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FUNDAMENTAL STUDY ON FINANCIAL DERIVATIVES

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ABSTRACT

As of Indian context, derivatives are an upgrowing phenomenon. It is one of the essential elements from investors' perspectives. Unlike mutual funds and stocks, these are little bit complex to invest and difficult for small investors to enter in. Risk aversors are not entertained in the world of derivatives market. But many investors are not aware about the derivatives and its investment. This research has been done for the basic investors of derivatives.

INTRODUCTION

Finance is the lifeline of the business and also it is the bread and butter for some investors. Without funds, no one is able to run a single day. Even for the household purpose, funds are required. Housewives need money for day to day activities. Person working and going for office needs money to reach. Fund is everywhere needed. But if it is talked professionally, there is a different perspective for funds. Investors invest their extra funds to earn income and profits. If the investor is knowledgeable, he himself can invest and if he is unaware about the investment he can approach the brokers for the same. Till 90s, the Indian economy dealt with the stocks and mutual funds, but with the come of the 21st century, Indian economy started with financial derivatives or simply derivatives.

Derivatives are the financial instruments whose value is determined by one or more than one underlying assets. It is basically a contract between the buyer and the seller whose value is based on the underlying asset. Common underlying assets may include bonds, securities, commodities, currencies etc. These are the advanced version of investment.

Such deals include minimum of two parties i.e., a buyer and a seller. Both the parties come in contact and exchange their needs. The seller is the owner of the commodity whereas the buyer is the purchaser of that particular good. Derivatives deal can be done only when the needs of both the parties are same. The amount for the particular commodity and the quantity should match each other.

Need of study

Derivatives is old but yet a very new concept for some investors. Being a developing country, India is going through many tough challenges for its growth. Investing in derivatives can lead towards the economic growth in a positive manner. This paper would help many of them to introduce their funds in such markets.

Scope of the study

This study will be limited to the basics of derivatives, so that one should be able to understand easily about the derivatives and its future. This paper will also focus on the types of market in which an investor can trade in.

Literature Review

Since 1990s, there has been a tremendous change in the financial system. This is the decade when the watchdog of the securities market was held i.e., SEBI. SEBI started regulating most of the types of market and the securities as before its inception many frauds took place. NSCCL, NSDL and many more had been the change agents and had helped in the cleaning system and also provided security at large. With the passage of time, changes took place and so were the regulations. Many committees were also established like the Narayanmurthy committee, Birla committee etc. for the investors. During that period, many fraudulent practises took place. One of the major breakthroughs for the fraud was the Harshad Mehta case, in which the prices were tampered drastically. This fraud led to many changes in the regulations. Earlier there was no transparency and much important information was hidden as the investors at that time were not aware and knowledgeable at that time. But now-a-days, investors are pretty knowledgeable and aware about their investments. The L.C. Gupta committee which was held on the derivatives in 1997, stock index futures were introduced.

Characteristics of derivatives

- **Different market, different regulations:** derivative markets deals in different types like futures, options and swaps. All the three markets have different rules and regulations depending on their features of commodities and markets.
- **Initial margin:** initial margin needs to be deposited in futures market but not in forwards and swaps market.
- **Permission requirements:** before trading in any of the types of derivatives, certain permission is required that needs to be gained from concerned authorities before investing.
- **Transaction cost:** as the markets are highly regulated, so the default risk is low. Due to this, feature, the transaction is minimal.
- **Efficiency:** the derivative markets are the advanced version for the investments, so the efficiency in dealing is quite high.
- **Volatility:** the volatility in case of forwards markets is quite high as these are traded only over-the-counter.
- **OTC trade:** derivatives, like stocks can be traded online, which means one can trade without moving himself physically.
- **Parties involved:** there exists atleast two parties i.e., a buyer and a seller. One who buys the commodities and the seller is the one who sells the commodities.
- **Obligation:** there is an obligation of both the seller and the buyer in case of futures contract but in case of options contract there is no obligation of buyer to fulfil the contract.

Participants

There can be many types of person who can participate in the investment in derivatives. But, the entry is not free for everyone as in the case of stock market.

- **Hedgers:** hedgers try to cover the risk through investment in futures and forwards market.

