BHARAT SCHOOL OF BANKING
Derivatives Market

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To understand the concept of **Derivatives**, first try to understand the following example - Suppose you want to **invest** in shares, or bonds, or some other **instruments**. But you don't know what will happen to your **investment,** meaning, your (bought) **share** may give you **profit**, or give you **loss** (you often hear news, that someone has lost all his money in shares), because it all depends on the **company** how it works in the **market** (same thing applies for other **investments** too).

Certainly there is always a **risk** factor that works in your **investment** in these type of **instruments**. So, to reduce the **risk**, there is a concept of **Derivatives**.

Derivatives

A **derivative** is a **contract / agreement** between **two** or more **parties**, whose **value** depends on or associated with one or more **underlying assets** (e.g., **shares, bonds, commodities, currencies,** etc.)

Derivatives are one of the **three** main categories of **financial instruments** -

1. **Stocks** (i.e,. equities or shares) (already discussed in previous post)
2. **Debt** (i.e., **bonds**, mortgages) (already discussed in previous post)
3. **Derivatives** (our topic of discussion)

Let's start with an example -

Suppose you want to **buy** an **asset** with **Rs. 500** (example figure just to understand the concept). But you are worried what will be the **market price** of the **asset** after some months, and their is a high probability **(**your **speculation)** that the market price can become less than **Rs. 400**. So in that case you will make a **loss** of around **Rs. 100**.

Therefore, you decide to make an **agreement** with an **investor**, stating that you want to **sell** him the **asset** in **Rs. 550** after **6 months (future agreement)**. The **investor** agrees with the **agreement**, because he thinks, he can **sell** the **asset** at a **higher profit** (may be **Rs. 600,** investor's **speculation)**, if the **market price** is high.

Now analyze. If the **market price** of the **asset** after **6 months,** becomes **Rs. 650**, then the **investor** will get a **profit** of **Rs. (650 - 550) = Rs. 100**. But you will get the **fixed** profit of **Rs. (550 - 500) = Rs. 50**, irrespective of the **market price**.
But if the **market price** of the **asset** becomes **Rs. 420**, then the **investor** will make a **loss** of **Rs. (550 - 420) = Rs. 130,** whereas you won't make any **loss**, but a fixed **profit** of **Rs. (550 - 500)**

= **Rs. 50**.

Note that you won't make any **loss**, if you make the **Derivatives** agreement, however your **profit** will be fixed (may be less, if you don't make the agreement). You reduce the **risk** of any **loss**, in this type of **derivatives agreement,** and this **process** of **reducing risk** is known as **Hedging.**
Also note that, the **value** of the **Derivatives** is dependent on your **asset** (known as **underlyingasset**).

Types of Derivatives

- **Forwards**
- **Futures**
- **Options,** etc.

Forward Contracts

Forward contract (or **forwards**) is a **non-standardized** contract between **two parties** to **buy** or **sell** an **asset** at a **specified future date**, where the **price** is decided **today** (on agreement day)

Points to be noted -

- **Buy/Sell** will be done in **future date**
- **Price** is decided **today** (reduces **risk** for the **seller**)
- These are **not standardized** (no **Future Exchange** is involved. Contract is made just between **buyer** and **seller - private agreement**)

Future Contracts

Future contract (or **futures**) is a **standardized** contract between **two parties** to **buy** or **sell** an **asset** at a **specified future date**, where the **price** is decided **today** (on agreement day)

Points to be noted -

- **Buy/Sell** will be done in **future date**
- **Price** is decided **today** (reduces **risk** for the **seller**)
- These are **standardized** (in contrast to **Forwards**). **Contracts** are negotiated at **Future Exchanges,** that acts as an **intermediary** between **buyer** and **seller**. There is also a guarantee from **Clearing Houses**)

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Option Contracts

Option contract (or **options**) is an **agreement/contract** between **two parties** that gives **purchaser** the **right** to **buy** or **sell** (option to buy/sell) an **asset** at a **specified future date**, where the **price** is decided **today** (on agreement day)

Points to be noted -

- **Buy/Sell** will be done in **future date**
- **Price** is decided **today**
- **Options** are the **right** to buy or sell, not an **obligation**, meaning the **purchaser** of the option, could buy/sell the **asset**, but if he doesn't want to, then he has no **obligation** to buy/sell it. But in case of **Forward** and **Future** contracts, there is an **obligation** to buy/sell the asset (they are **legally bound** to buy/sell the asset).

There are other types of derivatives, like **Warrants, Swaps,** etc.