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Derivatives And Its Classifications

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Abstract:--

The objective of an investment decision is to get required rate of return with minimum risk .To achieve this objective, various instruments have been developed in recent past. At present the Indian stock markets are not having any risk hedged instruments that would allow the investors to manage and minimize the risk. In industrialized countries apart from money market and capital market securities, a variety of other securities known as 'derivatives' have now become available for investment and trading. The derivatives originate in mathematics and refer to a variable which has been derived from another variable. A derivative is a financial product which has been derived from another financial product or commodity. The derivatives do not have independent existence without underlying product and market. Derivatives are contracts which are written between two parties for a easily marketable assets. Derivatives are also known as deferred delivery or deferred payment instruments. Since financial derivatives can be created by means of a mutual agreement, the types of derivative products are limited only by imagination and so there is no definitive list of derivative products. Derivative contracts are primarily of two kind—contract that are traded on the exchange and contract that are traded outside the exchange. Product/contract that are traded on exchange are called exchange traded derivative. And product/contract that are traded outside the exchange are called OTC derivative.(over the counter derivative)

Keywords: forward contract, put option plan, different factor etc.

Introduction:-

Literal meaning of derivative is that something which is derived .Now question arises as to what is derived? From what is derived? Simple one line answer is that value/price is derived from any underlying assets. Here underlying assets can be securities, commodity, currency etc. These financial instruments promise payoffs that are derived from the value of something else, which is called the "underlying."

Derivatives are totally different from securities. They are financial instruments that are mainly used to protect against and manage risks, and very often also serve arbitrage or investment purposes, providing various advantages compared to securities. Derivatives come in many varieties and can be differentiated by how they are traded, the underlying

they refer to, and the product type.

Underlying Assets for Derivatives:-

- Commodities such as gold, silver, etc.
- Currencies
- Market Index
- Individual Stocks
- Interest Rates

In other way the underlying asset may assume many forms:

- (i) Commodities including grain, coffee beans, orange juice;
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- (ii) Precious metals like gold & silver;
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- (iii) Foreign exchange rates or currencies;
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- (iv) Bonds of different types, including medium to long term negotiable debt, securities issued by governments, companies etc;
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- (v) Shares and share warrants of companies traded on recognized stock exchanges and stock index;
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- (vi) Short term securities such as T-bills;
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- (vii) Over the counter (OTC) money market products such as loans or deposits.

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Definitions:-

A derivative is a financial product which has been derived from another financial product or commodity.

D.G. Gardener defined the derivatives as

"A derivative is a financial product which has been derived from market for another product."

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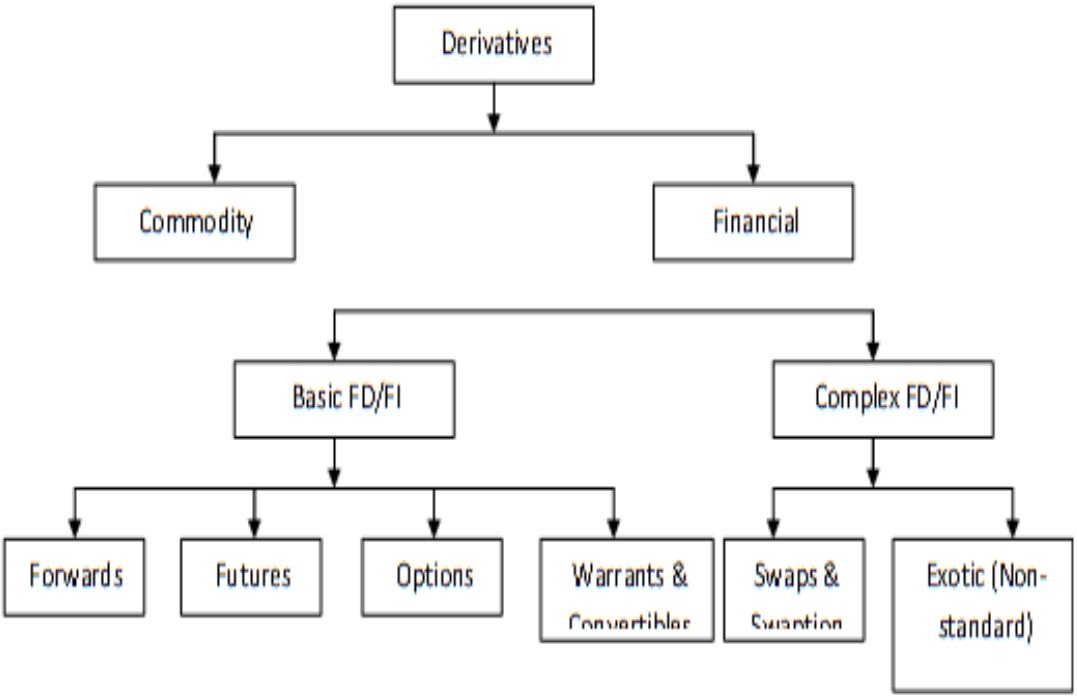
Types of Derivatives:-

Figure: Classification of Derivatives



- **FORWARD CONTRACT:-**

A forward contract specifies that a certain commodity will be exchanged for another at a specified time in the future at prices specified today. It's not an option: both parties are expected to hold up their end of the deal. If you have ever ordered a textbook that was not in stock, you have entered into a forward contract.

- The basic features of a contract are given in brief here as under:

- 1. Forward contracts are bilateral contracts, and hence, they are exposed to the counter party risk. There is risk of non-performance of obligation either of the parties, so these are riskier than to futures contracts.

- 2. Each contract is custom designed, and hence, is unique in terms of contract size, expiration date, the asset type, quality etc.

