EXAM FM QUESTION OF THE WEEK

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Week of May 12/08

An "exchange call option" gives the owner of the option the right to give up one share of Stock A in exchange for receiving one share of Stock B. Stock A currently has a price of \$56 and Stock B has a current price of \$52. The continuously compounded risk-free rate of interest is 5% and the price of a one-year European exchange call option is \$7.

Suppose that neither Stock A nor Stock B pays any dividends. Find the price of a European exchange put option expiring in one year which gives the owner the right to give up one share of Stock B in exchange for receiving one share of Stock A.

A) \$3 B) \$5 C) \$7 D) \$9 E) \$11

The solution can be found below.

Week of May 12/08 - Solution

According to put-call parity
$P +$ prepaid forward price of asset to be received
$= C +$ prepaid forward price of asset be delivered .
Therefore $P + 52 = 7 + 56$, so that $P = 11$. Answer: E