

CHAPTER IV

INDEX OPTIONS

ABOUT INDEXES

As referred to in this booklet, an index is a measure of the prices of a group of securities* or other interests. Although indexes have been developed to cover a variety of interests, such as stocks and other equity securities, debt securities and foreign currencies, and even to measure the cost of living, indexes on equity securities (which are called stock indexes) are among the most familiar, and they are the only indexes that underlie options trading at the date of this booklet. The following discussion refers only to stock indexes and stock index options.

Stock indexes are compiled and published by various sources, including securities markets. An index may be designed to be representative of the stock market of a particular nation as a whole, of securities traded in a particular market, of a broad market sector (e.g., industrials), or of a particular industry (e.g., electronics). An index may be based on the prices of all, or only a sample, of the securities whose prices it is intended to represent. Indexes may be based on securities traded primarily in U.S. markets, securities traded primarily in a foreign market, or a combination of securities whose primary markets are in various countries.

A stock index, like a cost of living index, is ordinarily expressed in relation to a "base" established when the index was originated.

EXAMPLE: On the starting or "base" date for a new value-weighted index, the total market values of the component securities (market price times number of shares outstanding) is \$50 billion. The publisher of the index will assign an arbitrary index level—say 100—to that base value. If the total market value of the component stocks increases by 2% the next day (i.e., to \$51 billion), the index level would rise to 102 (102% of the base level of 100).

*Some indexes reflect values of companies, rather than securities, by taking into account both the prices of constituent securities and the number of those securities outstanding.