Futures Vs Options: A Guide for Novice Traders in the Derivatives Market

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ABSTRACT: *Investments into markets are subject to market risks, is a commonly known statement. Many people want to grow their money rapidly in a short span of their lifetime. The key emphasis is on individuals to keep looking for avenues to invest and multiply their money drastically. One such choice is investing in the derivatives market.*

This paper deals with key differences between futurestrading and options trading emphasis on payout, the risk to return, contract features, expiry, and initial investment required to trade in both Future derivatives and Options Derivatives.

KEYWORDS: Future Contracts, Options Contracts, Derivatives, Markets, Hedging, Risk management

INTRODUCTION:

Everybody in the world wants money for many things, and always has the greed to earn more and more with less time span. Various markets do offer such a wide scope to do so, need it to be the stock exchange, real estate or a business. The focus here is on understanding the derivatives market and its scope for a novice. A derivative is a security with a price that is dependent upon or derived from one or more underlying assets. Derivatives are classified in various ways. Based on the platform on which it is traded like OTC and through a clearing house, also classified as financial derivatives and Commodity Derivatives.When it comes to Feature and Options are financial derivatives which are traded through Clearinghouses. These are the derivatives where the trader needs knowledge before trading because the basic mechanism of trading is totally different from equity trading.

The benefit of trading in F&O trading is you required little amount to get a larger contract. Basically, for Future trading you pay 10% contract value, for example, if you want to buy a share of Rs 200/- thinking the price will go up within a month, in the derivatives market single quantities are not traded and hence lot size is preferred in trading, if the share lot size is of 1000 then contract value will be Rs 2,00,000/-. So just Rs 20,000/- (10% contract value) margin money is required to trade the same. Likewise in Options trading, you need to pay Rs.10/- as a premium for the above example and it will become 10*1000 = Rs.10,000/- Premium trade 2,00,000 Contract.

Key players in the market are Hedgers, speculators, and Arbitrages. Hedgers are the ones who safeguard their assets with hedging either by selling or buying, they need to protect their assets from price fluctuation, and most of the time they act as sellers in the market. Speculators are the one who has an eye on the market/price movement of underlying assets hence they take the advantage of less price for the larger contracts and try to earn a good amount from their knowledge, The third category of players is Arbitrages, who takes the advantages of price difference of same assets In in different markets and makes money with less risk, Basically, differences in price are extremely short lives and hence they help in restoring the price differences. Combinations of all these players makethe market more liquidity.

REVIEW OF LITERATURE:

Small funds required

(Clifford, 2013)In an article, the author found that over the past few decades small retail investors across the world prefer options trading as their priority compared to other investments. As small investors with very little funds prefer to invest in options trading which provides disproportionately higher profits and controls stocks that would otherwise be too exclusive to own. Options trading is tremendously dangerous, powerful and complex too, If not dealt with carefully. While planning to make money from options trading, the investors must have a thorough basic knowledge of the basics of options trading.

Definition

A derivative is defined by (Clement, 1995)as "a contract whose valuedepends on the price of underlying assets, but which does not require anyinvestment of principal in those assets. As a contract between twocounterparts to exchange payments based on underlying prices or yields, anytransfer of ownership of the underlying asset and cash flows becomesunnecessary".

Risk Management

The most significant goal that derivatives anticipate accomplishing is Risk management. Hence, It is defined as a process that comprises identification of the ideal risk level, identification of the existent risk level and transforming the actual (level achievable without derivatives) to the ideal level of risk. It is categorised within "hedging and speculation"(CFA, 2009)

The benefits of using derivatives?

Sufficient attention is given to derivatives among other investments with many ambiguities. And many investors have failed because of such ambiguities. There is a lot of speculation against derivatives as certain individuals argue for their use in specific cases in order to moderate certain losses. (Aalberts, 2006)

Risk

(Edward S Adams, 2000) in their article state that, Options contracts are more preferred in comparison to other kinds of derivative instruments, as they reduce the shortcoming risks without losing the upside potential. Comparatively, options contracts don't have obligations but hold the right to perform a specific transaction with other parties.

