

Operational Strategies and Investors Preferences towards Various Investment Avenues in Market with Reference to Derivatives

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Abstract – In India, generally all market investment avenues are perceived to be risky by the investors. “A derivative is a synthetic construction designed to give the same profile of returns as some underlying investment or transaction, without requiring the principle cash outlay. They are called derivatives because they derive their value from the performance of the underlying instrument. Financial derivatives can be found in debt, equity, currency and commodity markets”. This study was undertaken to find out the awareness level of various capital market instruments and also to find out their risk preference in various segments. Options have peculiar quality under which the holder of the option has been given right to buy or sell an underlying asset at a specified period for a fixed premium, Options trading strategies used by speculators, hedgers and arbitrageurs and to find out the type of risk which are concerned by the investors. Options can be used to create portfolio with unique features, capable of achieving investment objectives. Keeping this view the present paper proceeds to investigate the dynamic operational strategies and performance of options trading in India.

Key Words: Derivatives, Options, Operations Strategies of Options, Performance of Options.

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INTRODUCTION

In India, generally all capital market investment avenues are perceived to be risky by the investors. Derivatives are meant to facilitate the hedging of price risks of inventory holdings or a financial/commercial transactions over the certain period. Even though the knowledge to the investors in Derivative segment is not adequate, they tend to take decisions with the help of the brokers or through their friends and were trying to invest in this market. Derivatives have become increasingly important in the field of finance, Options and Futures are traded actively on many exchanges, Forward contracts, Swap and different types of options are regularly traded outside exchanges by financial institutions, banks and their corporate in what are termed as over-the-counter markets-in other words, there is no single market place organized exchanges. This paper describes the evolution of Indian derivatives market, trading mechanism in its various securities, the various unsolved and the future prospects of the derivatives market.

RESEARCH METHODOLOGY:

Our study on the topic operational strategies and investor's preferences towards various investment avenues in market is based exclusively on secondary data taken from various articles, newspapers and bulletins and reports issued by NSE, BSE.

LITERATURE REVIEW:

“Investment property portfolio management and financial derivatives” by Patrick MC Allister, Johan R. Mansfield. His study on Derivatives has been an expanding and controversial feature of the financial markets since the late 1980s. They are used by a wide range of manufactures and investors to manage risk. This paper analyses the role and potential of financial derivatives investment property portfolio management. The limitations and problems of direct investment in commercial property are briefly discussed and the main principles and types of derivatives are analysed and explained. The potential of financial derivatives to mitigate many of the problems associated with direct property investment is examined.

“Derivatives, risk and regulation: chaos or confidence?” by R Dixon, R.K. Bhandari said that there has been an extraordinary increase in the use of financial derivatives in the capital markets. Consequently derivative instruments can have a significant impact on financial Institutions, individual investors and even national economics. This relatively recent change in the status of derivatives has led to calls for regulation. Using derivatives to hedge against risk carries in itself a new risk was brought sharply into focus by the collapse of Barings Bank in 1995. The principle concerns of regulators about how legislation may meet those concerns are the subject of current debate between the finance industry and the regulators. Recommendations have been made and reviewed by some of the key players in the capital markets at national and global level. A call for regulation through increased legislation are not universally welcome, whereas the regulators main concern is that the stability of international markets could be regulation. Considers the expanding role of banks and securities houses in the light of their sharp reactions to increase in interest rates and the effect their presence in the derivatives market may have on market volatility. Includes the reaction of some dealers and users to the recommendations of G-30 report and looks at some key factors in overcoming potential market volatility.

“Management’s disclosure of hedging activity: An Empirical investigation of analysts and investors reactions” by Jennifer Reynolds-Moehrle. This study aims to examine how market participants changed the way they process earnings information after learning of implementation of hedging activities.

Design/methodology/approach- Using a sample of derivative user and non-user firms, this study empirically compares earnings predictability, forecast revision behavior, and the earnings response coefficients before and after and after the disclosure of hedging activity.

