

The Value of an Option to
Exchange One Asset for Another

by

William Margrabe*

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RODNEY L. WHITE CENTER
FOR FINANCIAL RESEARCH
University of Pennsylvania
The Wharton School
Philadelphia, Pa. 19174

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ABSTRACT

In this paper I develop a model for the pricing of a European-type option to exchange one asset for another. I prove that a similar American-type option is never exercised until the last possible moment. Thus, the formula for the value of the American-type option is the same as that for the European-type option. This sort of option is not only a call option on the one asset, but also a put option on the other. Thus, the formula gives a closed-form expression for a special sort of American put option, and one can derive a put-call parity theorem for options of this sort. I also show how the model applies to four real-world financial arrangements: the investment advisor's performance incentive fee, the general margin account, the corporate exchange offer, and the standby commitment.

I. Introduction

Some common financial arrangements are equivalent to options to exchange one risky asset for another: the investment adviser's performance incentive fee, the general margin account, the exchange offer, and the standby commitment. Yet the literature does not discuss the theory of such an option.¹ In this paper, I develop an equation for the value of the option to exchange one risky asset for another. My theory grows out of the brilliant Black-Scholes (1973) solution to the longstanding call option pricing problem -- which assumed that the price of a riskless discount bond grew exponentially at the riskless interest rate -- and Merton's (1973) extension -- in which the discount bond's value is stochastic until maturity.

In section II, I develop the pricing equation for a European-type option to exchange one asset for another. In section III, I show that such an option is worth more alive than dead, which implies that its owner will not exercise it until the last possible moment. Thus, the formula for the European option is also valid for its American counterpart. Since such an option is not only a call, but also a put, the formula is a closed-form expression for the value of a special sort of American put option. I derive the put-call parity theorem for American options of this sort. Section IV contains applications of the model to financial arrangements commonplace in the real world: the investment adviser's performance incentive fee, the general margin account, the exchange offer, and the standby commitment. In the last section, I summarize the findings.

II. The mathematical problem and solution

Since this problem and its solution are extensions of the Black-Scholes work, I will use their notation and assumptions as much as possible. The capital market is perfect, of course. Let x_1 and x_2 be the prices of assets one and two. Assume there are no dividends: all returns come from capital gains. The rate of return on each asset is given by

$$dx_i = x_i[\alpha_i dt + v_i dz_i] \quad (i=1,2),$$

where dz_i is a Weiner process. That is, the rate of return is an "Ito process."² The correlation between the Weiner processes dz_1 and dz_2 is ρ_{12} . Further assume that α_i and v_i are constants.

We want the equation for the value $w(x_1, x_2, t)$ of a European-type option which can be exercised only at t^* , when it will yield $x_1 - x_2$ if exercised or nothing if not exercised. This option is simultaneously a call option on asset one with exercise price x_2 and a put option on asset two with exercise price x_1 . Of course, the owner exercises his option if and only if this brings him a positive return. This implies the initial condition

$$w(x_1, x_2, t^*) = \max(0, x_1 - x_2). \quad (1)$$

The option is worth at least zero, and no more than x_1 , if assets one and two are worth at least zero:

$$0 \leq w(x_1, x_2, t) \leq x_1. \quad (2)$$

The option buyer can hedge his position by selling $w_1 \equiv \partial w / \partial x_1$ units of asset one short and buying $-w_2 \equiv -\partial w / \partial x_2$ units of asset two. The pricing formula $w(\cdot)$ must be linear homogeneous in x_1 and x_2 ,³ so the hedger's investment will be

$$w - w_1 x_1 - w_2 x_2 = 0$$

by Euler's Theorem.

That investment equals zero may seem puzzling. But in this hedge, to eliminate risk we eliminated the entire return. Thus, the value of the hedged position must be nil.