Futures contracts

(Eatwell, 1998)in their argument mention that futures contracts are standardised and should be traded on an organised exchange, with a centralised place for the traders of standardised contracts to trade. As it eases to close out a futures position than a forward position for the trader.

Futures contracts differ in that they are standardised and must be traded on an organised exchange, providing a central location where buyers and sellers of standardised contracts trade (General Accounting Office Report, 1994). Thus, it is easier for a trader to close out a futures position than a forward position (Eatwell, Milgate, and Newman, 1998).

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Hedging

(Edward S Adams, 2000)in their article state that hedging is one of the usages of these instruments, wherein a transaction involving it, objectively efforts to reduce the impact of economic losses because of variations in value, cash flow, price, the number of assets or liabilities, etc., (Dembeck, 1999). (Frederick, 1995)state that Economic risks can be reduced with the thorough use of negatively correlated investments by the means of hedging. (Goldman, 1995)state that "*It requires an end-user to identify specific business assets subject to price fluctuations and then to purchase derivatives that counteract the effects of a change in the price of those assets, thus ensuring compensating gains for losses caused by underlying market movements*".

Liquidity.

"Model Uncertainty and Liquidity" research conducted by (Bryan R. Routledge, 2009) of Carnegie Mellon University in 2001, mentions that there is a deficiency of liquidity and trade with extreme market outcomes, thus leading to market collapse and traders' dependency on several specific models as in case of derivative markets.

RESEARCH METHODOLOGY:

The study is purely based on secondary data by reviewing various research articles/papers.

OBJECTIVES OF THE STUDY:

- To give insight about Derivatives markets in India.
- To make a novice trader understand Features and Options.
- To differentiate between Future Trading and Option Trading.
- To suggest risk and return involved

Similarities in features between Future and Options.

Future and Options are Standardised Contracts in terms of contract value and payoff, this is the main reason or advantage behind trading in F & O rather than OCT.Liquidity is crucial for any kind of contract. In both Future and Options Trading lot of Buyers and sellers buys contract and sell contracts, hence anyone should not worry about the liquidity in F&O trading. Margin Payment is required to trade in the F&O market. It Is the amount required to sell or buy a contract. For Options, it is called Premium amount.A guarantor is one who acts as a mediator between buyer and seller and delivers the profit or losses to the concerned parties. Both Futures and Options are exchange-traded derivatives hence guarantee in terms of exchange of contracts either in profit or loses

Differences

Contract Cycle - Futures contracts have a maximum of 3-month trading cycle - the near month (one), the next month (two) and the far month (three).2. every week Thursday is the maturity day in future contracts, if it's a holiday then the previous day is the maturity day.Whereas in Options trading you can have weekly contracts, monthly contracts and yearly contracts, you find more liquidity in nearer contracts. It is also termed as weekly expiry and monthly expiry, which is going to expire every Thursday, if it's a holiday then the previous day is the expiry day.

Pricing: to have a future contract for both buyer and seller needsthe same amount as *initial margin money*, which is changing on daily basis as the price of the contract changes daily, margin money can be wiped out if the price of the contract moves in one direction for few days, to protect from this situation a concept called *maintenance margin* is fixed which is about 75% of the margin money. Once it crosses the limit trader will get a *margin call*i.e.,the trader must deposit money to make it equal to the initial margin. For an option,the contract buyer has to pay just a premium amount and the seller must have a lot of margin money or asset holding.

Obligation:in future contracts, you are obligated to purchase the asset on the maturity date whereas in options buyer has a right, but not the obligation. i.e., when the buyer is under loss, he has a choice to terminate the contract with a loss of the premium paid.

PayOff: In futures contracts, the buyer's gain is the seller's loss and the seller's gain arebuyer's loss, it is also called a zero-sum game.

