FinanceIQ™
A Financial Training & Research Company

INVESTOR NEWS

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Investment News Letter

The purpose of a newsletter is to introduce investors to the New Rule introduced by SEBI increasing the time from 3.30 PM every day to 11.55 PM.

This is a chance for all working professional to get involved directly into stock market investments & earn hudge amount of returns, for which they look upon mutual funds.

There is a twist to it i.e... The market will trade in Derivatives instead of stocks itself. AND to learn & understand the Derivatives market you will have to educate your self to make profitable trades of this segment.

Derivatives are financial weapons of mass destruction.

Warren Buffett

Price is what you pay. Value is what you get.

Warren Buffett

Derivatives Explained In Short

This white paper will give the reader an idea of Derivative market & how to invest in it.

WHAT ARE DERIVATIVES

Derivatives are financial contracts that derive their value from an underlying asset. These could be stocks, indices, commodities, currencies, exchange rates, or the rate of interest. These financial instruments help you make profits or losses by betting on the future value of the underlying asset. So, their value is derived from that of the underlying asset. This is why they are called **'Derivatives'.**

WHAT IS DERIVATIVES TRADING

NOW on to the world of derivatives – considered one of the most complex financial instruments. The derivative market in India, like its counterparts abroad, and is increasingly gaining significance. Since the time derivatives were introduced in the year 2000, their popularity has grown manifold. This can be seen from the fact that the daily turnover in the derivatives segment on the National Stock Exchange, much higher than the turnover clocked in the cash markets on the same exchange.

USE OF DERIVATIVES

In the Indian markets, futures and options are standardized contracts, which can be freely traded on exchanges. These could be employed to meet a variety of needs.

1. **Earn money on idle shares**

So you don't want to sell the shares that you bought for long term, but want to take advantage of price fluctuations in the short term. You can use derivative instruments to do so. Derivatives market allows you to conduct transactions without actually selling your shares – also called as physical settlement.

2. **Arbitrage:**

When you buy low in one market and sell high in the other market, it called arbitrage trading. Simply put, you are taking advantage of differences in prices in the two markets.

3. **Protection**

Protection against fluctuations in prices the derivative market offers products that allow you to hedge yourself against a fall in the price of shares that you possess. It also offers products that protect you from a rise in the price of shares that you plan to purchase. This is called hedging.

4. **Transfer of risk**

The most important use of these derivatives is the transfer of market risk from risk-averse investors to those with an appetite for risk. Risk-averse investors use derivatives to enhance safety, while risk-loving investors like speculators conduct risky, contrarian trades to improve profits. This way, the risk is transferred. There are a wide variety of products available and strategies that can be constructed, which allow you to pass on your risk.

PARTICIPANTS OF DERIVATIVE MARKET

On the basis of their trading motives, participants in the derivatives markets can be segregated into four categories – hedgers, speculators, margin traders and arbitrageurs.

1. **Hedgers:**

Traders, who wish to protect themselves from the risk involved in price movements, participate in the derivatives market. They are called hedgers. This is because they try to hedge the price of their assets by undertaking an exact opposite trade in the derivatives market. Thus, they pass on this risk to those who are willing to bear it. They are so keen to rid themselves of the uncertainty associated with price movements that they may even be ready to do so at a predetermined cost.

2. **Speculators:**

As a hedger, you passed on your risk to someone who will willingly take on risks from you. But why someone do that? There are all kinds of participants in the market.

Some might be averse to risk, while some people embrace them. This is because, the basic market idea is that risk and return always go hand in hand. Higher the risk, greater is the chance of high returns. Then again, while you believe that the market will go up, there will be people who feel that it will fall. These differences in risk profile and market views distinguish hedgers from speculators. Speculators, unlike hedgers, look for opportunities to take on risk in the hope of making returns.

For every opportunity that the derivative market offers a risk-averse hedger, it offers a counter opportunity to a trader with a healthy appetite for risk.

