INTERNATIONAL JOURNAL OF RESEARCH IN COMMERCE AND MANAGEMENT

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RISK MINIMIZATION IN SPOT AND DERIVATIVE MARKET

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ABSTRACT

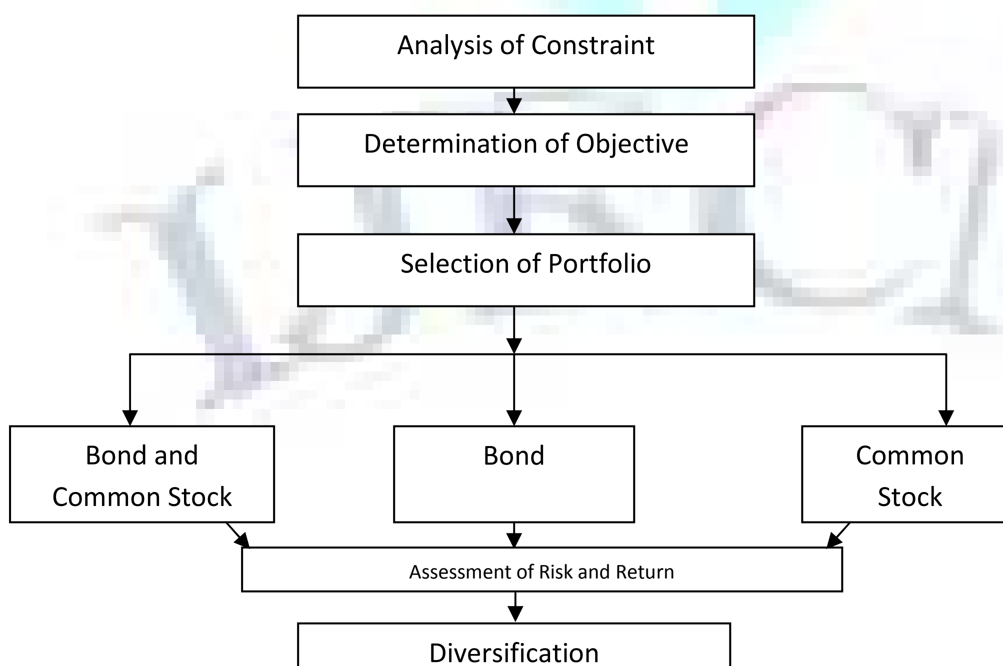
Investment is the employment of funds on assets with the aim of earning income or capital appreciation. Investment has two attributes namely time and risk. The sacrifice that has to be borne is certain but the return in the future may be uncertain. The attribute of investment indicates the risk factor. Commonly, there are two approaches in the construction of the portfolio of securities viz traditional approach and Markowitz efficient frontier approach. In the traditional approach, investor's needs in terms of income and capital appreciation are evaluated and appropriate securities are selected to meet the needs of the investors. In the modern approach, portfolios are constructed to maximize the expected return for a given level of risk. The study of spot market is carried on with the help of the technical analysis which is based on the doctrine given by Charles H. Dow in 1984. Technical analysis is a process of identifying trend reversals at an earlier stage to formulate the buying and selling strategies. With the help of several indicators they analyse the relationship between the price-volume and supply-demand for the overall market and the individual stock. The optionality characteristics of options in the derivative markets results in a non-linear payoff for options. In simple words, it means that the losses for the buyer of an option are limited however the profits are potentially unlimited. For a writer, the payoff is exactly the opposite. These non-linear payoffs are fascinating as they lend themselves to be used to generate various payoffs by using combinations of options and the underlying. Futures can be used as an effective risk-management tool. With security futures one can minimize one's price risk. One need to do is to enter into an offsetting stock future position. Hedging does not always make money. The best that can be achieved using hedging is the removal of unwanted exposure i.e. unnecessary risk. Analysis of growth rate of sale and net profit along with the P/E ratio gives an overall view and helps in empirical valuation of stock.

KEYWORDS
Risk, Market, Capital, Investment.