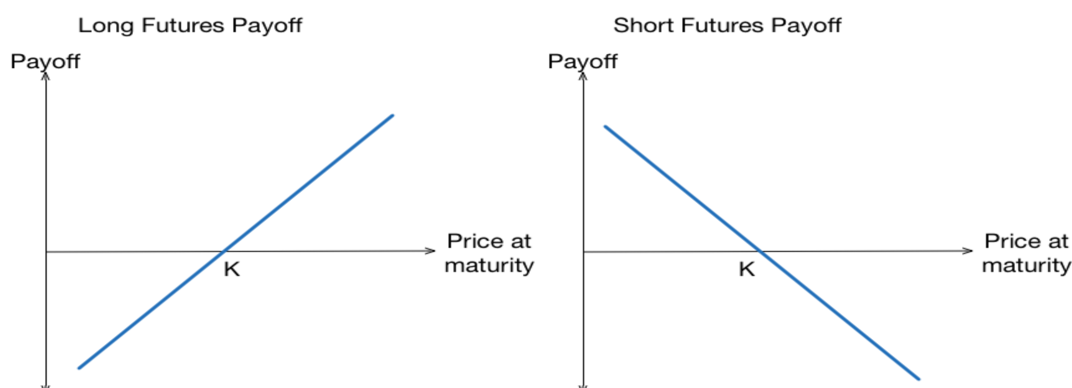

Image Source: (Forward contract, 2022)

In options, buyers gain is unlimited, and loss is limited amount paid as premium. For sellers gain is limited to option premium received and loss in unlimited. To buy a option contract buyer need an amount equal to the premium paid and to sell a options contracts one should have the required quantity of shares or a huge amount.

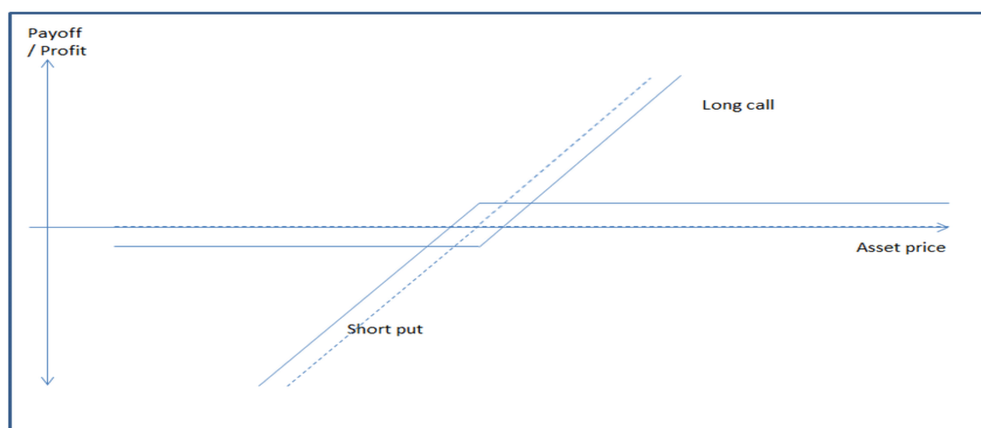

Image Source: (Anton Biebuyck, 2014)

Strategies: Strategies are the number of ways how one can go ahead with the risk vs return. These strategies also categorised High, medium, low risk vs high, medium, low Rewards strategies, usually high risk has high returns and vice versa.

Comparing the future trading strategies are less in number compared to Options strategies, because the difference in payoff and Options has Call Put option writers and call put buyers.

CONCLUSION*:*

Derivatives trading has a different mechanism of trading, one should have prior knowledge before trading, even though Future trading and Options Trading is termed as F&O derivatives trading, they have some key differences. Strategies used in both trading have different payoffs and risk rewards. Upon Comparing both the derivatives,It is concludedthat Futuresare easy to understand and Options are difficult to understand, but in terms of trading outcome and payoff, futures have no futures and Options have plenty of options.

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