- 3. In forward contract, one of the parties takes a long position by agreeing to buy the asset at a certain specified future date. The other party assumes a short position by agreeing to sell the same asset at the same date for the same specified price. A party with no obligation offsetting the forward contract is said to have an open position. A party with a close position is, sometimes, called a hedger.

- 4. The specified price in a forward contract is referred to as the delivery price. The forward price for a particular forward contract at a particular time is the delivery price that would apply if the contract were entered into at that time. It is important to differentiate between the forward price and the delivery price. Both are equal at the time the contact is entered into. However, as time passes, the forward price is likely to change whereas the delivery price remains the same.

- 5. In the forward contract, derivative asset can often be contracted from the combination of underlying assets; such assets are often known as synthetic assets in the forward market.

- 6. In the forward market, the contract has to be settled by delivery of the asset on expiration date. In case the party wishes to reverse the contract, it has to compulsory go to the same counter party, which may dominate and command the price it wants as being in a monopoly situation.

- 7. In a forward contract, covered party or cost of carry relations are relation between the prices of forward and underlying assets.

Risk involved in forward contract:-

Forward markets worldwide are afflicted by several problems:

(a) Lack of centralization of trading,

(b) Illiquidity, and

(c) Counter party risk.

In the first two of these, the basic problem is that of too much exibility and generality. The forward market is like the real estate market in that any two consenting adults can form contracts against each other. This often makes them design terms of the deal which are very convenient in that

specific situation, but makes the contracts non-tradable. Also the “phone market" here is unlike the centralization of price discovery that is obtained on an exchange.

Counter party risk in forward markets is a simple idea:

When one of the two sides of the transaction chooses to declare bankruptcy, the other suffers.

Forward markets have one basic property:

The larger the time period over which the forward contract is open, the larger are the potential price movements, and hence the larger is the counter-party risk. Even when forward markets trade standardized contracts, and hence avoid the problem of illiquidity, the counterparty risk remains a very real problem.

FUTURE CONTRACT:-

A future contract is standardised and organised contract which specifies that a certain asset will be exchanged for another at a specified time in the future at prices specified today. Its not an option: both parties are expected to hold up their end of the deal.

The features of a futures contract may be specified as follows:

1. Futures are traded only in organized exchanges.

2. Futures contract required to have standard contract terms.

3. Futures exchange has associated with clearing house.

4. Futures trading required margin payment and daily settlement.

5. Futures positions can be closed easily.

6. Futures markets are regulated by regulatory authorities like SEBI.

7. The futures contracts are executed on expiry date

TYPES OF FUTURE CONTRACT:-

There are different types of contracts in financial futures which are traded in the various futures market of the world. The followings are the important types of financial futures contract:

1. Stock future or equity futures
2. Stock index futures
3. Currency futures
4. Interest rate futures

Option contract:-

An option gives the holder the right, but not the obligation, to buy or sell a given quantity of an asset on (or perhaps before) a given date, at prices agreed upon today. In theory, option can be written on almost any type of underlying security. The person who buys an option is normally called the buyer or holder. Conversely, the seller is known as the seller or writer. Today, options are traded on a variety of instruments like commodities, financial assets as diverse as foreign exchange, bank times deposits, treasury securities, stock, stock indexes, petroleum products, food grains, metals etc.

The basic features of options or followings:

1. The option is exercisable only by the owner namely the buyer of the option.
2. The owner has limited liability.
3. Owners of options have no voting rights and dividend right.
4. Options have high degree of risk to the option writers.
5. Options involving buying counter positions by the option sellers.
6. Flexibility in investors needs.
7. No certificates are issued by the company.
8. Options are popular because they allow the buyer profits from favorable movement in exchange rate.

Types of option contract:-

Options can be classified into different categories like:

(i) Call options

(ii) Put options

Call option:-

An call option gives the holder the right, but not the obligation, to buy a given quantity of an asset on (or perhaps before) a given date, at prices agreed upon today.

For example:-

- Mr. Suresh agrees to buy the right to purchase one lot (100 Shares) of Tata Steel @ Rs. 423 per share from Mr. Dinesh on January 31, 2012. For this Mr. Suresh has paid premium of Rs. 10 per share to Mr. Dinesh.
- Contract Time = 1 month
- Starting Date = January 1, 2012
- Expiration Date = January 31, 2012
- Long Position = Mr. Suresh (Right)
- Short Position =Mr. Dinesh (Obligation)

Put option:-

A put option gives the holder the right, but not the obligation, to sell a given quantity of an asset on (or perhaps before) a given date, at prices agreed upon today.

Options come in two varieties { european vs. american. In a european option, the holder of the option can only exercise his right (if he should so desire) on the expiration date. In an American option, he can exercise this right anytime between purchase date and the expiration date.

What makes a contract successful:-

- Liquidity
  - The contract should be choice of a large set of market participants.
- Existence of risk in the underlying market is a prerequisite for success of derivative contract.
- Right contract size
- Well-laid regulatory framework
- Large volume of trading

Aims and Objectives of study of derivative market:

The *aim* of this research is to study the derivative market in India and its current and future trends ,which are carried out on the stock (equity) market. The *objectives* of the study are as follows:

- To have an overview of the Indian Derivative Market.
- To assess risk management tools and its strategies.
- To evaluate products of derivatives i.e. Forwards, Futures, Swaps and Options.
- To critically analyze its participants i.e. Hedgers, Speculators and Arbitrageurs.
- To evaluate the functions of derivatives.
- To analyze the trends of working and the future trends of Equity Derivatives.
- To propose conclusion and recommendation based upon the findings.

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