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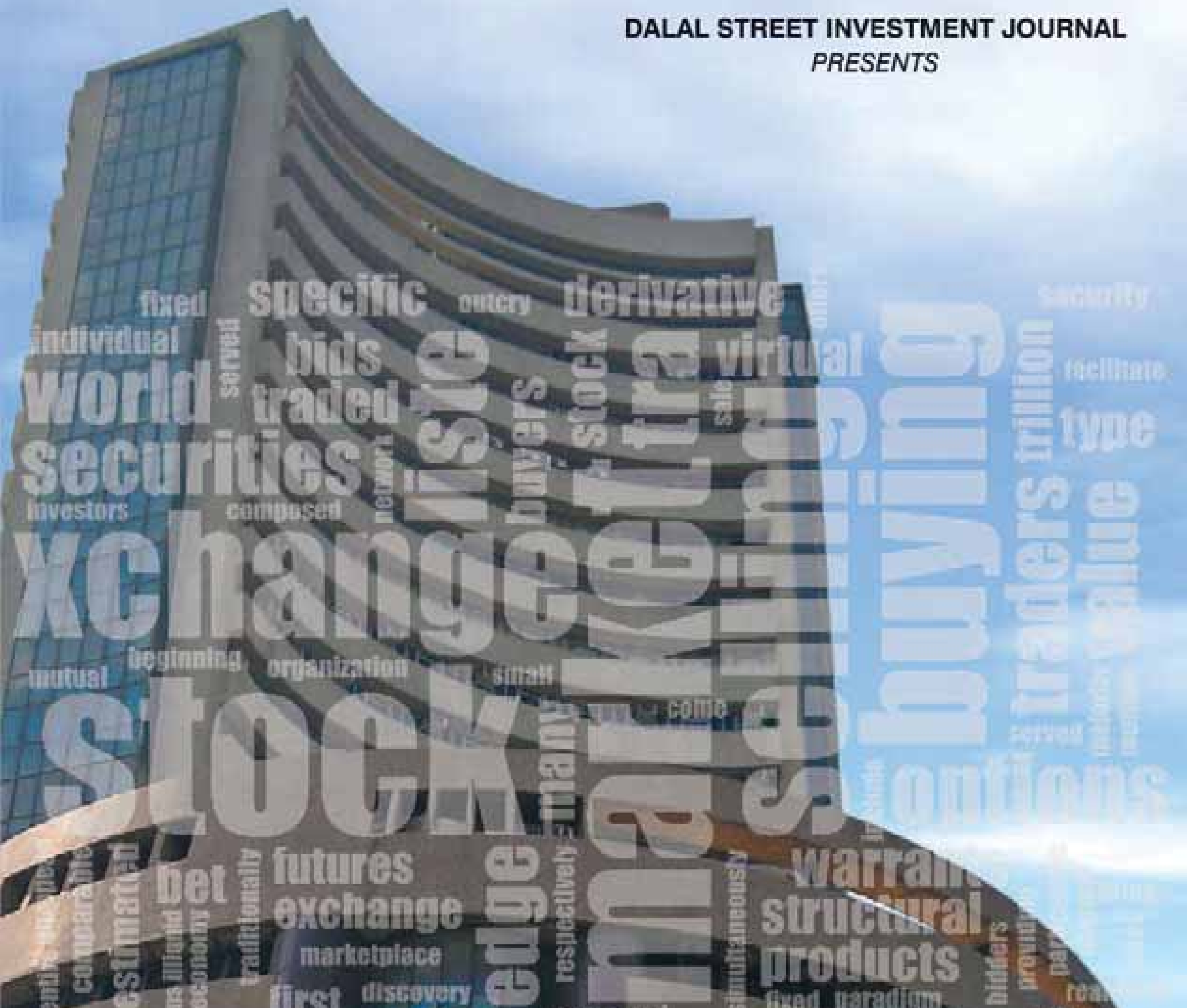
DALAL STREET INVESTMENT JOURNAL

PRESENTS



derivatives

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BSE

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FOREWORD

I am happy to write a preface for this handy and comprehensive book on the subject of Derivatives. The book appropriately provides detailed information on the fast-growing market segment at BSE - the Futures and Options segment. It covers many concepts and theories in simple ways. It also covers examples for SENSEX futures and options, which are the flagship derivative products on India's bellwether index tracked by the world – SENSEX.