The return on this investment over a short interval is nil:

$$dw - w_1 dx_1 - w_2 dx_2 = 0 . \quad (4)$$

Black and Scholes (1973, p. 642) eliminated all risk, but not all the return. They converted a long position in the stock and a short position in the option into a riskless investment.⁴ From the stochastic calculus,⁵ the return on the option is

$$\begin{aligned} dw = & w_1 dx_1 + w_2 dx_2 + w_3 dt \\ & + \frac{1}{2} [w_{11} v_1^2 x_1^2 + 2 w_{12} v_1 v_2 \rho_{12} x_1 x_2 + w_{22} v_2^2 x_2^2] dt, \end{aligned} \quad (5)$$

where $w_3 = \partial w / \partial t$.

Equations (3) and (5) imply

$$w_3 + \frac{1}{2} [w_{11} v_1^2 x_1^2 + 2 w_{12} v_1 v_2 \rho_{12} x_1 x_2 + w_{22} v_2^2 x_2^2] = 0 . \quad (6)$$

The function $w(x_1, x_2, t)$ is the solution to the differential equation (6), subject to the boundary conditions (2) and the initial condition (1):

$$w(x_1, x_2, t) = x_1 N(d_1) - x_2 N(d_2)$$

$$d_1 = \frac{\ln(x_1/x_2) + \frac{1}{2} v^2 (t^* - t)}{v \sqrt{t^* - t}} \quad (7)$$

$$d_2 = d_1 - v \sqrt{t^* - t}$$

Here, $N(\cdot)$ is the cumulative standard normal density function and $v^2 = v_1^2 - 2v_1 v_2 \rho_{12} + v_2^2$ is the variance of $(x_1/x_2)^{-1} d(x_1/x_2)$. ($v^2 = v_1^2$ if $v_2 = 0$, the Black-Scholes case.)

Equations (7) satisfy (6), (2), and (1) and are unique. The easiest way to prove this is to transform the problem at hand into the Black-Scholes problem. Let asset two be the numeraire.⁶ Then the price of asset two in terms of itself is unity. The price of asset one is $x \equiv x_1/x_2$. The option sells for

$$w(x_1, x_2, t)/x_1 = w(x_1/x_2, 1, t).$$

The interest rate on a riskless loan denominated in units of asset two is zero in a perfect market. A lender of one unit of asset two demands one unit of asset two back as repayment of principle. He charges no interest on the loan, because asset two's appreciation over the loan period is equilibrium compensation for the investment and risk.

Taking asset two as numeraire, the option to exchange asset two for asset one is a call option on asset one, with exercise price equal to unity and interest rate equal to zero. This is a special case of the Black-Scholes problem. Thus,

$$w(x_1, x_2, t)/x_2 = w(x, t)$$

$$\equiv x_1/x_2 N(d_1) - 1 \cdot e^{-\rho(t-t^*)} N(d_2),$$

where $w(x, t)$ is the Black-Scholes formula. Equations (7) follow immediately.

The Black-Scholes model is also a special case of (7), where

$x_2 = c e^{r(t-t^*)}$. The Merton (1973) model, which allows a stochastic interest rate, is also a special case, where $x_2 = cP(t^*-t)$, $P(t^*-t)$ is the stochastic value of a default-free discount bond maturing at t^* , and $P(0) = 1$. Thus, in Merton's model as in the Black-Scholes model, $x_2 = c$ at $t = t^*$.

III. Some Extensions

Equations (7) also give the value for American options, if x_1 and x_2 are equilibrium asset prices. The proof is simple. Consider two portfolios --

A: purchase a European option for $w(x_1, x_2, t)$

B: purchase asset one and sell two short.

The values of the portfolios at any time t are

A: $w(x_1, x_2, t)$

B: $x_1 - x_2$.

The returns at t^* are

A: $\max(0, x_1^* - x_2^*)$

B: $x_1^* - x_2^*$.

The return on portfolio A dominates that on B, so A must sell for at least as much as B:

$$w(x_1, x_2, t) \geq x_1 - x_2.$$

Thus, the value of a European option exceeds what you would get if you exercised a similar American option. So you will not exercise the American option early, and its value $W(x_1, x_2, t)$ will be exactly the same as that of a similar European option: $W(x_1, x_2, t) = w(x_1, x_2, t)$.

