Option Trading Strategies and Exotic Derivatives

Option Trading Strategies

Covered Call: A covered call involves buying the underlying stock and selling an OTM call. It has the effect of increasing one's income in exchange for potential upside. The profit is capped if the call option gets exercised. (Slides 3-4)

Protective Put: A protective put involves owning the stock and buying an OTM put. It is like an insurance policy. In exchange for a premium, the downside becomes limited. If the stock price falls significantly, the profit from the put will make up for the loss on the stock.
(Slides 5-6)

Bull Spread: A bull spread involves buying a call option and simultaneously selling a call option at a higher strike price. It caps the upside potential in exchange for greater income if the stock does not rise significantly. The profit becomes capped if the price goes above the higher call's strike. (Slides 7-8)

Bear Spread: A bear spread involves buying a put option and simultaneously selling a put option at a lower strike price. The payoffs are exactly opposite to a bull spread. It caps the profit potential in exchange for greater current income. (Slides 9-10)

Butterfly Spread: A butterfly spread involves buying an OTM call, buying an ITM call, and selling 2 ATM calls. The distance between the OTM and ATM call should equal the distance between the ITM and ATM call. It is a short volatility strategy and makes money when the stock price does not move much. The maximum profit occurs when the stock price does not move at all, and losses occur if all or none of the options are exercised. (Slides 11-12)

Straddle: A straddle involves buying an ATM call and simultaneously buying an ATM put. It is a long volatility strategy, and makes money if there is a large move in the stock price (in either direction). It loses money if the stock price does not move much. (Slides 13-14)

Strangle: A strangle involves buying an OTM call and simultaneously buying an OTM put. It is a long volatility strategy that profits if there is a large move in the stock price. It is cheaper to

implement than the straddle (because it uses OTM rather than ATM options), however it also requires a larger move before it becomes profitable. (Slides 15-16)

Exotic Derivatives

Exotic Swaps: A credit default swap (CDS) is equivalent to an insurance contract on a bond. The holder of the CDS on a particular bond makes quarterly premium payments to the writer of the CDS. In the event that the bond defaults, the owner of the CDS is compensated by the writer.A variance swap pays the difference between realized volatility and the swap rate. (Slides 17-21)

Exotic Options: Forward Start Options have a specified start date sometime in the future. Compound Options are options on options. Chooser Options are options that allow the holder to choose, within a certain period of time, whether the option is a call or a put option.Barrier Options are options where the payoffs depend on the stock hitting a certain barrier during a certain period of time. Binary or Digital Options payout a fixed amount or payout nothing, depending on the stock price movement. Lookback Options have payoffs dependent on the maximum or minimum price achieved over the life of the option. Asian Options or average options payout based on the average of the stock price over a specified period. Basket Optionsare options on multiple assets, which depend on the correlation between different assets. This includes Rainbow options. (Slides 22-28)

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