

DERIVATIVES-A TOOL TO HEDGE YOUR RISK

Derivative contract is a contract whose value is determined by the changes in the value of underlying asset. Underlying assets includes: stocks, bonds, commodities, currencies, interest rates and market indices. Derivatives are generally used as a tool to hedge risk but some people used derivatives for speculation purpose also. Some investors called derivatives as financial instrument that has a value based on the expected future price movements of the asset. It also means a forward, future, options or any other contract that has a predetermined fixed duration. As per securities contract regulation act a Derivative includes- A security derived from a debt instrument, share, loan, whether secured or unsecured, risk instrument or contract for differences or any other form of security.

A Derivative includes three types of participants: Hedgers, Speculators and Arbitrageurs. Hedgers are the investors who use derivative as a hedging tool to reduce their future risk. Hedge is an investment made in order to reduce the risk of adverse price movements in a security by taking an offsetting position in a related security. Speculators are the persons who don't invest any money but makes money by speculating on up and down movements of stocks and indices, where as arbitrageurs are the persons who makes money out of the difference between the stocks prices in two different markets (equity and future markets), they buy low in one market and sell the same at a high price in other market.

Derivative includes: Forwards, Futures, Options & Swaps. A forward contract is a non standardized contract between the two parties to buy or sell an asset at a specified future price and time agreed today. The price agreed upon is called the delivery price. Forward contract like other derivative contract is a tool to hedge risk. The other form of Derivative-Future is best defined as a standardized contract to buy or sell a specified commodity of standardized quality at a certain date in future and at a determined future price. The party agreeing to buy the underlying asset in future is said to have taken a long position and party which agrees to sell the underlying in future is said to have taken a short position.

Options are the refined form of Derivatives, in which one can go for a buy or sell positions. The trade in options is on premium. Option is a contract that gives the buyer the right, but not the obligation, to buy or sell an underlying at a specific price on or before a certain date. A Stock option which gives the holder the right to buy an asset at a fixed price during a certain period is called as Call Option, while an option which gives the holder the right to sell a stock at a fixed price is a Put Option.

An investor can trade in following types of options- exchange traded option, stock option, bond option, over the counter option, index options etc.

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