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Future(s) FIRST

Face it: you can't gaze at the mood of the markets with a crystal ball. But trading in futures & options may give you that extra edge. Aman Dhall finds out the risks & rewards of derivative trading

PREDICTING the future is by no means an easy job. It requires considerable erudition, creativity, and wisdom. In the capital markets, investors try to gaze into the future by trading in derivatives (read: futures & options). Since its launch in June 2000 on the National Stock Exchange (NSE), the risky yet rewarding form of trading has gained fast popularity in India. At present, more than 30 lakh contracts valued at almost Rs 50,000 crore are traded on the NSE every single day. Here's a layman's guide to trading in the world of F&Os, risks associated with them and precautions a first-time investor must take.

UNCOVERING THE FUNDAMENTALS

Derivatives are products that obtain their value from a spot price, called the "underlying". In India, F&Os are the two popular derivatives instruments traded on stock exchange. While in a futures contract, you agree to buy or sell shares at a certain price in the future, the option contract gives you the right, but not an obligation, to buy (through a call option) or sell (through a put option) the underlying scrip at a specified date and at a specified price.

To start trading in futures contract, you are required to place a certain percentage of the total contract as margin money. This feature of futures contract makes it a leveraged instrument since you can make a larger profit (or loss) with a comparatively small amount of capital. In India, futures contracts are available on equity stocks, indices, commodities and currency.

In options trading, you pay the premium for buying the rights to exercise your option. To take the buy or sell position on index and stock options, you are required to place a certain percentage of order value as margin money. An option can be a 'call' option or a 'put' option. A call option gives you a right to buy the asset at a given price or before a given future date. This 'given price' is called 'strike price'. Similarly, a 'put' option gives you a right to sell the asset at the 'strike price' to the buyer. Thus in an options contract, the right to exercise the option is vested with the buyer and the seller has only the obligation but no rights. Since the writer of an option bears the obligation, he is paid a price known as 'premium'.

TESTING THE UNTESTED

Before venturing into unknown waters, analysts advise that you must fully understand the implications arising out of trade in F&Os. "It is trading on margin with a leverage of four-six times. You should know that in leveraged trading, the market fall is magnified to the extent of the leverage availed by you. Understanding your risk appetite and risk tolerance is important in F&Os trading," says Sandeep Nayak, senior vice-president and head, private client dealing, Kotak Securities.

The golden rule — never trade anything that you don't understand — believe analysts, has a special significance for F&Os trading since the risk in them, with all the leverage and complexity, comes in multiple dimensions. "Unlike the cash market where your risk is limited to the amount you deploy, you can lose much more than what you've put in and in much more ways than a simple price move in the F&Os segment. Always think risk first and then think about returns," cautions Nilesh Shah, CEO of Ambit Capital.

According to Shah, a first-time investor must not trade in F&Os due to the associated risks. Only after having invested in stocks for over three years, an investor should try to become a trader. "However, you must start with very small ticket sizes initially and only once you've gained confidence about the nature and working of these instruments should you look to increase your ticket size. You should try to seek expert advice at least in the initial part of your trading journey," he feels.

Nayak, too, feels that a first-time investor trading in F&Os is akin to an individual trying to swim in the deep end of the pool on day one of swimming class.

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TIPS FOR A BEGINNER IN F&O TRADING

- **Start** small with capital which you are willing to lose entirely in the market
- **Do** dummy trades and maintain P&L records for 6-12 months before venturing out
- **Avail** the services of an experienced equity adviser
- **Trade** small in the cash market to gain experience because learning by experimenting can be expensive since the minimum trading lot size is high in the futures market
- **Always** have a trading strategy with an underlying view of the market. Trading strategies can go wrong, so you should be ready to book your losses quickly
- Market behaviour can be erratic or random. Hence, you must be prepared to emotionally withstand the mental stress involved

FUTURES

Example: On November 1, an investor feels the market will rise

- Buys one contract of November ABC Ltd futures at Rs 400 (market lot: 200)

November 12

- ABC Ltd futures price has increased to Rs 480
- Sells off the position at Rs 480. Books a profit of Rs 16,000 (200x80)

OPTIONS

Example: On November 1, an investor is bearish on the market

- Current Nifty is 2,980. You buy one contract (lot size 50) of Nifty

near month puts for Rs 20 each. The strike price is 2,940. The premium paid by you: (20x50) Rs 1,000. Your breakeven Nifty level is 2,920. If at expiration Nifty declines to 2,890, then

Put Strike Price 2,940

Nifty expiration level 2,890

Option value 50 (2,940-2,890)

Less: Purchase price 20

Profit per Nifty 30

Profit on the contract Rs 1,500 (Rs 30x50)

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