

Reading 72

PRICING & VALUATION OF FORWARD CONTRACTS & FOR AN UNDERLYING WITH VARYING

1. (A) spot price minus the present value of the forward price.

Explanation

During the life of a forward contract on an underlying asset with no holding costs or benefits, the value to the long equals the spot price minus the present value of the forward price:

$$V_t(T) = S_t - F_0(T) (1 + R_f)^{-(T-t)}$$

(Module 72.1, LOS 72.a)

2. (C) lock in an interest rate for future borrowing or lending

Explanation

The purpose of a forward rate agreement (FRA) is to manage interest rate risk by locking in an interest rate for future borrowing or lending. An FRA is a forward commitment rather than a contingent claim. An interest rate swap is used to exchange a floating-rate obligation for a fixed-rate obligation.

(Module 72.1, LOS 72.b)

3. (B) typically zero at initiation

Explanation

The value of a forward or futures contract is typically zero at initiation, and at expiration is the difference between the spot price and the contract price. The price of a forward or futures contract is defined as the price specified in the contract at which the two parties agree to trade the underlying asset on a future date.

(Module 72.1, LOS 72.a)

4. (C) $V_t = S_t - F_0(T) (1 + R_f)^{-(T-t)}$

Explanation

The value of a long position in a forward contract prior to settlement (expiration) is:

$$V_t = S_t - F_0(T)(1 + R_f)^{-(T-t)} \text{ when the net cost of carry is zero.}$$

(Module 72.1, LOS 72.a)

