

Arbitrage

Finance



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Arbitrage Arbitrage The put call parity is important in explaining the relationship the link between the put option and call option. Both have the same expiry date and strike price. When the expiry is due, the price of the stocks is considered (Albrecht, 2001). If it is higher than the strike price then the call option is exercised while if it is below the price, it is the put price that is exercised. This ensures that in any scenario, the asset is purchase at one of the available prices. An arbitrage opportunity arises when an individual can buy an asset in one market at a certain price and immediately sell it in another different market for a profit. In this case, the call price is \$1.15 while the put price is \$0.55. The stock price of the company does not pay any dividends. This shows that an arbitrage position does not exist for the firm. This is because the difference between the two prices is fairly small and the company already has the stocks at the exercise price (Chen, 2005). The time of expiry is only 60 days and the stocks can perform better than if they were sold for immediate profits by the company. It would therefore get a loss in the long term if arbitrage is exercised. The annual interest rate receivable by the company is a factor in calculating the value of the stock and given that it is 12% then the possibility of receiving prices above this when arbitrage is used is quite minimal. There are other costs that are involved when making a call such as the brokerage fees and taxes on capital gains, it is simpler to hold onto the shares and put.

References

Albrecht, J. W. (2001). Using stock price behavior to test the dividend signaling hypothesis. Bonn: Forschungsinst. zur Zukunft der Arbeit.

Chen, A. H. (2005). Research in finance: Vol. 22. Amsterdam: Elsevier JAI.