Today, BSE (formerly known as the Bombay Stock Exchange) is ranked among the Top 6 Exchanges in the world in the Index Options contracts traded on daily basis (Source - World Federation of Exchanges (WFE), March 2012).

A few months back, when BSE embarked on the journey to re-launch Derivatives segment at BSE, after obtaining necessary approvals from the regulator, no one would have visualized the success the initiative has met with. After 8 months of several multi-pronged efforts, the Derivatives segment at BSE is seeing healthy, consistent participation and steady rise in trading volumes. Of course, all of this could not have been achieved without the whole-hearted participation and support of investors and domestic and international market participants.

Since its establishment in 1875, Asia's first stock exchange - BSE has come a long way in introducing newer instruments since its inception in 1875. Futures and options are a welcome step in its long tradition of providing useful instruments to the investor community for their trading, investment hedging needs etc. There are a lot of apprehensions about the utility of such new instruments, especially in Indian circumstances.

Hence it is imperative that adequate efforts are put into driving education and knowledge of these asset classes. To provide correct information relating to how to use, when to use, why to use etc., these instruments, tremendous level of efforts are required. BSE has conducted several thousand Investor Awareness programs and training programs etc. in this area. This has led to several lakh investors being reached out to. However, given the vastness of the country and the population in excess of 1.2 billion, many more such efforts in various directions are required to be carried out. BSE continues to strive to contribute positively in the field of investor awareness and investor education through its own as well as partnered programs. This book is therefore aptly timed in evangelizing derivatives as an asset class for investors and market participants.

I welcome this initiative and wish it all the best. I am sure it will meet with all the success it deserves.

Ashish Chauhan
Interim CEO
Bombay Stock Exchange Limited

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DERIVATIVES

LESSON

1

INTRODUCTION

The derivatives market and its products emerged as a result of risk averseness to protect oneself against uncertainties arising out of fluctuations in asset prices.

Through the use of derivative products, it is possible to partially or fully transfer the price risks of assets. It is useful as tool to manage risk, and can protect against fluctuation. However, by locking-in asset prices, derivative products minimize the impact of fluctuations in asset prices and in turn protect profitability and cash flow situation of risk-averse investors.

Derivatives evolved as a solution to agricultural traders who were exposed to price risk in the process of transferring the product to the consumers. Derivative products emerged as hedging devices against fluctuations in commodity prices and commodity-linked derivatives for many years. Later newer financial derivatives evolved as markets grew invest stature and maturity. These newer derivatives products grew popular and accounted for major chunk of transactions against the total transaction.

All over the world, the most successful equity derivatives contracts are index futures, followed by index options, followed by security options.

The following factors have been driving the growth of financial derivatives:

1. Increased volatility in asset prices in financial markets,
2. Increased integration of national financial markets with the international markets,
3. Improvement in communication facilities and sharp decline in their costs,
4. Development of sophisticated risk management tools providing choice of risk management tools, and
5. Awareness of risk return outcomes to agents who are willing to take on risk

"Practicing the Golden Rule is not a sacrifice; it is an invest-ment."

– Anonymous

LESSON

1

ONE

Aristotle described the story of Thales, a poor philosopher from Miletus who developed a "financial device, which involves a principle of universal application". Thales used his skill in forecasting and predicted that the olive harvest would be exceptionally good the next autumn. Confident in his prediction, he made agreements with local olive press owners to deposit his money with them to guarantee him exclusive use of their olive presses when the harvest was ready. Thales successfully negotiated low prices because the harvest was in the future and no one knew whether the harvest would be plentiful or poor and because the olive press owners were willing to hedge against the possibility of a poor yield. When the harvest time came, and many presses were wanted concurrently and suddenly, he let them out at any rate he pleased, and made a large quantity of money. Derivatives have probably been around for as long as people have been trading with one another. Forward contracting dates back at least to the 12th century and may well have been around before then. Merchants entered into contracts with one another for future delivery of specified amount of commodities at specified price. A primary motivation for pre-arrangement between a buyer and seller for a stock of commodities in early forward contracts was to lessen the possibility that large swings would inhibit marketing the commodity after a harvest.