Options: They are the second, most important group of derivative securities, first being futures. It is “a contract between two parties where by one party acquires the right, but not the obligation to buy or sell a particular commodity of financial instrument at a specified date.” Options are of two types.

(a). call option (b). Put option.

Call option: Call option gives the holder the right but not the obligation to buy an asset by certain date for price.

Put option: Put option gives the holder the right but not the obligation to sell an asset by a certain date for a certain price.

Complex Derivatives

Using futures and options it is possible to build number of complex derivatives. It is designed to suit the particular needs and circumstances of a client.

Example: SWAPS, Credit Derivatives

Weather Derivative

This is new tool for risk management. This is a contract between 2 parties that stipulate how payment will be exchanged between parties depending on certain meteorological conditions during the contract period. They are based on data such as temperature, rainfall, snowfall etc. The Primary objective of the derivative is to initiate the volume risks, which will influence the Balance Sheet and Profit and Loss figures.

Functions of Derivatives:

Risk Management: It involves structuring of financial contracts to produce gains or losses that counter balances the losses or gains arising from movements in financial prices. Thus risks are reduced and profit is increased of a financial enterprises.

Price Discovery: This represents the ability to achieve and disseminate price information without price information investors; Consumers and producers cannot make decisions. Derivatives are well suited for providing price information.

Transactional Efficiency: Transactional efficiency is the product of liquidity. Inadequate liquidity; results in high transaction costs. This increases investment and causes accumulation of capital. Derivatives increases market liquidity, as a result transactional costs are lowered, and the efficiency in doing business is increased.

RISK OF DERIVATIVES:

Any comment about derivative would be inadequate without a word of caution. There are 4 inherent risks associated with derivatives. These risks should be clearly understood before establish in position in derivatives market.

- a) **Credit Risk:** The exposure to the possibility of loss resulting from a counter party's failure to meet its financial obligation.
- b) **Market Risk:** Adverse movements in the price of financial asset or commodity.
- c) **Legal Risk:** An action by a court or by regulatory body that could invalidate a financial contract.
- d) **Operations Risk:** Inadequate controls, Human error system failure of fraud.

Performance of Options Trading In India:

Derivatives Market in India has registered an “explosive growth” and is expected to continue the same in the year to come. Introduced in 2000, financial derivatives market in India has shown a remarkable growth both in terms of volumes and numbers of traded contracts. NSE alone accounts for 99 percent of the derivatives trading in Indian markets. The introduction of derivatives has been well received by stock market players. Trading in derivatives gained popularity soon after its introduction. In due course, the turnover of the NSE derivatives market exceeded the turnover of the NSE cash market.

Derivatives Products Traded in Derivatives Segment of BSE

The Bombay Stock Exchange (BSE) created history on June 9, 2000 when it launched trading in Sensex based futures contract for the first time. It was then followed by trading in index options on June 1, 2001; in stock options and single stock futures (31 stocks) on July 9, 2001 and November 9, 2002, respectively. It permitted trading in the stocks of four leading companies namely; Satyam, State Bank of India, Reliance Industries and TISCO (renamed now Tata Steel). Chhata (mini) SENSEX 7 was launched on January 1, 2008. With a same or ‘mini’ market lot of 5, it allows for comparatively lower capital outlay, lower trading costs, more precise hedging and flexible trading. Currency futures were introduced on October 1, 2008 to enable participants to hedge their currency risks through in the U.S. dollar-rupee future platforms. Table 1 summarily specifies the derivative products and their date of introduction on the BSE.

