6. Option Moneyness.

A description of a derivative relating its strike price to the price of its underlying asset. Moneyness describes the intrinsic value of an option in its current state. Moneyness also tells option holders whether exercising will lead to a profit or a loss. There are mainly three forms of moneyness, which are in, out or at the money. Moneyness looks at the value of an option if you were to exercise it right away. A loss would signify the option is out of the money, while a gain would mean it's in the money. At the money means that you will break even upon exercising the option.

The elements of option pricing contain the information such as name of underlying asset, expiration date, and strike price etc. As we know the option premium is the amount of money that the buyer of an option pays to the seller for the right, but not the obligation, to exercise the option. The above elements work together to determine the moneyness of an option.

Intrinsic Value and Time Value: -

The option premium is broken down into two components: the intrinsic value and the speculative or time value. The intrinsic value is an easy calculation - the market price of an option minus the strike price - and it represents the profit that the holder of the option would enjoy if exercised the option, took delivery of the underlying asset and sold it in the current marketplace. The time value is calculated by subtracting the intrinsic value of the option from the option premium.

In-The-Money Option:

A call option is said to be in the money when the strike price of the call is below the current price of the underlying stock. It is "in the money" because the holder of this call has the right to buy the stock below its current market price. When you have the right to buy anything below its current market price, then that right has value. For an example, If the price of stock is at Rs.35, then all of the call options with strike prices at Rs.34 and below are in the money. They are ‘In the money’ because those options have intrinsic value. If you have the right to buy stock at Rs.30 and the current market price is Rs.35, then that stock is ‘in the money’ by Rs.5. If you had that call and you had to exercise it, you could buy shares of stock at Rs.40 and sell them immediately in the open market for Rs.35 for a gain of Rs.5.

Out-Of-The-Money Options:

A call option is said to be out of the money if the strike price of the option is above the current price of the underlying stock. In case of put option if the current price of the underlying stock is above the strike price of the option. For an example, if the price of stock is at Rs.35, then all of the call options with strike prices at Rs.36 and above are out of the money. They are out of the money because those options don't have any intrinsic value. If you have the right to buy stock at Rs.40 and the current market price is Rs.35, then that stock Rs.5 is out of the money by Rs.5. If you had that call and you had to exercise it, you could buy shares of stock at Rs.40 and sell them immediately in the open market for Rs.35 for a loss of Rs.5. therefore no trader will perform trade therefore those calls are out of the money.

Likewise for the same stock Rs.45 and Rs.50 calls are also way out of the money.

At-The-Money Options:

A call option is said to be at the money if the strike price of the option is same as current price of the underlying stock. For an example, if the price of stock is at Rs.35, then all of the call options with strike prices at Rs.35 are at the money. If you have the right to buy stock at Rs.35 and the current market price is Rs.35, then that stock providing no gain or no loss. If you had that call and you had to exercise it, you could buy shares of stock at Rs.35 and sell them immediately in the open market for Rs.35 for no gains and no loss.

For any queries related to above topic kindly contact us on knowledge@grovalue.in