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**RISK MANAGEMENT APPLICATIONS OF OPTIONS STRATEGIES**

Cross-Reference to CFA Institute Assigned Reading #72

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**Call Holder's Perspective** Vol 6 pg 161

- If the option expires out-of-the-money, the maximum loss to the call option holder equals the premium paid for the option.
- Breakeven on the option position occurs when the market price equals the strike price plus option premium.
- The call option holder's profits are unlimited. As the stock price rises, her profits continue to increase.
- The call option holder will exercise the option if there is a positive payoff, i.e when the stock price exceeds exercise price.

**Call Writer's Perspective** Vol 6 pg 162

- When the option expires out-of-the money (when the stock price is less than the exercise price) it is not exercised by the holder so the writer makes a maximum profit equal to the option premium.
- The writer's breakeven occurs at the same price as the holder's breakeven.
- The call option writer's losses are unlimited. As stock price rises, the writer continues to suffer increasingly negative payoffs on the option position.

**Put Holder's Perspective** Vol 6 pg 164

- If the put expires out of-the-money, the maximum loss to the option holder equals the premium paid for the option.
- Breakeven on the option position occurs when the stock price equals the strike price minus option premium.
- The put option holder's profits are maximized when the stock price falls to zero.
- The put option holder will exercise the option when there is a positive payoff, i.e. when the stock price is below exercise price at expiration.

**Put Writer's Perspective** Vol 6 pg 166

- When the put option expires out of-the-money (when the stock price exceeds the exercise price) it is not exercised by the holder so the writer makes a maximum profit equal to the option premium
- The writer's breakeven occurs at the same price as the holder's breakeven.
- The maximum loss to the put option writer occurs when the stock price falls to zero.

**Call versus Put Options**

- Call option holders and put option writers benefit when underlying asset prices *increase*. Call option buyers believe that the underlying asset is *undervalued*.
- Put option holders and call option writers benefit when underlying asset prices *decrease*. Put option buyers believe that the underlying asset is *overvalued*.

**A Covered Call Strategy** Vol 6 pg 168

A covered call strategy on a stock involves owning the stock and writing call options (usually out-of-the money) on the stock. A covered call is written when an investor believes that the stock price will not increase in the near future. Therefore, she expects the written calls not to be exercised, and hopes to supplement her return by collecting option premia while maintaining her holding of the stock. In case she is wrong and the stock price exceeds the exercise price at option expiration, the options will be exercised and the stock will be called away. This strategy has an element of risk in it- an investor essentially trades away the stock's upside potential in return for the call premium.

**Protective Put Strategy** Vol 6 pg 172

A protective put is a hedging strategy that protects a portfolio from falling in value below a particular level. A protective put is constructed by owning a stock and purchasing a put option on the stock.

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**ALTERNATIVE INVESTMENTS**

 Cross-Reference to CFA Institute Assigned Reading #73
 

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An **investment company** is a financial institution that pools together investors' funds and invests them to earn a return. These returns are then distributed on a pro-rata basis to investors. The investment company itself collects a fee for managing and investing funds.

In **unmanaged** investment companies (e.g. unit investment trusts in the U.S.), funds are pooled together and invested in a fixed portfolio of investments. If, at any point in time, an investor wishes to redeem (or cash in) her investment, her shares are redeemed at market value.

**Managed** investment companies are classified according to whether they stand ready to redeem investors' shares.

*Open-end* funds allow investors to redeem their investments at any point in time at market value, whereas *closed-end* funds do not. Closed-end investment companies issue shares that are traded in secondary markets.

**Fund Management Fees** Vol 6 pg 190

- **Front-end loads** are charged on initial investment.
- **Back-end loads** are charged at the time of redemption.
- **Contingent deferred sales charges** are back-end loads that decrease over time to give investors an incentive to remain invested in the fund for a longer period. They also discourage frequent trading turnover in shares of the fund.