Recall that the option to exchange two assets can be viewed as a call

on x_1 or a put on x_2 , and that such an option is worth more alive than dead for $t < t^*$. This does not contradict Merton's (1973) conclusion that it may pay to exercise the ordinary American put option early. The exercise price for the ordinary American put is constant, not an asset price.

For the moment, assume as Black and Scholes did that the interest rate is known and constant. Then $ce^{r(t-t^*)}$ is the value of a default free discount bond paying c at t^* . We know that an American option (whether a put or a call) with such an exercise is worth more alive than dead. Then, equations (7) give the formula for an American option (put or call) whose exercise price grows exponentially at the riskless interest rate and equals c at t^* .

Now, let $E(t)$ be the deterministic exercise price of the option, a function of time. Stipulate that $E(t^*) = c$. Any American call option with an exercise price $E(t) \geq ce^{r(t-t^*)}$ for $t < t^*$, must be worth the same as a European call option with exercise price c .⁷ We know that an American call option with exercise price $E(t) = ce^{r(t-t^*)}$ is worth the same as the similar European option. Increasing the exercise price cannot increase the call option's value. Nor can increasing the exercise price decrease the option's value. The European call option has, in effect, an infinite exercise price until t^* . Yet, this option sells for as much as the American call option with exercise price growing exponentially at the instantaneous interest rate.

Similarly, an American put option with exercise price growing exponentially at the market interest rate until it reaches c at t^* will sell for the same as a European put option with exercise price c at t^* . If the American put option's exercise price is always less than or equal to $ce^{r(t-t^*)}$ then that American option is worth the same as a similar European option.

The preceding arguments imply a parity theorem⁸ for American-type put and call options whose common exercise price is the price of some asset. Consider two portfolios. The first portfolio contains an American call option on asset one with exercise price equal to the price of asset two, a short position in an American put on asset one with the same exercise price as the call, and asset two. The second portfolio contains asset one. We know that an American option is worth more alive than dead, if its exercise price is an asset price. So the American options are worth the same as European options and will be exercised only at the expiration date t^* . The holder of portfolio one will exchange asset two for asset one at t^* , in any event. Thus, portfolios one and two will have the same value at t^* . They must be worth the same at any time $t < t^*$, or arbitrage would occur. Hence, the usual put-call parity theorem holds for these particular American-type options. The reader can confirm that

$$w(x_1, x_2, t) - w(x_2, x_1, t) + x_2 = x_1$$

and

$$W(x_1, x_2, t) - W(x_2, x_1, t) + x_2 = x_1.$$

IV. Applications

The performance incentive fee, the margin account, the exchange offer, and the standby commitment are common arrangements which are also options to exchange one risky asset for another.⁹

The Performance Incentive Fee.

Modigliani and Pogue (1975) opened the discussion of performance incentive fees of the form

$$\text{Fee} = \delta(R_1 - R_2) \quad (8)$$

for portfolio managers, where R_1 is the rate of return on the managed portfolio, R_2 is the rate of return on the standard against which performance is measured, and δ is a number of dollars. The number δ will usually fall between zero and the total that investors have invested in the managed portfolio. Margrabe (1976) proved that such a fee is worth nothing when entered into, in Sharpe-Lintner equilibrium.

This fee arrangement is valuable to the adviser if he can default on his obligation under the arrangement. The adviser could declare personal bankruptcy in case the fee were so negative that his net worth was negative. Or an investment adviser might form a corporation to handle his business and collect the fee. He would have the protection of limited liability in case the fee were negative. In such cases, the portfolio management fee is equivalent to an option. We can compute its value using equations (7).

For example, suppose the management corporation receives \$10 million from its clients and invests it all. Management has no other assets. Management collects 10% of any superior performance of the managed portfolio over the standard and promises to pay its clients 10% of any inferior performance. (That is, $\delta = 1$ million.) Management plans to default if the managed portfolio does worse than the standard, and its clients know this. The fee arrangement lasts for six months. The monthly standard deviation of rate of return is 5% for the managed portfolio and 5% for the standard. The rates of return on the two portfolios are uncorrelated.

