CONTINGENT CLAIM FEATURES AND INSTRUMENTS

1. (C) is not legally binding.

Explanation

A forward commitment is a legally binding promise to perform some action in the future and can involve a stock index or portfolio.

(Module 69.2, LOS 69.c)

2. (C) zero.

Explanation

For a call option, the value at expiration is zero if the price of the underlying is less than or equal to the exercise price. The holder will allow the option to expire unexercised.

(Module 69.2, LOS 69.b)

3. (A) a deposit is required to return the account margin to the initial margin level.

Explanation

Once account margin (based on the daily settlement price) falls below the maintenance margin level, it must be returned to the initial margin level, regardless of subsequent price changes.

(Module 69.1, LOS 69.a)

4. (C) underlying asset price minus the exercise price.

Explanation

The value of a call option at expiration is its exercise value, which is Max [0, S – X].

(Module 69.2, LOS 69.b)

5. (B) put option

Explanation

A put option gives the holder the right to sell an asset at a specified price on a specific future date. A call option gives the holder the right to buy an asset at a specified price on a specific future date. A swap is an obligation to both parties.

(Module 69.1, LOS 69.a)

6. (C) an average of the trade prices over a period at the end of a trading session.

Explanation

The settlement price is calculated as the average trade price over a specific closing period at the end of the trading day. The length of the closing period is set by the exchange.

(Module 69.1, LOS 69.a)

7. (A) The holder of a put option has the right to sell to the writer of the option.

Explanation

The holder of a put option has the right to sell to the writer of the option. The writer of the put option has the obligation to buy, and the holder of the call option has the right, but not the obligation to buy.

(Module 69.1, LOS 69.a)

8. (B) a contingent claim.

Explanation

Contingent claims are contracts with payoffs that depend on a specified event occurring. Options and credit default swaps are examples of contingent claims, but neither of these terms describes all contingent claims.

(Module 69.2, LOS 69.c)

9. (A) $0

Explanation

A call option has an expiration day value of Max (0, S − X). Here, X is $120 and S is $105.Because the call option is *out of the money* at expiration, its value is zero.

(Module 69.2, LOS 69.b)

10. (A) −$4.50.

Explanation

The option is in-the-money by $0.50 ($23.00 − $22.50). The investor paid $5.00 for the call option; thus, the net loss is −$4.50 ($0.50 − $5.00).

(Module 69.2, LOS 69.b)

11. (A) positive.

Explanation

Put options are in the money (have positive value) at expiration if the spot price of the underlying asset is less than the exercise price, because the put option holder has the right to sell the asset for the higher exercise price. The value of an option cannot be negative; at expiration its value is the greater of zero or its intrinsic value.

(Module 69.2, LOS 69.b)

12. (B) $9.

Explanation

The call has a $9 ($41 − $32) value at expiration, because the holder of the call can exercise his right to buy the stock at $32 and then sell the stock on the open market for $41. The intrinsic value of a call at expiration is Max (0, S − X).

(Module 69.2, LOS 69.b)

13. (A) $3.80.

Explanation

The put option will not be exercised because it is out-of-the-money, Max (0, X − S). Therefore, Steadman keeps the full amount of the premium, $3.80.

(Module 69.2, LOS 69.b)

14. (C) $15.40.

Explanation

The put option will be exercised and has a value of $145-$128 = $17 [Max (0, X − S)]. Therefore, Casteel receives $17 minus the $1.60 paid to buy the option. The profit is $15.40 ($17 less $1.60).

(Module 69.2, LOS 69.b)

15. (B) breakeven point for the buyer is the exercise price plus the option premium.

Explanation

The breakeven for the buyer and the seller is the exercise price plus the premium. The call holder will exercise if the market price exceeds the exercise price.

(Module 69.2, LOS 69.b)

16. (B) $26

Explanation

A put option has an expiration day value of Max (0, X − S). Here, X is $65 and S is $39.

(Module 69.2, LOS 69.b)

17. (B) in-the-money by $7.50.

Explanation

The put allows a trader to sell Basil common stock for $7.50 more than the current market value ($55.00 − $47.50). The trade is normally closed out with a cash settlement, but the trader could buy 100 shares for $47.50 per share and immediately sell them to the option writer for $55.00.

(Module 69.2, LOS 69.b)

18. (A) equal to its intrinsic value.

Explanation

The intrinsic value of a call, either European or American, at expiration is Max (0, S – X), which is its intrinsic value. The asset price minus the present value of the exercise price can be negative, but options cannot have a negative value.

(Module 69.2, LOS 69.b)

19. (C) forward commitments.

Explanation

Credit default swaps are contingent claims and not forward commitments because their payoff depends on a future event taking place. Credit derivatives are a form of insurance against a credit event.

(Module 69.1, LOS 69.a)

20. (A) $5

Explanation

A put option has an expiration day value of Max (0, X – S). Here, X is $80 and S is $75

(Module 69.2, LOS 69.b)

21. (C) $12

Explanation

A call option has an expiration day value of MAX (0, S – X). Here, X is $35 and S is $47.

(Module 69.2, LOS 69.b)

22. (A) zero.

Explanation

At expiration, the value to the holder (long position) of a put option on a stock is the greater of zero or the exercise price minus the stock price. If the stock price is greater than the exercise price, the value of a put option to the holder is zero and the holder will allow the option to expire unexercised.

(Module 69.2, LOS 69.b)

23. (A) makes a series of payments to a credit protection seller.

Explanation

In a credit default swap (CDS), the buyer of credit protection makes a series of payments to a credit protection seller. The credit protection seller promises to make a fixed payment to the buyer if an underlying bond or loan experiences a credit event, such as a default. In a total return swap, the buyer of credit protection exchanges the return on a bond for a fixed or floating rate return. A security that is paid using the cash flow from an underlying bond is known as a credit-linked note.

(Module 69.1, LOS 69.a)

24. (A) $0.

Explanation

The put has a value of $0 because it will not be exercised. Put value is Max (0, X-S).

(Module 69.2, LOS 69.b)

25. (C) initial margin

Explanation

In futures trading, a margin call requires the investor to restore the account to the initial margin level or close the position.

(Module 69.1, LOS 69.a)