Relative advantage and disadvantage of using options and features to lay off risk...

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While the uncertainty that prevails in the contemporary business world is evident, the risk that accompanies such uncertainty could be handled in varied ways. Each method employed in addressing the issue of risk carries with it the desired advantages or merits while at the same time it might bring about other more risks sprouting from its demerits. Options and futures are some of the means businesses employ to lay off the risk that might exist in the business arena.

One major advantage the traders in futures contract have over the ones who use options , Spence (1999: 23) observes, is that the amount of frisk in the case of the futures lies squarely and equally on both the parties (buyer and seller of the futures contract). For instance, if an individual A buys a futures contract, he will have the obligation of paying for the delivery of the commodity as long as he goes on having the futures contract. In the same way, the seller of the futures contract has the obligation of providing the expected delivery in exchange for cash. As opposed to this aspect, options are somewhat asymmetrical in the manner in which they confer obligation to the parties in agreement. Options confer an obligation to one party while giving the other party right. Because the options contract gives the buyer the right while on the other hand an obligation to the seller, the risk is not symmetrically spread. The risk of uncertainty still faces the seller since the buyer has the right but does not have the obligation to buy the pre-agreed good. Therefore the futures contract guards both the parties against the risk of price fluctuation before expiration of the contract.

As an illustration, if a party sold an option for a stock with a strike price of $12. 00, the party has the obligation of buying that stock from the party that

purchased the option. There would be no more choice other than the party to honor the commitment as agreed and make the purchase at that price even if the stock falls below the $12. 00 price.

Conversely, the buyer of the option does not have any obligation to do anything. Should the price of the stock depreciate below $12. 00, he has an alternative of selling the stock to the seller at $12. 00 without influence or force from anybody. And if the stock does not fall below the $12. 00 the loss that accrues to the buyer is the amount of money put in purchasing the option. Moreover, the buyer is not all indebted to any body since the seller must honor his obligation of purchasing the option even where the stock's price depreciates to become virtually worthless.

However, one major disadvantage encompasses around trading in futures. The leverage effect in future contracts exerts pressure in both directions and therefore the general risk involved in these contracts is relatively very high (Spence 1999). For this reason, trading in options remains relatively more flexible since the options contracts can be customized in several ways to fit different risk situations than expecting depreciation or appreciation of stock prices. In addition, the leverage effect that works to the disadvantage of the futures contracts works to the advantage of the options contracts since an investor can make a stock leverage even in situations where he does not commit to it.

Reference:

Spence, D., (1999) " *Futures and Options* " New York (NY); Lessons Professional Publishing