

The Stop–Loss Start–Gain Paradox and Option Valuation: A New Decomposition into Intrinsic and Time Value

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Abstract

The downside risk in a leveraged stock position can be eliminated by using stop–loss orders. The upside potential of such a position can be captured using contingent buy orders. The terminal payoff to this stop–loss start–gain strategy is identical to that of a call option, but the strategy costs less initially. This article resolves this paradox by showing that the strategy is not self–financing for continuous stock–price processes of unbounded variation. The resolution of the paradox leads to a new decomposition of an option’s price into its intrinsic and time value. When the stock price follows geometric Brownian motion, this decomposition is proven to be mathematically equivalent to the [Black–Scholes \(1973\)](#) formula.

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