Derivative Market (PUN020)

A derivative is a formal financial contract that allows an investor to buy and sell an asset for a future date. The expiry date of a derivative contract is fixed and predetermined. Derivative trading in the share market is better than buying the underlying asset since the gains can be substantially inflated. Moreover, derivative trading is a leveraged form of trading, meaning you can buy a large quantity of the underlying assets by paying a small amount. You can trade in different types of derivatives, such as stocks, commodities, currencies, benchmarks, etc. Derivative contracts are of two types - futures and options. In essence, both are the same since the investor, and the seller predicts the price of the underlying asset for a specific future date but futures and options are different in that, in futures, both the buyer and seller are under the legal obligation to honour the contract on expiry. However, in the case of options, the buyer or seller can buy/sell before expiry by exercising their rights or letting the contract expire without any exercise of rights. Options are of two types - Call option and Put option. Investors buy a Call option when they are confident that the underlying asset will go up. In contrast, they buy a Put option when they feel certain that the price of the underlying asset will come down.

Types of Derivatives: The Derivatives definition is a financial contract between two parties that derive its value from an underlying asset such as stocks, currencies, commodities, etc. Entities in India effectively use such instruments to speculate on the underlying asset's price movement, leverage holdings, or hedge a position. There are four types of assets tradable in the derivatives market. **Options Contract** gives the buyer the right but not the obligation to buy/sell the underlying securities to a different investor over a predetermined period, depending on the type of options contract. The security price in the options contract is known as the strike price, and the seller of the contract is called the option's writer. In an options contract, the buyer can pass on the exercise right as they are not obliged after paying the premium to the option's writer. There are two types of options contracts: A call option and a put option. **Futures Contract** in the derivatives meaning binds both parties legally to exercise the agreement within the predefined period. The involved parties set a quantity of the underlying assets and a price payable by the buyer at a specific date in the future. Unlike options, the buyer or the seller of futures must exercise the contract before the expiry date. The futures contracts include currency futures, index futures, commodity futures, etc. **Forwards** are financial contracts between two parties based on a predetermined quantity and price of the underlying securities to be executed before the expiry date. Like futures, forwards obligate both parties to exercise the contract before the expiry date. However, investors can only trade such contracts using an Over-The-Counter trading market rather than a supervised stock market exchange. **Swaps** allow two parties to swap or exchange their financial obligations or liabilities. Both parties set the cash flow within the contract based on a rate of interest. In this contract, one cash flow is usually fixed while the other varies per benchmark interest rate.

Advantages of Derivatives:

Hedge Risks: derivative trading lets you hedge your position in the cash market. For example, if you buy a positional stock in the cash market, you can buy a Put option in the derivative market. If the stock tumbles in the cash market, the value of your Put option will increase. Hence, your losses will be minimal or nil.

Low Expenses: Since derivative trading is primarily done to reduce risks, the charges are lower compared to shares or debentures.

Transfer Risks: Unlike stock trading, derivative trading allows you to transfer the risks to all stakeholders involved in the process. Hence, your risks reduce considerably.

Disadvantages of Derivatives: When invested with prior knowledge and extensive research, derivatives trading may offer numerous benefits toward hedging or increasing profits. However, these financial instruments are complex at their core and come with certain disadvantages for the market entities.

High Risk: These instruments are market-linked and derive their value in real-time based on the changing price of the underlying asset. Such prices depend on the demand and supply factors and are volatile. The volatility exposes such financial contracts to risk, forcing the entities to incur potentially huge losses.

Speculation: A large part of the derivatives market follows a system of assumptions. Entities speculate on the future price direction of the underlying asset and hope to profit from the difference between the strike price and the exercise price. However, if the speculation goes sideways, entities can incur losses.

Counterparty Risk: Although market entities can trade futures contracts through supervised exchanges, they trade options contracts over the counter. It means there is no defined system for due diligence with a possibility of the other party defaulting on the payment or exercise promise. Hence, counterparty risk can expose market entities to financial losses.

Hedgers: They are the market participants who trade in financial contracts to hedge or mitigate their risk exposure. Hedgers are usually manufacturers or producers of the underlying assets, primarily commodities, such as oil, pulses, metals, etc. Hedgers use financial contracts to ensure that they receive a predefined price for their produce/products if the underlying assets' price falls within the contract's expiration date. By creating a financial agreement with a specific strike price, hedgers ensure they mitigate their losses and get a guaranteed price. One can form such a contract and be a hedger for any underlying asset held, such as stocks, commodities, currencies, etc.

Speculators: They are traders using the included financial contracts to profit based on the difference between the strike price (predetermined price) and the spot price (current market price). Speculators use various tools and techniques to understand the market and try to predict the future price of the underlying assets. If they think that the underlying asset's price may go up in the next few months, they buy a financial contract of that asset and sell it before the expiry date when the spot price is higher to make a profit. Speculators can trade in various contracts irrespective of the underlying asset, ranging from equities to commodities. As they want to avoid the delivery of the asset but to make a profit, they usually sell the contract before the expiry date.

Arbitrageurs: They are traders who take advantage of the geographical differences between the prices of the same underlying securities in two markets. When such entities enter the market, they ensure they can get a better price for the same underlying assets. Once identified, arbitrageurs buy those securities attached to the financial contracts in one market, only to sell them at a higher price in a different market. Such entities make profits through market imperfections that remain unidentified to others.

Margin Traders: These traders use a part of their investment amount to buy and sell financial contracts but utilise margins from the stockbrokers. They purchase and sell contracts daily and profits based on the price movement of the underlying assets within a single day. When such margin traders identify profitable financial contracts, they take a margin as credit from the stockbrokers. Once they sell, they return the margin amount to the brokers with interest.

Derivatives Market: Having understood the derivatives definition, the next step in effective diversification and making better profits is learning about trading in these financial contracts. Choose a quality lender and create an online trading account before you can begin to trade in various financial contracts. The Demat account has the added service of trading in the F&O contracts. Once you open a Demat account, you can ask the stockbroker to open an account with the F&O service. The broker requires you to pay a margin amount, which you must maintain until you execute or leave the contract. While trading, if your account falls below the minimum required margin, you will get a margin call to rebalance the trading account. You can only trade in financial contracts available in the market, which usually has an expiry date of three months and expires on the last Thursday of the month. Hence, you must settle the contract within the specified expiry date, or it will get auto-settled on the expiry day.

Derivative Trading: As previously mentioned, you need a Demat account and an online trading account to trade in derivatives. 5paisa provides easy and quick online account opening for free. Click here to open an account now. Once your account gets ready, you need to add sufficient funds to your account to buy or sell derivatives in the share market. The amount is proportionate to the margin amount required for the contract. You may contact the broker to know about the minimum investment needed to start derivatives trading. Derivative trading is easy but highly technical. Proper knowledge is essential to trade in derivatives efficiently. Check this space for more interesting articles to improve your knowledge and trade like a professional. Derivatives allow various investors to hedge against future losses or make profits based on the price difference. Although they can provide numerous benefits to the participants, it is essential to trade them with caution as they require extensive knowledge to trade successfully. Thus, it is always wise to consult your stockbroker and create a strategy based on market evaluation and practical techniques to deal successfully with these financial contracts.

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