INTRODUCTION
Investment is the employment of funds on assets with the aim of earning income or capital appreciation. Investment has two attributes namely time and risk. Present consumption is sacrificed to get a return in the future. The sacrifice that has to be borne is certain but the return in the future may be uncertain. The attribute of investment indicates the risk factor. The risk is undertaken with a view to reap some return from the investment. Financial investment is the allocation of money to assets that are expected to yield some gain over a period of time.

SELECTION OF EFFICIENT PORTFOLIO
Commonly, there are two approaches in the construction of the portfolio of securities viz. traditional approach and Markowitz efficient frontier approach. In the traditional approach, investor's needs in terms of income and capital appreciation are evaluated and appropriate securities are selected to meet the needs of the investors. The common practice in the traditional approach is to evaluate the entire financial plan of the individual.

STEPS IN TRADITIONAL APPROACH

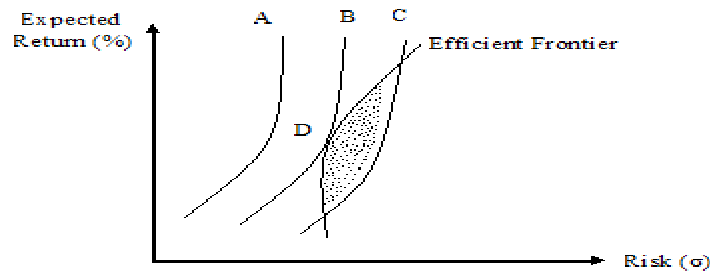


MARKOWITZ EFFICIENT FRONTIER APPROACH

In the modern approach, portfolios are constructed to maximize the expected return for a given level of risk. It views portfolio construction in terms of the expected return and the risk associated with obtaining the expected return.

The optimum portfolio or portfolios to select is one that should be selected in which an indifference curve touches the efficient frontier of portfolios as a tangent. In the figure 1 a portfolio D, where the indifference curve B touches the efficient frontier as a tangent, is the optimum portfolio. Any portfolio on an indifference curve to the right of curve B, such as one on curve C, would be worse than portfolio D. Thus, if we consider portfolios on the efficient frontier, no portfolio is dominated by any other. That is why; the consideration of an efficient frontier becomes paramount in optimum portfolio selection.

FIGURE 1



Optimum Portfolio Selection

RISK MINIMIZATION IN SPOT MARKET

The study of spot market is carried on with the help of the technical analysis which is based on the doctrine given by Charles H. Dow in 1984. He developed the theory on the basis of certain hypotheses. The first hypothesis is that, no single individual or buyer can influence the major trend of the market. His second hypothesis is that the market discounts everything. Even natural calamities get quickly discounted in the market. His third hypothesis is that the theory is not infallible. It is not a tool to beat the market but provides a way to understand it better.

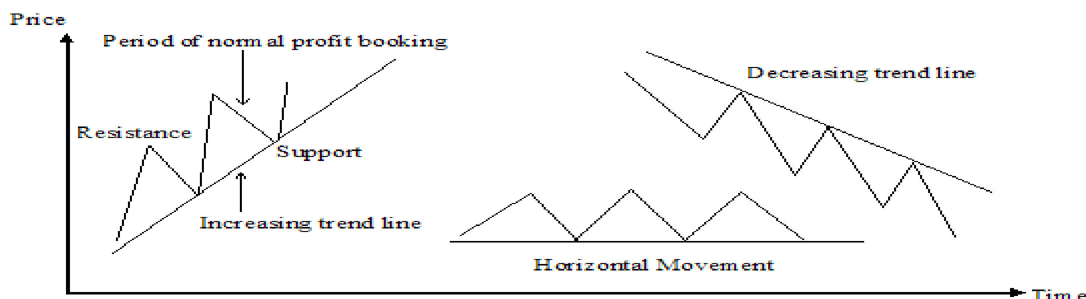
Technical analysis is a process of identifying trend reversals at an earlier stage to formulate the buying and selling strategies. With the help of several indicators they analyse the relationship between the price-volume and supply-demand for the overall market and the individual stock. Volume is favourable on the upswing i.e. the number of shares traded is greater than before and on the downside the number of shares traded dwindle. If it is the other way round, trend reversals can be expected.