Under these assumptions, the management corporation's option would be worth \$690 thousand, and management would have to pay its investors for it to get their business.¹⁰

If management put up collateral to ensure its compliance with the fee agreement, it would be less likely to default and its option would be worth less. Equations (7) would still give the option value, though the calculations would be more tedious.

In order to prohibit abuse, the management contract may specify that the management cannot change the nature of the managed portfolio, without compensating the investors for the change. Management would never unilaterally end the contract, because its option is always worth more alive than dead. Investors may find it desirable to withdraw their funds early, if that is allowed. But, this would void the manager's option, so he would either rule out this possibility by contract or refuse to pay anything for the performance incentive fee.

The Margin Account

Suppose an investor buys securities worth x_1 on margin. (He borrows a fraction of the securities' cost from his broker, securing the loan with the portfolio of securities.) When the sum c of the principal amount and accrued interest is payable, he can either repay his debt and claim the collateral or default. If the margin loan is his only liability and the collateral includes all his assets, he has an option on the collateral, where the striking price is c . Below, I discuss mainly this simple case.

One may not think of this as an option, because its life is so brief. When the securities markets are open, the broker monitors the value of the collateral for the margin loan. He may ask for more collateral if its value

shrinks (this is the margin call). If the investor fails to put up more collateral immediately, the broker may sell off some of the collateral and reduce the investor's debit balance, until the remaining debit balance is adequately secured. If the collateral is dangerously small, the broker may sell some of it without notifying the investor.

If the broker measures the value of the collateral every t^*-t years, he has issued an option with a life of t^*-t . In this application t^*-t can grow arbitrarily small, at the broker's discretion. As t^*-t approaches zero, the option value approaches the net asset value of the account, $x_1 - c$.

At the market's daily close the margin trader has a European option which expires when the markets reopen. He ordinarily exercises this option by borrowing the exercise price from the broker if the collateral is adequate. He may have to meet a margin call if the collateral is poor. He might let the option expire if the collateral were inadequate.

Sometimes the option lasts longer than the eighteen hours from the New York Stock Exchange's daily close at 4:00 p.m. until the 10:00 a.m. reopening. When a holiday interrupts the business week, the option is for 42 hours. Over a normal weekend the option is for 66 hours. Over a three-day weekend the option is for 90 hours.

An investor might not exercise his option under exactly the circumstances implied by my analysis. I assume the investor holds all his non-human capital in his margin account. If the investor has other assets and liabilities, he may default when his net worth is negative. An investor might not default even if his net worth, as usually measured, was negative, if he thought the stigma of personal bankruptcy was horrible enough or would

cause him sufficient future inconvenience.

If the margin trader sells a risky security short, his option is to exchange his risky short position for his risky long position. Equations (7) can tell us what this option is worth.

For example, consider two closed-end funds with the same systematic and nonsystematic risk ($\rho_{12} \approx 1$ and $v_1 \approx v_2 \approx .05$). An investor wants to finance the purchase of \$100,000 worth of shares in the first fund with a short sale of shares in the second.¹¹ The broker arranging this transaction will find it less risky than making a margin loan. In fact, it is virtually riskless. In equilibrium he will demand less compensation for this sort of transaction than he would for selling securities on margin.

For other values of ρ_{12} , v_1 and v_2 , the broker may find a short sale riskier. Suppose in the above example $\rho_{12} = -1$. Then the short sale and purchase would together be twice as risky as either one alone ($v = 2v_1 = 2v_2$). The margin trader would be willing to pay some \$1433 for this option over a three-day weekend and the broker would not sell it for less.