> *"I know from experience that nobody can give me a tip or a series of tips that will make more money for me than my own judgment."*
>
> – JESSE LIVERMORE
> The Greatest Stock Market Trader Who Ever Lived

Why DERIVATIVES?

The derivatives market performs a number of economic functions:

1. They help in transferring risks from risk averse people to risk oriented people
2. They help in the discovery of future as well as current prices
3. They catalyze entrepreneurial activity
4. They increase the volume traded in markets because of participation of risk averse people in greater numbers
5. They increase savings and investment in the long run

What is DERIVATIVE?

Derivative is a product whose value is derived from the value of one or more underlying variable (underlying asset, index, or reference rate) and is a contract entered between a buyer and seller to undertake their obligations.

The underlying asset can be equity shares, currency, commodity, rate or any other asset. For example, A farmer who cultivates rice may wish to sell his harvest at a future date and to eliminate the risk of a change in prices by that date he enters a Rice derivatives transaction. Such a transaction is an example of a derivative. The price of this derivative is driven by the spot price of rice which is the "underlying".

Chronology of Instruments In the World's Derivatives Industry	
1874:	Commodity Futures
1972:	Foreign currency futures
1973:	Equity options
1975:	T-bond futures
1981:	Currency swaps
1982:	Interest rate swaps; T-note futures; Eurodollar futures; Equity index futures; Options on T-bond futures; Exchange{listed currency options
1983:	Options on equity index; Options on T-note futures; Options on currencyfutures; Options on equity index futures; Interest rates caps and floors
1985:	Eurodollar options; Swaptions
1987:	OTC compound options; OTC average options
1989:	Futures on interest rate swaps; Quanto options
1990:	Equity index swaps
1991:	Dierential swaps
1993:	Captions; Exchange-listed FLEX options
1994:	Credit default options

> "No matter what information you have, no matter what you are doing, you can be wrong."
>
> – Larry Hite
> Mint Investment Management Company

Participants in the DERIVATIVES MARKETS

The following three broad categories of participants in the derivatives markets:

1. Hedgers
2. Speculators
3. Arbitrageurs

Hedgers face risk associated with movement in asset price. They use futures or options markets to reduce or eliminate this risk.

Speculators wish to bet on future movements in the price of an asset. Futures and options contracts give them an extra leverage;

Arbitrageurs are in business to take advantage of a difference between prices in two different markets. For example, they see the futures price of an asset getting out of line with the cash price, they will take offsetting positions in the two markets to lock in a profit.

Futures and options are a welcome step in its long tradition of providing useful instruments to the investor community for their trading, investment hedging needs etc. Hence it is imperative that adequate efforts are put into driving education and knowledge of these asset classes. To provide correct information relating to how to use, when to use, why to use etc., these instruments, tremendous level of efforts are required. This book is one of the initiatives towards this.

Ashish Chauhan, *Interim CEO, Bombay Stock Exchange Limited*

Derivatives are now one of the most vital and integral part of capital market segment. Different participants with different logics are playing out together in this interesting area where lots of things like hedging, speculation, strategies are implemented as per individual requirements and likings. In India, derivatives have become quite popular. Derivative turnover at present constitutes about 90 per cent of the total turnover of capital market. All that is needed is expert guidance and knowledge to investors on proper use of this tool to extract maximum benefit out of it. This step taken up by BSE and Dalal Street Magazine is a welcoming step and I feel, the knowledge shared in the book will help investor community in a very positive way.

D K Aggarwal, *CMD, SMC Investments and Advisors Limited*

Derivatives are like poison. How we use it can make or break us. Over dose can kill and in form of medicine saves life. Similarly derivatives is a wonderful tool by which investor can protect their capital, enhance their returns, reduce capital required for investments. However when they get over leveraged, it leads to disaster. I believe right use of derivatives whether futures or options can generate far better risk adjusted returns on the invested capital. Here, knowledge of the instruments and its effective utilization is the key to success.

Dinesh Thakkar, *Chairman & Managing Director, Angel Broking*

Instead of keeping cash reserves unutilised, it is always better to study the various investment options available and chalk out a portfolio that provides good returns and is also relatively risk-free. It is better for investors to learn about the various options available to them. Our emphasis should be on the fact that the options are not always about speculation.

Sudip Bandyopadhyay, *MD & CEO, Destimoney Securities*

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DERIVATIVES

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