

ANALYZING THE PROFITABILITY OF OPTION TRADING IN SRI LANKA

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Thesis submitted in partial fulfillment of the requirements for the degree Master of
Science



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“I have supervised and accepted this thesis for the submission of the degree”

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ABSTRACT

The aim of the research was to identify the introduction of options to CSE will give the investors the opportunity to gain more profit.

The research was based on equity and index European call options and focused on two objectives. The first objective was to identify if equity options have an advantage over direct investment in the underlying stock in terms of returns. The second objective was to compare the returns of equity options with the return of index options

Three basic strategies were used to analyze the potential returns from options in order to compare with the stock investment returns from a fixed investment amount of 1 million.

First strategy was to invest in the same number of options as an alternative to investing directly in stocks and invest the cash remaining at risk free rate.

It was concluded that this strategy is recommended only as an alternative for investors' having intentions on buying the stock at a fixed price. Both equity options and index options did not provide better returns. The only advantage observed in terms of better returns was investing in put options in a bearish market.

Second strategy was to use the entire investment amount to buy options.

It was concluded that this was a strategy recommended for investors willing to take very high risk by continuously investing in options in order to benefit from the highest percentage of profit observed out of all 3 strategies. The index options showed a clear advantage over equity options in terms of returns and risk.

Third strategy was to use the frequently employed 90-10 strategy used by investors in options trading where 10% of the investment money is used to buy options and 90% cash remaining from the options investment is invested at risk free rate.

This strategy showed better returns than strategy 1 but lower returns than strategy 2 but did not always give better returns than direct stock investments. It was concluded that this strategy is recommended for investors who desire returns without having the intention to own stocks but need to limit the risk taken.

Overall it was concluded that introducing equity and index options has its advantages for investors.

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LIST OF ABBREVIATIONS

CSE

Colombo Stock Exchange



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