What are Derivatives?

Definitions

"To define in the simplest possible way a derivative, it will be said that it is an instrument whose valuation depends on (*derives from*) the value of another instrument, which is then called the underlying asset." -Françoise Caclin

"A financial derivative is an agreement to set the price of an investment based on the value of another asset. For example, when you purchase currency futures based on a specific exchange rate, the value of the futures will change as that currency's exchange rate changes." – Your Dictionary

Derivatives: Explanation

Derivatives are financial instruments to deal with financial risks. Derivatives are one of the remedies to insure investments against market fluctuations. Since risk is an inseparable part of any investment, financial markets developed derivatives to manage financial risk. Derivatives are prepared as contracts and derive their returns from other financial instruments (Under lying instruments) from which they are inherited. General underlying instruments include bonds, commodities, currencies, interest rates, market indexes and stocks.

Derivatives are developed as contracts indicating an agreement between two different parties, where they are expected to do something for each other. Where one party pays some money to the other and in return, receives coverage against future financial losses.

Derivative contracts bear a short and defined life. Every derivative begins on a certain date and ends on a later date. Generally, the payment from a certain derivative contract is calculated and/or is made on the end date, though this can differ in some cases.

The value of the underlying security keeps changing according to market environment. The basic motivating factor behind going into derivative contracts is to earn profits by speculating on the value of the underlying security in future. Suppose in the market, price of an equity share may go up or down, there is a chance of a loss because of fall in the stock value. In this situation, we may enter a derivative contract to make profit by offering accurate bet.

Financial Derivatives Terms

To understand financial derivatives some terms must be understood like

- the type of relationship between the underlying security and the derivative, this relationship may be a "forward," "swaps" or "options."

- Concentrating on what kind of market the underlying security and the derivative trade in. They may be exchanged in a trade in the stock market, or they may be traded personally or "over the counter."

Why Do Investors Enter in to Derivative Contracts?

Earning profit is the prime motive behind entering in derivatives market but there are various other causes behind attraction in derivative contracts. Few of them are:

Arbitrage Advantage

Arbitrage transactions involves buying a commodity or security at a less price in one market and selling it at a higher price in the other market. Due to this we can be benefited by the differences in prices of the security or commodity in the two different markets.

Protection against Fluctuations

Possibility of losses is increased due to price fluctuation of asset. By entering in to derivatives market possibility of losses can be minimised. We can look for products in the derivative market, which will help us to shield against a reduction in the price of stocks that we own. In addition, we may buy products to secure against a price rise in case of stocks that we are planning to buy.

Advantage of Surplus Funds

Most of the individuals use derivatives as a means of transferring risk. Some use it for speculation and making profits. Here, we can take advantage of the price fluctuations without really selling the underlying shares.

Participants of Derivatives Market

Each type of investor will have an objective to enter in the derivative market. We can divide them into following categories based on their trading objects:

1) Hedgers

These are risk-averse participants in stock markets. They enter into derivative markets to secure their investment portfolio against the market risk and price fluctuations. They do this by supposing an opposite position in the derivatives market. In this way, they transfer the risk of loss to those others who are ready to take it. In return for the hedging facility, they need to pay a premium to the risk taker.

2) Speculators

They are the risk-takers of the derivative market. They want to take risk in order to have gain. They have fully opposite point of view than hedgers. This difference of views helps them to make big profit if the bets turn right.

3) Margin Traders

Margin means the minimum amount that we need to deposit with the broker to enter in the derivative market. It is used to reflect our losses and gains on a daily basis as per market conditions. It helps us to get a leverage in derivative transactions and maintain a large outstanding position. Suppose with a sum of Rs. 1 lakh we could buy 100 shares of XYZ Ltd. of Rs 1000 each in the stock market. Though in the derivative market we can have a three times bigger position i.e. Rs 3 lakh with the same amount. A small price change will lead to bigger gains/losses in the derivative market in comparison to stock market.

4) Arbitrageurs

They use the low-risk market imperfections to make gains. They at the same time buy less-priced securities in one market and sell them at high price in another market. This is possible only when the same security is quoted at different prices in different markets. For example an equity share is priced at Rs 100 in stock market and at Rs 105 in the futures market. If an arbitrageur buys the stock at Rs 1000 in the stock market and sells it at Rs 1050 in the futures market. In this way he earns a low-risk profit of Rs 50.

==============Part One Ends====================