The Exchange Offer.¹²

An exchange offer of shares in one unlevered corporation for shares in another presents shareholders in the offeree corporation with an option to exchange one type of share for another. Suppose firm one wants to buy up all the shares of firm two. For simplicity, let the price of a share in firm one, z_1 , equal the price of a share in firm two, z_2 . Firm one has N shares; firm two has n . Suppose firm one, the much larger firm, announces it will trade one of its shares for one of firm two's. The offer is firm and uncontested by firm two's management. The offer expires at t^* .

Further, assume that this offer conveys no information about the prospects of either firm. Then the offer may increase the price of shares in the second firm, because these shareholders now have an option to exchange their shares for something else. This option is worth at least zero. Any gain to shareholders of firm two must equal a loss to shareholders in firm one, which grants the option. We can compute the increase in the value of shares in firm two, after the exchange offer is made, but before it expires, by substituting the value of what shareholders in firm two get if they exercise their option,

$$x_1 = (Nz_1 + nz_2)/(N + n),$$

and the value of what they give up,

$$x_2 = z_2$$

into equations (7). As usual, this option's value depends on the characteristics of the joint distribution of x_1 and x_2 and on the length of time until the option expires.

Under these circumstances, the management of firm one would be acting against the best interest of its shareholders. As soon as firm one makes the exchange offer, the value of its shares falls. Thus, firm one is giving up this option in return for nothing. Firm one could have bought the shares of firm two outright at the going price by issuing new shares in the market and using the proceeds of the issue to buy up firm two. In a perfect market, a cash tender offer would be a similarly unwise move. This says more about the stringent assumptions in this paper than about managerial irrationality.

Management of the offering firm could charge shareholders of the

offeree firm a premium for the right to tender a share of the offeree's stock. It would compensate the shareholders of the offering firm for the option they give up. This right would be valuable and might even trade apart from the stock to be tendered.

The Standby Commitment

The standby commitment is a European put option on a forward contract in mortgage notes. The buyer gets a put option to sell a bundle of mortgage notes at a predetermined price in the forward market. He must exercise his option on or before the notification date, some 25 days before the delivery date, so if he does exercise his option, he sells his mortgages in the forward market. Thus, the option is on a forward sale of mortgage notes. The commitment fee is the option premium.

We want to find the value at t of an option expiring at t^* on a forward contract calling for delivery at some later date t^*+1 . Buyer will exercise his option at t^* if he can lock in a profit on the forward contract, upon delivery; that is, if $c-x_{t^*} > 0$, where c is the striking price, and x_{t^*} is the forward price in a contract for delivery at t^*+1 made at t^* . At t^* this profit is worth

$$\pi_{t^*} [c-x_{t^*}],$$

where π_t is the price at t of a riskless discount bond maturing at t^*+1 .

Thus the option value at t^* will be

$$\max [0, \pi_{t^*}(c-x_{t^*})].$$

Assume that percentage changes in the forward price x_t are an Ito process with constant drift α_x and dispersion s_x ($dx/x = \alpha_x dt + s_x dz_x$ and dz_x is Gaussian white noise). As Merton (1973c) proposed, assume there is a risk-

less discount bond which will be worth unity when it matures. Until then changes in its prices are given by the stochastic differential
 count bond which will be worth unity when it matures. Until then changes in its prices are given by the stochastic differential

$$d\pi_t / \pi_t = \alpha_\pi dt + v_\pi dz_\pi .$$

Let $x_1 = \pi_t c$ and $x_2 = \pi_t x_t$. Then for all $t \leq t^*$ this option is worth

$$\begin{aligned} w(x_1, x_2, t) &= w(\pi_t c, \pi_t x_t, t) \\ &= \pi_t [cN(d_1) - x_t N(d_2)] , \end{aligned}$$

where

$$\begin{aligned} d_1 &= [\ln(c/x_t) + v^2(t^*-t) \div 2] \div v\sqrt{t^*-t} , \\ d_2 &= d_1 - v\sqrt{t^*-t} , \end{aligned}$$

and

$$v^2 = s^2 .$$

If we assume that the interest rate r is known and constant,

$$\pi_t = \exp [r(t-t^*)],$$

and we get the put-option analog to Black's (1976) formula for the value of a call option on a futures contract.