PRICE VOLUME RELATIONSHIP

Price	Volume	Market Trend
↑	↑	(+)ve; market trend is positive due to buying pressure.
↑	↓	(-)ve; market trend is negative because price will decrease due to exit of traders from the market.
↓	↑	(-)ve; market trend is negative due to selling pressure.
↓	↓	(+)ve; market trend is positive in near future due to buying pressure at support price.

In Figure 2 we have drawn three trend lines indicating the significance of each point. The increasing trend line is drawn by touching two higher bottoms. From empirical analysis of the price movement of individual stock it is found that the price do not move in straight line rather it moves in zigzag way; during increasing trend once the price starts rising it will fall after some time, this phase indicates that the traders make normal profit booking and thereafter the price starts moving upward. The point from which it starts an upward movement is the support price. In the next downward swing the price decreases but what is most interesting that the lower price in the second rally will not cross the previous bottom, so this is the positive trend line that can be drawn by touching two higher bottoms. This phase is bullish in nature. During this phase both the volume and price increases.

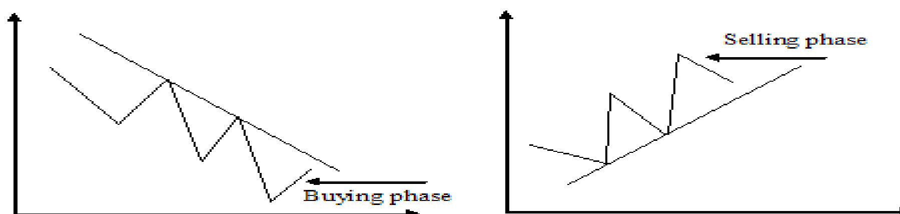
FIGURE - 2



The decreasing trend line can be drawn by touching two lower tops. During this phase once the price starts decreasing it is found that after some time the graph takes an upward swing but the interesting part here is that the price increase does not cross the previous high, as a result lower top is formed and by touching these two tops a decreasing trend line can be drawn. This phase is bearish in nature. During this phase the price and volume starts decreasing. In the horizontal movement of price no trend line can be drawn.

In all the stock exchanges these trend lines is drawn to know about the bullish or bearish phase of the market. It also indicates whether to buy the stock or to exit from the market. Empirical study shows that the market moves in these three phases in a chronological order.

From this trend analysis we can decide whether to buy the stock / hold the stock / sale the stock. When the market moves from decreasing trend and two lower tops are not formed it indicates the



buying phase of the stock. This is done after fixing a price band (say ±3%). For example say the price of the stock is Rs 90. After fixing a price band of ±3% the price movement of the stock is studied. Since the current price of Rs 90 is the bottom price and if the price crosses (+3% i.e. Rs 90 + 3% of Rs 90 i.e.) Rs 93; then it indicates a buying phase. If the price moves downward and crosses (-3% i.e. Rs 90 – 3% of Rs 90 i.e.) Rs 87; it indicates that one should restrain from buying the stock and to wait and watch the price movement. Similarly when two higher bottoms are not formed then it indicates the selling phase. For example let the price of the stock is Rs 120. After fixing a price band of ±3% the price movement of the stock is studied. Since the current price of Rs 120 is the top price and if the price crosses (-3% i.e Rs 120 – 3% of Rs 120 i.e.) Rs 116; then it indicates the selling phase. If the price moves upward and crosses (+3% i.e., Rs 120 + 3% of Rs 120 i.e.) Rs 124; it indicates that one should restrain from selling the stock and to wait and watch the price movement.

