Finance 4335 “Derivatives and Options”
Outline and Study Questions

Here is a summary of the key points from the *Derivatives and Options* reading, along with Study Questions and Answers:

Summary

Here is a bullet point summary of the key points from the sixth chapter of the course textbook, titled "Derivatives and Options":

- Forwards and futures are agreements to buy or sell an asset at a future date for a price fixed today (i.e., the forward or futures price).
- Forward contracts are customized over-the-counter deals; futures are standardized exchange-traded contracts.
- Options give the holder the right, but not the obligation, to buy (call option) or sell (put option) an asset in the future at a predetermined price.
- Options can be used to hedge risk or speculate on price movements.
- Swaps are agreements to exchange cash flows, commonly currencies (currency swaps) or interest rates (interest rate swaps).
- Debt can be valued as default-free debt minus a default put option held by shareholders.
- The equity of a corporation represents a call option on its assets, with an exercise price equal to the face value of debt.
- Projects and assets have embedded options to abandon that can increase their value.
- Insurance contracts have option-like features (e.g., deductibles).

Study Question	Answer
What is a forward contract?	A customized agreement to buy or sell an asset at a specified future date for a price fixed today (i.e., the forward price).
What is the difference between a forward and a future?	Forwards are customized over-the-counter contracts, whereas futures are standardized contracts traded on exchanges. Futures involve daily cash settlement and collateral.
What is an option?	A derivative giving the holder the right, but not obligation, to buy (call option) or sell (put option) an underlying asset at a predetermined price on or by a specified future date.
How can options be used?	To hedge risk or speculate on asset price movements.
What is a swap?	An agreement to exchange cash flows, commonly currencies (currency swap) or interest rates (interest rate swap).
How can debt be valued using options?	As default-free debt minus the value of a default put option held by shareholders.
How do abandonment options add value?	By allowing the option to terminate projects and sell assets if future cash flows become unfavorable.
What option-like features do insurance contracts have?	Deductibles function like the exercise price on call options.