V. Summary

In this paper I developed an equation for the value of an option to exchange one asset for another within a stated period. The formula applies to American options, as well as European ones; to puts, as well as calls. Thus, I found a closed-form expression for this sort of American put option and a put-call parity theorem for such American options.

One can apply the equation to options that investors create when they enter into certain common financial arrangements. The investment adviser, who receives a fee which depends at least in part on how well his managed portfolio does relative to some standard, has an option to refuse the fee and declare bankruptcy if the fee is extremely negative. The short-seller has the option to similarly escape his obligations, at the expense of his broker. The offeree in an exchange offer may have the opportunity to exchange one company's securities for those of another. The buyer of a standby commitment has the (put) option to trade mortgage notes for dollars in the forward market. In each case the value of the option depends not only on the current values of the assets which might be exchanged, but also on the variance-covariance matrix for the rates of return on the two assets, and on the life of the option.

Footnotes

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Lecturer, Department of Finance, University of Pennsylvania. The author thanks Stephen Ross, Jeffrey Jaffe, and Randolph Westerfield for helpful discussions; an anonymous referee for useful comments; and the Rodney L. White Center for Financial Research for assistance in preparing the manuscript.

1

The Black-Scholes (1973) breakthrough spawned a burgeoning literature on the theory of option pricing -- with applications. Smith (1976) comprehensively reviews these articles.

2

See McKean (1969) for a discussion of the theory of Ito processes and Merton (1973a) and Fischer (1975) for applications.

3

First, consider the distribution of returns on an option to exchange asset two for asset one. This distribution of returns sells for $w(x_1, x_2, t)$.

Second, the distribution of returns on λ options to exchange asset two for asset one sells for $\lambda w(x_1, x_2, t)$ in a perfect market (where all participants are price takers).

Third, consider the distribution of returns of the option to exchange asset two for asset one, when both assets sell for λ times what they sold for in the first case. Denote this market value by $w(\lambda x_1, \lambda x_2, t)$.

The distribution of returns in the third case is identical to that given in the second case, given the Ito processes (described in paragraph one of section II) which generate prices x_1 and x_2 . Thus, the returns in the second case must sell for the same as those in the third case:

$$\lambda w(x_1, x_2, t) = w(\lambda x_1, \lambda x_2, t).$$

Thus $w(\cdot)$ is linear homogeneous in x_1 and x_2 . See also Merton (1973c, p.149) on this point.

4

We can create a long (short) position in either underlying asset out of a short (long) position in the other asset and an appropriate position in the option to exchange the assets. According to equation (3):

$$x_1 = (w + w_2 x_2) / w_1$$

and

$$x_2 = (-w + w_1 x_1) / w_2.$$

5

See McKean (1969). Also Merton (1973c, sec. 6) develops the same differential equation en route to his alternative derivation of the Black-Scholes model.

6

Stephen Ross suggested this lucid approach, which emphasizes the Black-Scholes heritage of this problem and its solution, and which lets us avoid much tedious mathematics. The student who wants to see all the mathematics can follow Merton's (1973c, sec. 6) solution to an isomorphic problem.

7

Merton (1973c, p. 155) proved a similar theorem for a strong inequality and a risky asset interest rate.

8

Stoll (1969) stated the theorem. Merton (1973b) shows that the theorem does not hold for ordinary American options.

9

Randolph Westerfield pointed out a further application. If the inflation rate is stochastic, then the exercise price on an ordinary call option is stochastic, in real terms. Making appropriate assumptions about the stochastic processes generating the price of the underlying asset and the price level, we can apply equations (7) to the problem of call option pricing.

10

Evaluate equations (7) for $x_1 = x_2 = \$10$ million, $t^* - t = 6$,

$v_1 = .05$, $v_2 = .06$, and $\rho_{12} = 0$.

11

Here we assume away regulations on short sales.

12

Ron Masulis suggested this application of the model.

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