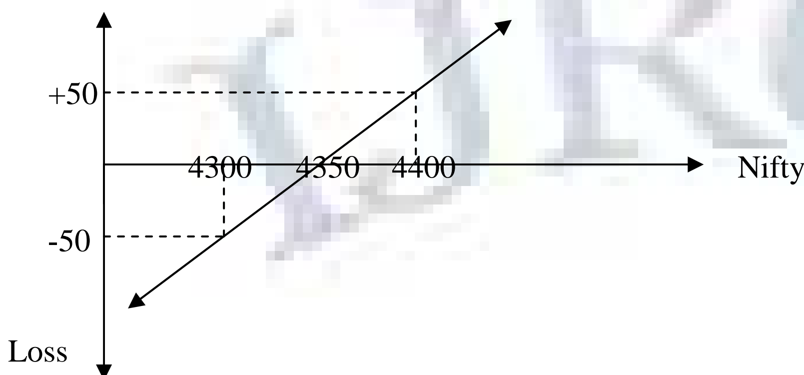
RISK HANDLING IN THE DERIVATIVE MARKET

The optionality characteristic of options results in a non-linear payoff for options. In simple words, it means that the losses for the buyer of an option are limited; however the profits are potentially unlimited. For a writer, the payoff is exactly the opposite. His profits are limited to the option premium; however his losses are potentially unlimited. These non-linear payoffs are fascinating as they themselves to be used to generate various payoffs by using combinations of options and the underlying. We look here at the six basic payoffs.

1. PAYOFF PROFILE OF BUYER OF ASSET: LONG ASSET

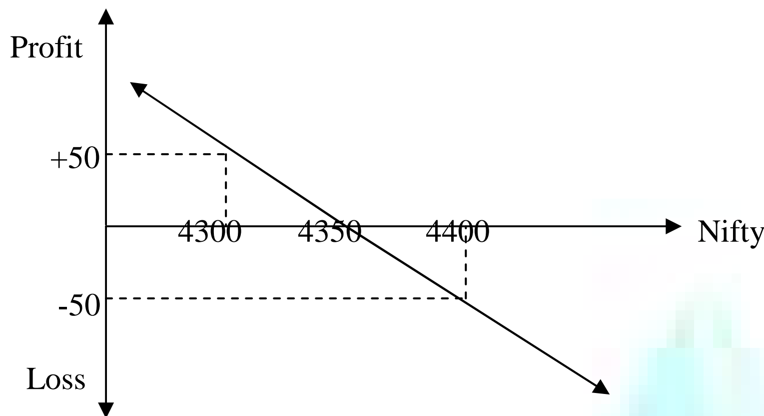
In this basic position, an investor buys the underlying asset, Nifty for instance, for 4350, and sells it at a future date at an unknown price, S_t. Once it is purchased, the investor is said to be "long" the asset.

The figure shows the profits / losses from a long position on the index. The investor bought the index at 4350. If the index goes up, he profits. If the index falls he looses.



2. PAYOFF PROFILE FOR SELLER OF ASSET: SHORT ASSET

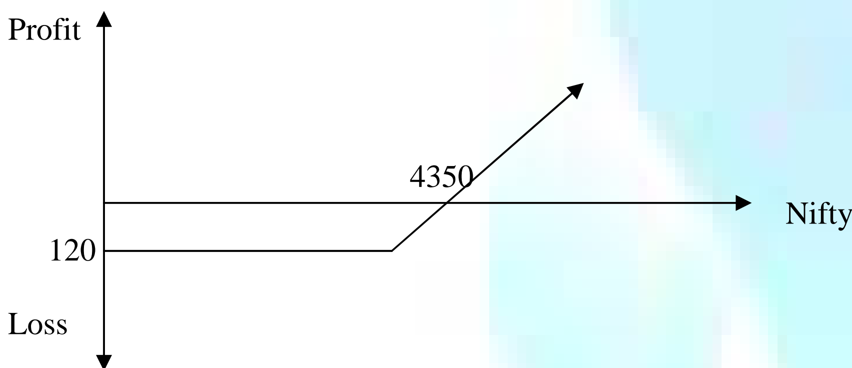
In this basic position, an investor shorts the underlying asset. Nifty for instance, for 4350, and buys it back at a future date at an unknown price, S_t. Once it is sold, the investor is said to be "short" the asset.



The figure shows the profits / losses from a short position on the index. The investor sold the index at 4350. If the index falls, he profits. If the index rises, he looses.

