

Session 22: Post Class Test Answers

- 1. b. A value greater than the DCF value.** If an option exists in an asset, the DCF valuation of that asset will not capture the optionality and a premium has to be added on to that value.
- 2. a. Limited losses, potentially unlimited profits.** The key to option payoffs is that the buyer of an option can never lose more than what he or she paid for the option and hence has limited losses. At least with call options, since the stock price can keep rising without a bound, you have unlimited profits.
- 3. d. All of the above.** An option needs an underlying asset with a variable price, a payoff contingent on that price and a limited life.
- 4. c. Both call and put options will become more valuable.** Since your losses are limited on all options (calls and puts), increased risk/volatility in the underlying asset can only help you and increase value.
- 5. a. True.** A correctly constructed decision tree, with discount rates that vary depending on where you are in the tree and probabilities attached to each branch should deliver the same value as the option model.