In the Indian markets, there are two types of speculators – day traders and the position traders.

A day trader tries to take advantage of intra-day fluctuations in prices. All their trades are settled by undertaking an opposite trade by the end of the day. They do not have any overnight exposure to the markets.

On the other hand, position traders greatly rely on news, tips and technical analysis – the science of predicting trends and prices, and take a longer view, say a few weeks or a month in order to realize better profits. They take and carry position for overnight or a long term.

3. **Margin traders:**

Many speculators trade using of the payment mechanism unique to the derivative markets. This is called margin trading. When you trade in derivative products, you are not required to pay the total value of your position up front. . Instead, you are only required to deposit only a fraction of the total sum called margin. This is why margin trading results in a high leverage factor in derivative trades. With a small deposit, you are able to maintain a large outstanding position. The leverage factor is fixed; there is a limit to how much you can borrow. The speculator to buy three to five times the quantity that his capital investment would otherwise have allowed him to buy in the cash market. For this reason, the conclusion of a trade is called 'settlement' – you either pay this outstanding position or conduct an opposing trade that would nullify this amount.

This is how a margin trader, who is basically a speculator, benefits from trading in the derivative markets.

4. **Arbitrageurs:**

Derivative instruments are valued on the basis of the underlying asset's value in the spot market. However, there are times when the price of a stock in the cash market is lower or higher than it should be, in comparison to its price in the derivatives market.

Arbitrageurs exploit these imperfections and inefficiencies to their advantage. Arbitrage trade is a low-risk trade, where a simultaneous purchase of securities is done in one market and a corresponding sale is carried out in another market. These are done when the same securities are being quoted at different prices in two markets.

Speculators, margin traders and arbitrageurs are the lifeline of the capital markets as they provide liquidity to the markets by taking long (purchase) and short (sell) positions.

DIFFERENT TYPES OF DERIVATIVE CONTRACTS

1. **Futures** are contracts that represent an agreement to buy or sell a set of assets at a specified time in future for a specified amount.
2. **Forwards** are futures, which are not standardized. They are not traded on a stock exchange.
3. **Options** contracts are quite similar to futures & forwards. However, the key difference is that you buy an options contract & are not obligated to hold the terms of the agreement.
4. **Swaps** are complex instruments that are not available for trade in the stock markets.

Note: - In the derivatives market, you cannot buy a contract for a single share. It is always for a lot of specified shares and expiry date. This does not hold true for forward contracts. They can be tailored to suit your needs.

HOW TO – TRADE IN DERIVATIVES

Trading in the derivatives market is a lot similar to that in the cash segment of the stock market.

First - do your research & remember that the strategies need to differ from that of the stock market. For example, you may wish you buy stocks that are likely to rise in the future. In this case, you conduct a buy transaction. In the derivatives market, this would need you to enter into a sell transaction. So the strategy would differ.

Second - Arrange for the requisite margin amount. Stock market rules require you to constantly maintain your margin amount. This means, you cannot withdraw this amount from your trading account at any point in time until the trade is settled.

Third - Conduct the transaction through your trading account. You will have to first make sure that your account allows you to trade in derivatives.

Fourth - Select your stocks and their contracts on the basis of the amount you have in hand, the margin requirements, the price of the underlying shares, as well as the price of the contracts and it should fit your budget.

Fifth - You can wait until the contract is scheduled to expiry to settle the trade. In such a case, you can pay the whole amount outstanding, or you can enter into an opposing trade.

PREREQUSISTS

Trading in the derivatives market is very similar to trading in the cash segment of the stock markets.

This has three key requisites:

1. Demat Account – This is the account which stores your securities in electronic format.
2. Trading Account – This is the account through which you conduct trades. This makes the trade unique to you. It is also linked to the demat account.
3. Margin Maintenance – This is prerequisite to derivatives trading. Many traders in cash segment too use margins to conduct trades.