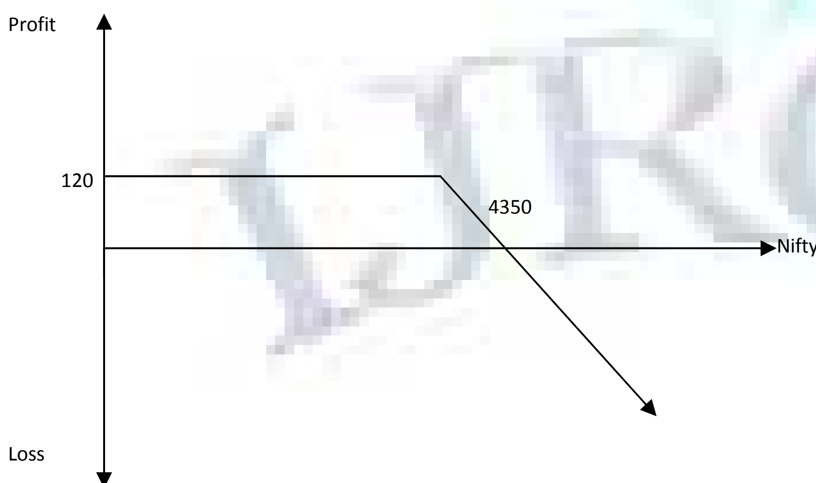
3. PAYOFF PROFILE FOR BUYER OF CALL OPTIONS: LONG CALL

The call option gives the buyer the right to buy the underlying asset at the strike price specified in the option. The profit / loss that the buyer makes on the option depend on the spot price of the underlying. If upon expiration, the spot price exceeds the strike price, he makes a profit. Higher the spot price more is the profit he makes. If the spot price of the underlying is less than the strike price, he lets his option expire un-exercised. His loss in this case is the premium he paid for buying the option. The figure gives the payoff for the buyer of a three month call option (often referred to a long call) with a strike price of 4350 bought at a premium of Rs 120.



4. PAYOFF PROFILE FOR WRITER OF CALL OPTIONS: SHORT CALL

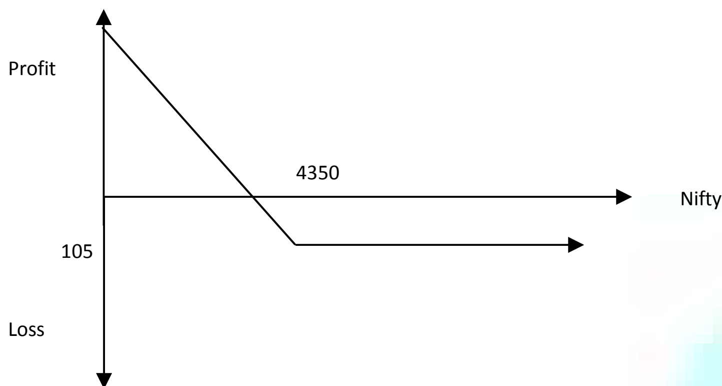
A call option gives the buyer the right to buy the underlying asset at the strike price specified in the option. For selling the option, the writer of the option charges a premium. The profit / loss that the buyer makes on the option depend on the spot price of the underlying. Whatever is the buyer's profit is the seller's loss. If upon expiration, the spot price exceeds the strike price, the buyer will exercise the option on the writer. Hence as the spot price increases the writer of the option starts making losses. Higher the spot price more is the loss he makes. If upon expiration the spot price of the underlying is less than the strike price, the buyer lets his option expire unexercised and the writer gets to keep the premium. Figure gives the payoff for the writer of a three month call option (often referred to as short call) with a strike of 4350 sold at a premium of Rs 120.



5. PAYOFF PROFILE FOR BUYER OF PUT OPTIONS: LONG PUT

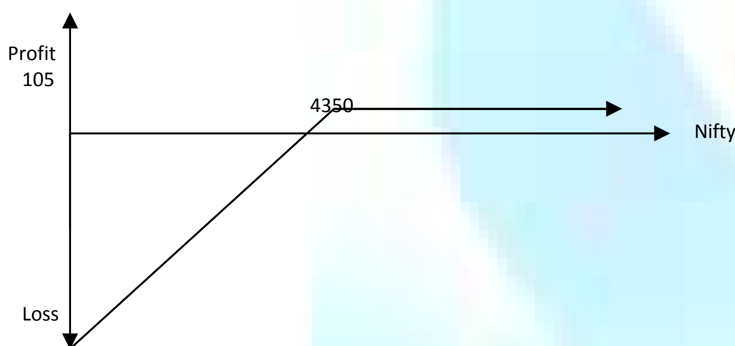
A put option gives the buyer the right to sell the underlying asset at the strike price specified in the option. The profit / loss that the buyer makes on the option depend on the spot price of the underlying. If upon expiration, the spot price is below the strike price, he makes a profit. Lower the spot price more is the profit he makes. If the spot price of the underlying is higher than the strike price, he lets his option expire un-exercised. His loss in this case is the premium he paid for

buying the option. Figure gives the payoff for the buyer of a three month put option (often referred to a long put) with a strike of 4350 bought at a premium of Rs 105



