CALL OPTION

Simplifying Call Option

– By Prof. *Simply* Simple ™

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Let's understand this concept by taking the example of a farmer & a baker.

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Our farmer cultivates wheat…

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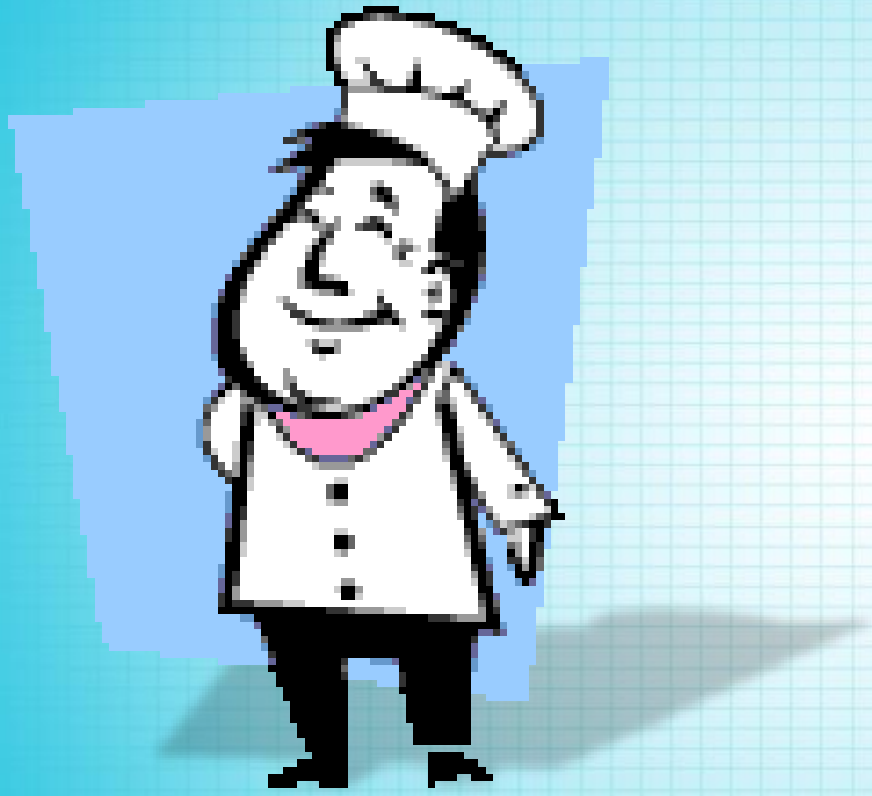
And our baker needs wheat as an input for making bread…



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- The farmer thinks that the price of wheat which is currently trading at Rs. 100 could fall to Rs. 90 in 3 months.
- The baker on the other hand feels that the price of wheat might become Rs. 120 in 3 months.

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- Both of them come together & sign a contract which says that at the end of 3 months the bread manufacturer would buy wheat from the farmer at Rs. 110.
- Thus the baker is protected against a possible rise in prices.
- And the farmer is protected against any drop in the price of wheat in the near future.

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Such a contract is called a Futures contract.

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- In a Futures contract both parties are obliged to honor the contract and there is no escape route for either party.
- But what if the contract gives the baker the “option” of (either)
  - Buying the wheat from the farmer at the pre-agreed price of Rs 110 (or)
  - Choosing to exit the contract and buy wheat from the open market at the prevailing market price?
- In other words, the baker is given the option of not honoring the contract made with the farmer on the date of settlement.

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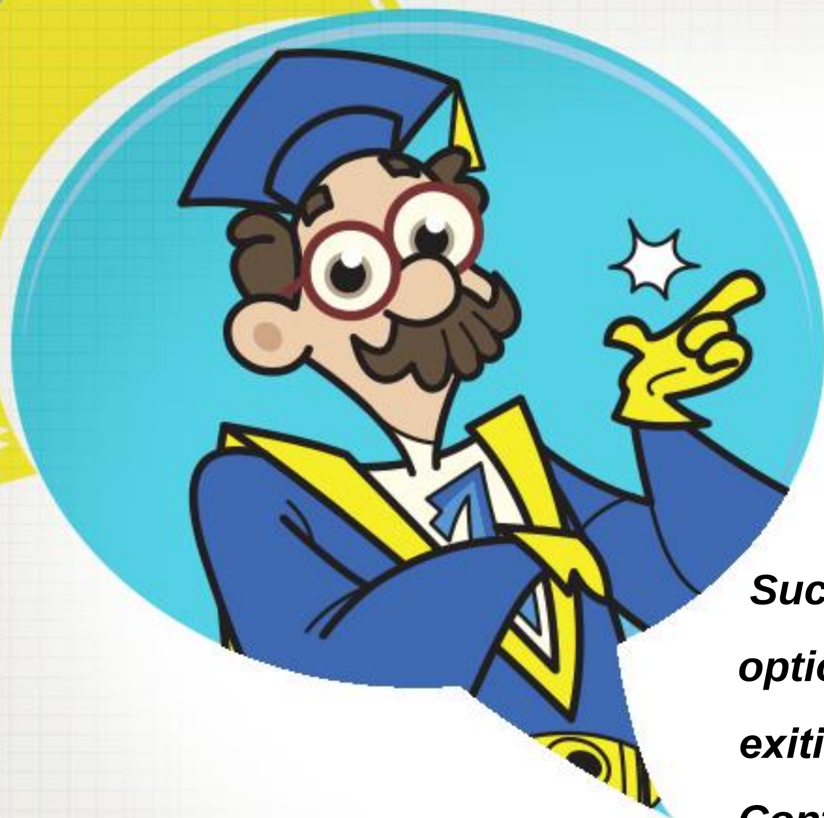

Such a contract that gives the baker the option of either executing the contract or exiting it is known as an 'Options' Contract.

But the baker obviously has to pay a price for exercising this facility.

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- Now, let’s say that after 3 months the price of wheat falls to Rs. 90.
- In this case the baker quite clearly would want to exit the contract so that he is free to buy wheat from the open market for Rs. 90.
- If he does so, the farmer is left high and dry and has to sell his produce in the open market at Rs 90.

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- But the farmer is compensated by the baker. This compensation is called an "Option Premium" and is usually a small amount.
- Let's assume in our case the amount is Rs 5.
- So the baker is obliged to pay the farmer Rs 5 as he has chosen to opt out of the contract.
- So even if the price is Rs. 90 in the open market, for him the effective price turns out to be Rs. (90+5) = Rs 95

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- It is important to understand that in an ‘Options’ contract, only one party gets the privilege to exercise the option while the other party is obliged to honor the option if it is chosen.
- In our case, the bread manufacturer has the option to either execute or exit the contract whereas the farmer is obliged to honour the decision of the bread manufacturer.
- A contract such as this where only the purchaser of the commodity gets the option to either exercise or exit the contract is known as ‘Call’ option.

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What is the difference between a put option and a call option?

In the 'Put' option the choice of honoring the contract is with the farmer or seller while in the 'Call' option this option is with the bread manufacturer or purchaser.

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To Sum Up

- In a ‘Futures Contract’ both parties are obliged to honor the contract.
- In an ‘Options Contract’ one of the parties is given the privilege to exit the option on settlement date and the party has to oblige.
  - In a ‘Put’ option this privilege is given to the seller (in our example - the farmer)
  - In a ‘Call’ option this privilege is given to the buyer (in our example - the bread manufacturer)

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Please do let me know if I have managed to clear the concepts of 'Call Option' as well as the difference between 'Call' & 'Put' Options.

Your feedback is very important as it helps me plan my future lessons.

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