EXAM FM QUESTION OF THE WEEK

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Week of March 31/08

An off-market forward contract is a forward where either you have to pay a premium or you receive a premium for entering into the contract. (With a standard forward contract, the premium is zero). Suppose the effective annual interest rate is 10% and the (non-dividend-paying) S&R index is 1000. Consider 1-year forward contracts. Suppose you are offered a long forward contract at a forward price of $900. What would you be willing to pay to enter into this forward contract?

(A) Less than $150.000
(B) $150.000 but less than $160.000
(C) $160.000 but less than $170.000
(D) $170.000 but less than $180.000
(E) $180.000 or more

The solution can be found below.

Week of March 31/08 - Solution

A standard forward contract would have a forward price of 1000*1.1. This one at 900 will give a payoff more by a discounted amount (1000*1.1 - 900)/1.1=$181.818 ,