6. PAYOFF PROFILE FOR WRITER OF PUT OPTIONS: SHORT PUT

A put option gives the buyer the right to sell the underlying asset at the strike price specified in the option. For selling the option, the writer of the option charges a premium. The profit / loss that the buyer makes on the option depend on the spot price of the underlying. Whatever is the buyer's profit is the seller's loss. If upon expiration, the spot price happens to be below the strike price, the buyer will exercise the option on the writer. If upon expiration the spot price of the underlying is more than the strike price, the buyer lets his option expire un-exercised and the writer gets to keep the premium. Figure gives the payoff for the writer of a three month put option (often referred to a short put) with a strike of 4350 sold at a premium of Rs 105.



RISK MINIMIZATION IN DERIVATIVE MARKET THROUGH HEDGING: LONG SECURITY, SELL FUTURES

Futures can be used as an effective risk management tool. Take the case of an investor who holds the shares of a company and gets uncomfortable with market movements in the short run. He sees the value of his security falling from Rs 390 to Rs 350. In the absence of stock futures, he would either suffer the discomfort of a price fall or sell the security in anticipation of a market upheaval. With security futures he can minimize his price risk. All he needs to do is to enter into an offsetting stock futures position; in this case, he has to take on a short futures position. Assume that the spot price of the security he holds is Rs 390. Two-month futures cost him Rs 402. For this he pays an initial margin. Now if the price of the security falls any further, he will suffer losses on the security he holds. However, the losses he suffers on the security, will be offset by the profits he makes on his short future position. Take for instance that the price of his security fall to Rs 350. The fall in the price of the security will result in a fall in the prices of futures. Futures will now trade at a price lower than the price at which he entered into a short futures position. Hence, his short futures position will start making profits. The loss of Rs 40 incurred on the security he holds, will be made up by the profits made on his short futures position.

Index futures in particular can be very effectively used to get rid of the market risk of a portfolio. Every portfolio contains a hidden index exposure or a market exposure. This statement is true for all portfolios, whether a portfolio is composed of index securities or not. In the case of portfolios, most of the portfolio risk is accounted for by index fluctuations (unlike individual securities, where only 30-60% of the securities risk is accounted for by index fluctuations). Hence, a position LONG PORTFOLIO + SHORT NIFTY can often become one-tenth as risky as the LONG PORTFOLIO position.

Hedging does not always make money. The best that can be achieved using hedging is the removal of unwanted exposure, i.e. unnecessary risk. The hedged position will make less profit than the unhedged position, half the time. One should not enter into a hedging strategy hoping to make excess profits for sure; all that can come out of hedging is reduced risk.

CONCLUSION

Risk minimization in spot and derivative market is analysed through the analysis of the current market price which reflects the future price of the company. The viability of the current market price can be done through trend analysis of the growth rate of the top line (i.e. the sales) and the growth rate of the bottom line (i.e. the net profit). This is done through the study of Earning Per Share and Price Earning Ratio. Earning Per Share (EPS) – EPS measures the profit available to the equity shareholders on a per share basis, that is, the amount that they can get on every share held. It is calculated by dividing the profits available to the shareholders by number of outstanding shares. The profits available to the ordinary shareholders are arrived at by net profit after taxes and preference dividend. Price Earning Ratio (P/E Ratio) – The P/E ratio reflects the price currently being paid by the market for each rupee of currently reported EPS. It measures investors' expectations and market appraisal of the performance of a firm.

If the growth rate of sales and profit is more than the P/E ratio or if the future prospect indicates that the growth rate of sales and profit will be more than the current P/E ratio then only the current market price is viable for selecting the stock in the portfolio. Analysis of the growth rate of the sales and net profit along with the P/E ratio gives an overall view for the price of the stock.

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