- **Speculators:** speculators try to earn more and more profits through regular dealings in derivatives market.
- **Arbitrageurs:** arbitrageurs try to balance between the risk and the return through awared dealings.

Functions of derivative markets:
Derivative markets play various functions for the investors.

- Derivative acts as a catalyst for new entrepreneurial activity.
- Derivatives help in increasing the savings and investment perspective.
- It also helps in sharing and reducing the risks in investments.
- Somewhere derivatives help to assure the profitable dealings.

Types of Derivatives contract:
There are various types of contract prevailing in derivatives market. Following are some of the types of contract.

Futures contract
Futures are the contract which helps in fulfilling the process of buying and selling the goods at a pre-determined price at a pre-determined time. Such contracts are exchange traded securities which fixes the future date today. While dealing in futures contract, there is regulatory body which regulates the market. While dealing, initial margin needs to be maintained. The default risk in futures contract is absolutely minimal as these contracts are traded in exchange. These are used by the hedgers to mitigate the risk.

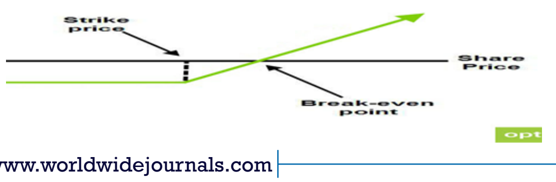
Forward contract
Forward contract are those contracts which are traded over the counter, which is not done in exchanges. These contracts also serve the same purpose for the dealers. Contracts are signed at today's price but at a future date. Such contracts are customised which means that these are not standardised contracts. Speculation and hedging purpose is served with such tradings.

Options contract
Options are the contract which is same as the futures and serve the purpose of hedging and speculation. In such contracts, buyers are under no obligation to fulfil the contract. If the buyer observes that dealing in the signed contract can lead towards losses then he has the right to step back from the contract. But as opposite, the seller in options contract is under obligation to fulfil the contract if the buyer is in the favour of it. There are two types of options contract i.e., call option and the put options.

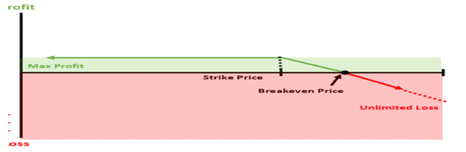
Swaps
Swaps are private agreements between the two parties to exchange the cash flows in future. There can be many types of swaps like interest rate swaps, currency swaps etc.

The pay-off strategies
This part of the research paper deals with the pay-off strategies of the contracts. Such pay-offs will help the scholars to understand the situations in which the buyers and the sellers can earn the profit or incur the losses.

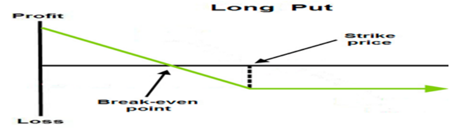
Long call or call-buy option
Call buy is a situation in which the buyer has the right to buy the option. Profits can be unlimited and the losses would limit to the amount of option premium. The reason for such unlimited profit is that the buyer is under no obligation to fulfil the contract and vice versa for the sellers.



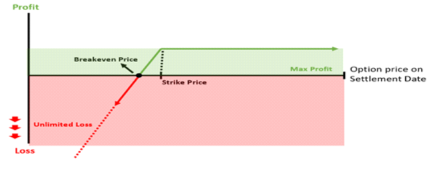
Short call or Call sell
this pay-off is just the opposite of call buy option. This pay-off determines the loss situation of the seller. If the strike price is greater than the spot price then the buyer would not fulfil the contract. In such a case, the seller's profit would limit to the premium.



Long put or put buy
Investors may buy the options when they are in observation that the stock prices would fall in future. In such a case, it grants the right to sell an underlying asset at a fixed price for a future time.



Short put or put sell
In case of put sell options, the seller agrees to buy the option at an agreed price. Put sellers may lose money if the stock prices fall. They are bullish in nature.



CONCLUSION

- In call option, the buyer would always be in a situation where he can earn unlimited profits. This situation will occur when the strike price is less than the spot price.
- In case of losses, call buyer will incur losses at limited rate up to the amount of premium. This situation will occur when strike price is more than the spot price.
- In put option, put buyer is in a profitable situation when the strike price is less than spot price.
- In put option, put seller will be in a profitable situation when strike price is more than spot price.

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