OPTION IN THE REAL MARKET – PUT OPTION

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Understanding how a typical Option Deal is done in the market – *Put Option*

– By Prof. *Simply* Simple ™

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In the stock market there are several participants who are both buyers and sellers…

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A stock market is a platform

where this is free flow of information…

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This is so that the current stock price is known to every participant (buyers and sellers) Any participant trying to extract a higher price will not be able to do so because of the free flow of information which prevents any sort of price arbitrage.

This is what we call 'Price Discovery'.

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Now lets say there is a stock option on stock A, which is currently quoting at Rs.100. And let's say the option expires after 5 days…

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Now let's say there are two participants "Ram" & "Shyam" in this market.

Ram is of the view that the stock prices would fall to Rs. 80 in the near future. But Ram does not want to take a risk (i.e. in case the price rises to Rs 120).

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Hence he chooses to 'buy' a put option which protects him against any rise in price. For getting this service, he would have to pay a premium to the seller of the option. The seller of the option, Shyam, on the other hand has a view that the price of the stock will rise.

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But what if the contract gives Ram the “option” of (either)

- **Selling the stock to Shyam at the pre-agreed price of Rs 100 (or)**
- **Choosing to exit the contract**

In other words, Ram is given the option of not honoring the contract made with Shyam on the date of settlement.

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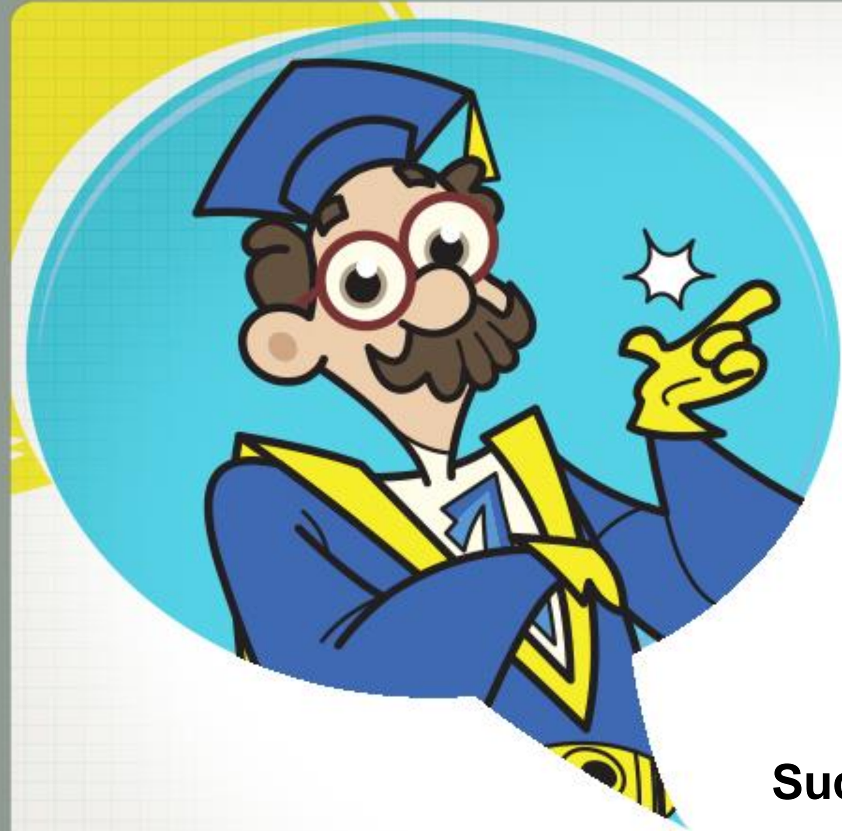

Such a contract is called a Futures contract.

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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

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Such a contract which gives the farmer the option of either executing the contract or exiting it is known as an "Options" contract

But the farmer obviously cannot get this privilege just like that.

He obviously has to pay a premium for exercising this facility

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Now, let's say that after 3 months the price of wheat reaches Rs. 120

In this case the farmer quite obviously will want to exit the contract so that he is free to sell his produce in the open market for Rs. 120. Thus while the farmer gets away the bread manufacturer is left high and dry and has no other option but to buy from the open market at Rs 120

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But it is not such a bad situation for the bread manufacturer as it appears as he gets compensated by the farmer for having been a party to the "Options" contract.

This compensation * in the form of price is called the "Option premium" that the farmer has to pay for the Options contract and quite evidently it would be a small amount.

Let's say in our case the amount is Rs 2. So the farmer is obliged to pay the bread manufacturer Rs 2 as he has chosen to opt out of the contract.

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Thus although the bread manufacturer has no other option left but to go to the open market and purchase wheat at Rs. 120, he does get the benefit of Rs 2 as compensation for being a party to the "Options" contract.

So even if the price is Rs. 120 in the open market, for him the effective price turns out to be Rs. (120 -2) = Rs 118.

So by simply participating in the contract he too stands togain something

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As far as the farmer is concerned it is a win – win scenario for him by participating in the contract.

Had the prices fallen to Rs 90 as he had anticipated he would have executed the Options contract. But since prices rose to Rs 120 he chose to exit the contract. Thus he is blessed with the “Option” by signing such a contract.

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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 chosen.

Thus in our case the farmer has the option to either execute or exit the contract whereas the bread manufacturer is obliged to honor the decision of the farmer.

A contract such as this where only the seller of the commodity gets the option to either exercise or exit the contract is known as "Put" option.

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There is another option which is called a “Call” option

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- **Even in an Options contract both parties land up achieving their goals and their interest is protected**
- **The farmer stands to gain the most by getting to exercise a choice that benefits him the most**
- **The bread manufacturer too benefits by being a party to the contract due to the compensation he receives from the farmer for not honoring the contract.**

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- **The bread manufacturer due to the compensation receives wheat from the open market at an effective price of Rs 118**
- **And hence is better off than the ordinary or spot buyer who would have to pay Rs 120.**

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Thus in a sense both parties landed up getting some gains by being parties to the "options contract".

However unlike in a "Futures" contract, in the "Options" contract one party gains more than the other party.

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- I hope I have been able to explain to you what 'margin money' is all about.

- Do give me your feedback about my lessons so that I can work on them and improve them for your better comprehension.

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Please do let me know if I have managed to clear this concept for you. Your feedback is very important to me as it helps me plan my future lessons.

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