19BAE710-FINANCIAL DERIVATIVES

Types of Traders in Derivative markets

The derivatives market is growing considerably all over the world. The main reason is that they have attracted many types of traders having a great deal of liquidity. When an investor wants to take one side of contract, there is usually no problem in finding someone that is prepared to take the other side. The different traders active in the derivatives market can be categorized into three parts:

Hedgers

Hedging is an activity to reduce risk and hedger is someone who faces risk associated with price movement of an asset and who uses derivatives as a means of reducing that risk. A hedger is a trader who enters the futures market to reduce a pre- existing risk. For example, an importer imports some goods from USA for $ 100 and the payment is to be made after three months. Suppose, today the dollar-price quote is 1$= Rs. 45. Therefore, if the payment is to be made today, the cost of goods in Indian currency will be Rs. 4500. But due to uncertainty in future movement in prices, there may be chance of dollar appreciation thereby increasing the cost of goods for the importer. In that case, there would be a loss to the importer. To avoid such risk, he enters in the three months futures contract to buy $100 at Rs. 45/$. This would have the effect of fixing the price to be paid to the US exporter at Rs. 4500 regardless of the dollar-price quote after three months that may appreciate or depreciate.

Basically futures contracts are used to eliminate risk when the future course of action regarding the receipt or payment is certain while the option contract are used when the future course of action is uncertain.

Speculators

While hedgers are interested in reducing or eliminating the risk, Speculators buy and sell the derivatives to make profit and not to reduce the risk. They buy when they believe futures or options to be under priced and sell when they view them as over- priced. John Stuart Hill (1871) elaborated by observing that speculators play an important role in stabilizing prices. Because they buy when prices are low and sell when prices are high, in turn improve the temporal allocation of resources and have a dampening effect on seasonal price fluctuations. Speculators willingly take increased risks. Speculators wish to take a position in the market by betting on the future price movements of an asset. Futures and options contracts can increase both the potential gains and losses in a speculative venture. Speculators are important to derivatives market as they facilitate hedging, provide liquidity, ensure accurate pricing and help to maintain price stability. It is the speculators who keep the market going because they bear the risk, which no one else is willing to bear. It is unlikely in any market that hedgers wishing to buy, for example, will precisely match hedgers selling futures in terms of number of contracts. It is only the speculators who take the opposite position with the hedgers and therefore, provide liquidity to the market. A liquid market is one in which there is considerable buying and selling on a continuous basis. In a liquid market, hedgers can make their transactions with ease and with little effect on prices. In the absence of speculators, hedgers may have difficulty in finding counter parties and they may need to move prices in order to attract counter parties.

Speculators also help to make a market informationally efficient. A market is informationally efficient when prices fully reflect all available relevant information. Speculators are likely to consider all relevant information when deciding

upon the appropriate price of a future or option contract. If actual prices differed from those judged appropriate, they will be brought into line with the estimated prices by speculative traders, under priced futures will be bought (and so their prices will tend to rise), while overpriced futures will be sold until their prices have fallen to the level considered correct. Therefore, it is rightly said that a well-regulated speculative transactions are the backbone of an efficient and liquid market.

Arbitrageurs

An arbitrageur is a person who simultaneously enters into a transaction in two or more markets to take advantage of price discrepancy in those markets. It is totally a riskless activity. For example, if the futures prices of an asset are very high relative to the cash price, an arbitrageur will make profit by buying the asset in spot market and simultaneously selling the futures. Hence, arbitrage involves making profits from relatively mispricing and thereby enhancing the price stability in the market. All three types of traders and investors are required for a healthy functioning of the derivatives market. Hedgers and investors provide economic substance to the market and without them market would become mere tools of gambling. Speculators provide liquidity and depth to the market. Arbitrageurs help in bringing about price uniformity and price discovery. The presence of hedgers, speculators, and arbitrageurs, not only enables the smooth functioning of the derivatives market but also helps in increasing the liquidity of the market.

Difference between Hedging and Speculation

Basis for Comparison	Hedging	Speculation
Meaning	The act of preventing an investment against unforeseen price changes is known as hedging.	Speculation is a process in which the investor involves in a trading of financial asset of significant risk, in the hope of getting profits.
What is it?	A means to control price risk.	It relies on the risk factor, in expectation of getting returns.
Involves	Protection against price changes.	Incurring risk to make profits from price changes.
Operators are	Risk averse	Risk lovers

Difference between Arbitrage and Speculation

- The aim of both arbitrage and speculation is to make some form of profit even though the techniques used are quite different to each other.
- Arbitrage traders take lower levels of risk, and benefit from the natural market inconsistencies by buying at a lower price from one market and selling at a higher price at another market.
- Speculation is done by trading instruments such as stocks, bonds, currency, commodities, and derivatives, and a speculator looks to make a profit through the rising and falling of the prices in these assets.

Difference between Cash Market and Derivative Market

1. Ownership

When you buy shares in the cash market and take delivery, you are the owner of these shares or you are a shareholder, until you sell the shares. You can never be a shareholder when you trade in the derivatives segment of the capital market. This is because you just hold positional stocks, which you have to square-off at the end of the settlement

2. Holding period

When you buy shares in the cash segment, you can hold the shares for life. This is not true in the case of the futures market, where you have to settle the contract within three months at the very maximum. In fact, when you buy shares in the cash segment they can also be trans-generational, that is they can be transferred from one generation to the other.

3. Dividends

When you buy shares in the cash segment, you normally take delivery and are a owner. Hence, you are entitled to dividends that companies pay. No such luck when you buy any derivatives contract. This is not only true in the case of dividends, but, also other corporate benefits like rights shares, bonus shares etc.

4. Risk

Both, cash and futures markets pose risk, but the risk in the case of futures can be higher, because you have to settle the contract within a specified period and book losses. In the case of shares bought in the cash market, you can hold onto them for an indefinite period and can hence sell when prices are higher.

5. Investment objective differs

You buy a contract in the derivatives market to hedge risk or to speculate. Individuals buying shares in the cash market are investors.

6. Lots vs shares

In the derivatives segment you buy a lot, while in the cash segment you buy shares.

7. Margin money

In the derivatives segment you pay only margin money for example, if you buy 1 lot of Punjab National Bank (4000 shares) you just pay 15 to 20 per cent of the cost of the 4,000 shares and not the entire amount. That is not true in the case of cash segment, where you have to pay the entire amount and not only margin.