

Video lecture

https://youtu.be/HbIBhgI3_zw

What?

A call option, for the writer, is an obligation to sell an underlying financial security at a specific (**strike**) price before an expiration (**maturity**) date. Anybody can write call options. Call options trade very similar to stocks through brokerage companies during normal market trading hours. The money that is collected to write call options is income for taking risk. Call options expire on their maturity dates. Call option value may go to zero. Call option writer's potential loss is unlimited. Call options trade in contracts and each contract is usually for 100 shares of the underlying financial security.

Example

A call option with a strike price of \$200 and maturity date of January 18th on AAPL is trading at \$1 per share. We can write one contract for: $\$1 \times 100 \text{ shares} = \100 for one contract. We have the obligation to sell 100 shares of AAPL at \$200 per share until January 18th. Note that the \$100 that we collect to write this option is our income. It is not a down payment. It is not a deposit. There are no refunds. We can try to buy this option back from the market. However, the new sale price has nothing to do with the \$100 we collected. Thus, \$100 is an instant income that we collect up front, as soon as we write the call option. If AAPL price increases to \$215 then we will lose \$15 per share ($\$215 - \$200 = \$15$ per share). Since we have the obligation to sell 100 shares, we will lose \$1,500 ($\$15 \times 100 \text{ shares} = \$1,500$). Remember that we collected \$100 to write this call option. If AAPL price decreases to \$185 then we will not lose any money. Remember that the call option gives the buyer right but not the obligation. Thus, the buyer will chose not to exercise his/her right to buy AAPL at \$200 from us when the market price is below our strike price (i.e. \$185). We will end up keeping our initially collected \$100.

Pricing

Call option price is determined by two factors: 1) **exercise value** (a.k.a. intrinsic value) and 2) **pre-**

mium.

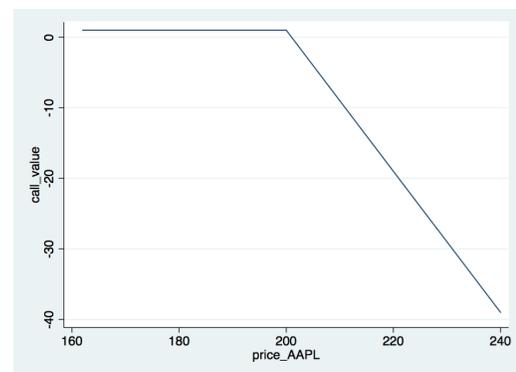
Exercise value is the value that the call option buyer will attain if s/he chose to exercise the option. So, based on our example above the \$15 per share ($\$215 - \$200 = \15 per share) is the exercise value. Exercise value is precise and easily calculated.

Premium is the value that is dependent on traders' perception of the specific call option. Think of a memorabilia (ex. baseball) that is signed by a celebrity. The actual baseball may be worth a few dollars but the autograph by the celebrity adds significant value. However, how much value the autograph adds is hard to determine. The best way is to try to sell it. Then, we would know the true value of the autographed memorabilia. Option premium is similar to the autograph's value. Traders perception of the specific call option's value is hard to determine. However, the market traded prices will show true value.

Possible outcome

We will now evaluate possible outcomes of writing the call option in our previous example. Note that, since it is hard to determine the premium, our exercise is based on exercise value.

```
set obs 40
gen price_AAPL = 160 + (_n*2)
gen call_price = -1
gen strike = 200
gen call_value = -(max(price_AAPL-strike,0) + call_price)
twoway (line call_value price)
```



The horizontal axis is the possible AAPL share price in the market. The vertical axis is the call option outcome based on possible AAPL share prices. Note that the call option outcome can be positive \$100. This is what we collected when we wrote and sold the call option. Note that, when we write call options, our potential loss is unlimited. Our potential profit however is limited to the \$100 we collected.