

# Free essay on advanced valuation

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### Question 1

You own a \$250,000 house and pay \$1,000 for fire insurance. What is the exercise value of the fire insurance put option if the house does not burn (and you have paid no claim)? What is the realized return on your investment in fire insurance?

Exercise value for a put option = Put strike price - Current price of the underlying asset

$$= 0 - 1000 = - \$1000$$

### Question 2

What are the exercise values and time premiums of the following option: Exxon Mobile call with a strike price of \$35 and a market value of \$1.80. Exxon Mobil stock is selling for \$33.40.

Exercise value for a call option = Current asset price - the strike price  
 $= \$33.4 - \$35 = -\$1.6$

Time premium = Market value of the option - The exercise price

$$= 1.8 - (-1.6) = \$3.4$$

### Question 3

Perfect monitoring in a perfect market environment always provides an optimal contract. Explain why monitoring is not always the best choice, even in a well-functioning market environment with low transaction costs

Monitoring refers to supervising activities that are meant to ensure that the terms of a contract are adhered to and performance targets are attained.

Monitoring enhance parties performance of their contractual obligations.

Monitoring is not necessarily the best alternative, even in market environments that are well-functioning with low transaction costs. Low monitoring cost implies that there will be lower costs associated with monitoring. Despite the belief that monitoring creates an optimal contract, there are several disadvantages associated with monitoring.

The first disadvantage is cost implications. Even in circumstance where transaction costs are low, there are some monitoring costs that cannot be avoided such as legal fees and manpower required ensuring contracts are adhered to. This reduces the cash flows that a contract is expected to generate. The second disadvantage is the opportunity cost of time wasted. A lot of time and effort is wasted on monitoring contracts that would otherwise be used in more productive ventures. The time wasted can be looked at in two ways; man-hours wasted on supervision of contracts and the contracts forgone to provide time for monitoring existing contracts.

Thirdly, monitoring creates distrust and destroys mutual relationships between parties. Naturally, people do not like being supervised. Monitoring give the party being monitored the impression that you do not trust them. This destroys mutuality and may make the party being monitored unwilling to engage in other contracts with that monitoring party in future. Lastly, there are ethical implications associated with monitoring. Monitoring may involve spying at the private affairs of the other party for effective supervision. These raise ethical concerns about privacy and infringing on the privacy rights of the party that is being monitored. Therefore, monitoring is

not necessarily the best alternative, even in market environments that are well-functioning with low transaction costs.

### **Question 4**

Steve Bolten sold his sailboat for \$225, 000. He paid a sales commission of 10% (\$22, 500) to the boat brokers, had legal fees of \$500, and had additional selling costs of \$1, 000. What are Steve's total transaction costs? What are his transaction costs as a percentage of the gross selling price?

Transaction cost = Legal fee + Sales commission + Additional selling costs  
 $= 500 + 22, 500 + 1000 = \$24, 000$

Transaction costs as a percentage of the gross selling price =  $(24, 000/225, 000)*100\% = 10. 67\%$

### **References**

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