CHAPTER 24

Review Questions

24.16 The shares of Hindustan Machinery Manufacturers (HMM) are selling for Rs 100 per share. Its warrants to purchase 2 shares at Rs 90 per share are selling for Rs 40. An investor who has Rs 16,000 to invest in evaluating the HMM's shares and warrants to select the better investment. Ignore transaction costs.

Required

1. Calculate the number of (i) shares and (ii) warrants the investor can purchase.
2. If he purchases the shares, hold them for one year and sell for Rs 120 per share, what would be his total gain?
3. If he purchases the warrants and holds them for one year and the price of the shares increase to Rs 120 per share, what would be his total gain if the market value of the warrants increases to Rs 90 and he sells it?
4. What benefit would he get from the warrants? What are the differences in the risk associated with the two alternative investments: shares and warrants?

24.17 An investor can invest Rs 12,600 in the shares or the warrants of Max Life (ML). Its shares are currently selling for Rs 60 per share. Its warrants provide for the purchase of 2 shares at Rs 56 per share are currently selling for Rs 14. The share prices are expected to increase to Rs 64 within one year as a result of which the theoretical value of the warrant (TVW) over the next year would be Rs 16. The expiration date of the warrant is one year. Ignore transaction costs.

Required

(a) if the investor purchases the shares and sells after one year, what is his total gain?
(b) If he purchases the warrants and converts them into shares in one year, what is his total gain?
(c) Discuss the trade-off associated with the two alternatives.

24.18 An investor is considering to buy 100 shares of Reliance Industries (RI) at Rs 620 per share. He expects the price of these shares to increase to Rs 700.

As an alternative, he can purchase a call option for 100 sharese of RI at a striking price of Rs 600. The 90-day option would cost him Rs 6,000. Transaction costs are assumed to be nil.

Required

1. Computer the profit the investor would earn on the sale of shares of RI if its price does not increase to Rs 700.
2. If the underlying share prices increase to Rs 700, what would be his profit on the option transaction?
3. How much should the share prices increase for the investor to break-even on the option transaction?
4. Discuss the comparative profit and risk associated with the (i) share and (ii) option transactions.

24.19 An investor is planning to purchase a put option in anticipation of a decline in the price of shares of Infosys Ltd (IL). An option to sell 100 shares of IL at any time during the next 3-months at a striking price of Rs 450 can be purchased for an option cost of Rs 3,800. The shares of IL are currently selling for Rs 460. Assume there are no transaction costs.

Required

1. For the lowest price of IL's shares during the 3-month period at (i) Rs 460, (ii) Rs 440, (iii) Rs 400 and (iv) Rs 350, compute the profit/loss to the investor from the option trading.
2. If the share prices slowly increase from Rs 460 to Rs 550 at the end of the 3-month period, what would be the effect on his purchases?
3. Discuss the potential risk and return associated with put options trading from an anticipated decline in share prices.