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Study of Options with Respect to Utility as Hedging and Speculation

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Abstract

Options are very popular derivatives market product. Other products in derivatives market are forwards, futures and swaps. In Indian context, trading in index option commenced in June 2001 whereas stock options are being traded from July 2001. So the journey of Exchange traded Options in Indian scenario is just about 20-22 years. In the country like India, where people are even scared of basic products like equity shares, speculation using exchange traded derivatives is a very rarely used tool by the retail investors. The current paper signifies the basics of derivatives with the context and language understandable to retail investors. Though initially derivative products are intended for risk management and hedging now a days those are being speculated to the great extent.

***Keywords**: Hedging, Speculation, Retail, Investors*

Methodology:

The current paper is descriptive in nature and is based on the secondary data. The paper intends to present complicated option terminologies in simple language so as to appeal the usage of options to common reader.

Objectives

1. To study the concept of Option.
2. To understand the utility of option in hedging and speculation.

The option contract gives the right to buy or sale the underlying asset by entering into the contractual obligation for a price. It is noteworthy to mention that the right pertains to buy or sale the asset at a predefined price in a specific quantity on or before the specified date. The rights either to buy or sale the asset connects with the buyer of an option who eventually pays the premium as the price of that particular right. The pay off of option is basically unsymmetrical that is non linear which signifies that the person who is having the right can make the losses only up to the amount paid as premium, whereas the buyer can make the profit which may be far higher than the amount of loss he can make. This is the beauty of the Option.

Within Options there are call options and put options. Call option involves two parties of which one may go long and the other will go short. Similarly one may go long on put option and the other one will go short on the put option. The specific features associated with these options are presented below:

Long Call

- Gives right to buy
- Pays premium
- Limited loss

- Bullish on the market
- Come into the advantageous position when the spot price of the underlying assets goes up.

Short Call

- This is the opposite party for Long Call
- Gives obligation to sale
- Receives premium
- Limited profit
- Bearish on the market
- Come into the advantageous position when the spot price of the underlying assets goes down.

Long Put

- Gives right to sale
- Pays premium
- Limited loss
- Bearish on the market
- Come into the advantageous position when the spot price of the underlying assets goes down.

Short Put

- This is the opposite party for Long Put
- Gives obligation to buy
- Receives premium
- Limited profit
- Bullish on the market
- Come into the advantageous position when the spot price of the underlying assets goes up.

Understanding the four ways of going into the trade one can have with him two ways each when he is bullish or bearish. If a speculator is bullish on the market he can either choose going with long call or may choose short put. The major difference in this two is in Long Call his losses will be limited whereas in short put his profits are limited. If a speculator is bearish on the market he can either choose going with long put or may choose short call. The major difference in this two is in Long put his losses will be limited whereas in short call his profits are limited.

The basic utility of the options when it is conceived as products was hedging and risk management. For example one can have insurance for his portfolio by going Long with put option. In this situation one can protect his portfolio against the falling market as the value of portfolio will fall but buying the put option will generate the profits in falling market.

This is the easiest way to protect the portfolio in the falling market.

Conclusion:

Option is a derivative product recognized to trade on Indian Stock Exchanges since about last 20 years. Options were initially designed for hedging and risk management purposes but eventually those are being heavily used by speculator. After introduction of options there is increase in volume of trades on Cash Market even. One can take a very significant leverage using options which is actually a double edged sword. At the first instance it gives one the leverage and the other way it can eat up everything one has paid as a premium. So there is a risk and there is a reward too. The outcome will depend upon one's ability to predict the market movement. What is most fascinating in options is that one can even earn when the market is falling. This feature of earning from falling markets is generally not available with the traditional market products. When a trader is bullish on the market he can either go long call or may choose short put. The major difference in this two is, in Long Call his losses will be limited whereas in short put his profits are limited. If a trader is bearish on the market he can either choose going with long put or may choose short call. The difference in these two is that, in a Long put position his losses will be limited whereas in short call his profits are limited.

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