Table 1: Products Traded in Derivatives Segment of the BSE

S. No.	Product	Traded with underlying Asset	Introduction Date
1	Index Futures	SENSEX	June 9,2000
2	Index Options	SENSEX	June 1,2001
3	Individual Stock Option	Concerned Company Stock	July 9,2001
4	Individual Stock futures	Concerned Company Stock	November 9,2002
5	Weekly Option	4 Stocks	September 13,2004
6	Chhota (mini)	SENSEX	January 1, 2008
7	Currency Futures	US Dollar Rupee	October 1, 2008

Source: Compiled from BSE data

Derivatives Products Traded in Derivatives Segment of NSE:

NSE started trading in index futures, based on popular S&P CNX Index, on June 12, 2000 as its first

derivatives product. Trading in the index options was introduced on June 4, 2001. On November 9, 2001, Futures on individual securities started. As stated by the Securities & Exchange Board of India (SEBI), futures contracts are available 233 securities. Trading in options on individual securities commenced w.e.f. July 2, 2001. The options contracts, available on 233 securities, are of American style and cash settled. Trading in interest rate futures was started on 24 June, 2003 but it was closed subsequently due to pricing problem. The NSE achieved another landmark in product introduction by launching Mini Index Futures & Options with a minimum contract size of Rs. 1 lac. NSE created history by launching currency futures contract on US Dollar-Rupee on August 29, 2008 in Indian Derivatives market. Table 2 presents a description of the types of products traded at F & O segment of NSE.

Table 2: Products Traded in F & O Segment of NSE

S. No.	product	Trading with underlying Asset	Introduction Date
1	Index Futures	S&P CNX Nifty	June 12,2000
2	Index Options	S&P CNX Nifty	June 4, 2001
3	Individual stock option	Concerned Company Stock	July 2, 2001
4	Individual stock Future	Concerned Company Stock	November 9, 2001
5	Interest Rate Future	T- Bills and 10 Years Bond	June 23, 2003
6	IT Futures & Option	CNX IT	August 29,2003
7	Nifty Futures & Options	Bank	June 13,2005
8	Nifty Juniors Futures & Options	CNX	June 1, 2007
9	Futures & Options	CNX100	June1, 2007
10	Midcap 50 Futures & Options	NIFTY	October5,2007
11	Mini index Futures & Options	S&P CNX Nifty index	January 1, 2008
12	Long Term Option Contracts	S&P CNX Nifty index	March 3, 2008
13	Currency Future	US Dollar Rupee	August 29, 2008

Source: Copiled from NSE data.

IMPORTANT TABLE REFERENCES

Influencer

Influencer	No. of Respondents	Percent
Brokers	36	36.0
Friends & Relatives	40	40.0
Advertisement	9	9.0
Banks	15	15.0
Total	100	100.0

Perception towards Capital Market Instruments

Statement	Cash Market	Options Market	Commodities Market	Futures Market
Highly favorable	29	20	27	30
Favorable	28	26	18	24
Neutral	27	26	30	18
Unfavorable	9	18	17	18
Highly Unfavorable	7	10	8	10
Total	100	100	100	100

Basis of overcoming risk

Basis of overcoming risk	No. of Respondents	Percent
Financial Experts	24	24.0
News Paper	49	49.0
Friends	18	18.0
Others	9	9.0
Total	100	100.0

Investment Options in derivatives

Investment options in derivatives	No. of Respondents	Percent
Stock Index Futures	29	29.0
Stock Index Options	27	27.0
Futures on Individual stocks	26	26.0
Options on Individual stocks	18	18.0
Total	100	100.0

Perception towards derivative trading in India

Perception of Investors	Frequency	Percent
Grow Very fast	17	17.0
Grow Moderately	37	37.0
Grow Slowly	37	37.0
Can't say anything	9	9.0
Total	100	100

CONCLUSION:

Option strategies provide means of risk reduction, anyone who is at risk from a price change can use options to offset that risk. Different strategies are useful for different market perceptions of the price movements. Option trading strategies are used both hedging and speculation. In different market perception and price movements different strategies are useful. Option strategies are complex positions

created including a combination of options and underlying shares which help the investor to benefit from his view. Hence the complexities of the investment risks and their management gives rise to commensurate solution through a series of innovative strategies in the form of combination of options of different types. It is indeed attribute to the versatility of the mechanics of option trading that a customized solution can be worked out for each specific risk management problem. Solution of these issues will definitely lead to boost the investors' confidence in the Indian derivative market and bring an overall development in the all the segments of this market.

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