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Hedging Strategy Influencing Derivative Investment on Investors

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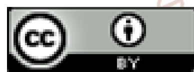

ABSTRACT

The paper titled "Hedging Strategy influence Derivative Investment on Investors". Generally Speaking in India Derivative contracts have not been majorly focused by investors, because of certain myths in the minds of people. Therefore Derivative Investment is not taken largely as on investment option by Individual investors.

Many authors stated that derivative market is the marketplace in which traders come to exchange risks. In worldwide economy with divergent hazard exposures, derivatives permit businesses and traders to defend themselves from rapid price fluctuations and negative events.

The aim of the article is to identify the major risk and hedging strategy in derivative market. In Derivative Contracts as a high risk that are Market risk, Liquidity risk, Credit risk, Counterparty risk, Legal risk and Transaction Risk. Pricing risk and systematic risk is also very important. Derivative investor must analyze the market and make the decisions while trading this will undergoes the uncertainty. Derivatives plays a major role for minimizing the risk involved in the marking an investment in futures contracts by expecting to get good result. The investors should also invest in options contracts which help to reduce the risk by use of hedging strategy. Hedging strategy is used for reducing the risk and maximization of profits. Though the futures contracts are subjected to high level the loss can be reduced to an extent by using the hedging strategy

Keywords: *Hedging Strategy, Risk in Derivatives*

Introduction

Most of the investors who hedge to use derivatives in order to reduce their risk on their investment. These are economic contracts that derive their value from an underlying actual asset, including an inventory. An Option is the maximum typically used Derivative. It offers you the proper to buy or sell a stock at a unique price inside opening a limited duration.

Hedging is buying or selling futures contract as safety in opposition to the threat of loss because of changing value within the cash market. If you are feeding monopolize to marketplace, you want to guard in opposition to falling value in the cash market. If you need to buy for feed grain, you want to shield in opposition to growing value within the cash market.

In Derivative markets, any trader may be in a long or a short role. In a long role, the dealer has a requirement to sell any asset at the future date, while in a short role; the trader needs to buy the asset at the future date. The New popular tools are known as financial derivatives which now not best decrease financial threat but additionally open new possibility for high risk takers. As Derivative is an economic tool of risk management, these generally do not influence the fluctuation within the underlying asset cost. However, by way of locking-in asset value, derivative products minimize the effect of fluctuation in asset value at the profitability and cash flow scenario of hazard-averse investors. Derivatives are utilized by different buyers with exceptional purposes to hedge the danger bobbing up from the investments made on the underlying asset to speculate on the underlying asset and gain from fee fluctuations, for arbitrage, or to create artificial products. These also are used to make investment strategies for safe and hazard –unfastened investment.

Review of Literature

Morteza Nagahi, Mohammad Nagahisarchoghaei, Nadia Soleimani and Raed M Jaradat (2018): These authors conclude that the connection between hedging and dividend yield inside the proposed version is negative. The identical analysis conducted for Indian organizations has proven that there is no statistically vast explanatory variable for hedging; therefore, it is not dependent on any of the predicted theories of hedging. On the other hand, we find a few huge relationships between firms' features. Large Indian companies use inner hedge strategies instead of marketplace techniques, along with derivatives. The derivative marketplace improvement then should play a major position in phrases of hazard management of firms throughout international locations.

Fazal M. Mahomed (2017): The overview results emphasize the want for combining futures hedging and options hedging, and it additionally shows that implementing background risk, whether it is additive or multiplicative, continually has a notable effect on the hedging efficiency. He additionally presents a few sensitivities of the relevant parameters to offer some tips for the investors.

Diskshista Wadhawan and Harjit Singh (2015): These authors will recognition on getting tool rated with options trading and selling angle, so one can make investor handle any approach situation and hedge the hazard with a view to benefit precise rewards. This will also guide the investor to determine the threat reward ratio, previous to access inside the alternate. Options buying and selling can be taken to subsequent level with the help of information of Greeks and their Hedging strategies.

Sathya. S (2015): This review deal with the risk premium of equity is basically same as commodity, equity return are negatively correlated with commodity return and currency return of derivatives is used for hedging reason. The risk top rate of equity (5.65) extra excessive examine with commodity (5.23) and currency (2.22) so it is suggested that the risk avoids may additionally invest on equity, commodity and foreign money derivatives combos.

Gunjan Tripathi (2014): He attempts to understand the profile of retail buyers dealing in derivative trading, to recognize the various purpose for which the traders are the use of these securities in system of preference, popularity of a specific derivative security out of overall set and motives for no longer making an investment by way of a few traders. He reveals that education; profession and gender do not impact the derivative investing conduct; however income is located to have an extensive impact on derivative investment.

Raimonda Martinkute-Kaulience (2014): He says that market hazard is the most major type of risk that in many situations affects the extent of remaining risk. Market hazard happens when the investor misjudges the market direction, counterparty risk occurs when misjudgement refers back to the business partner. Some risks exist dispute the employment of derivatives.

Varvara Nazarova (2014): In their survey entails reading the ultra-modern strategies of hedging financial options, comparing and contrasting the brand new techniques with those historically used in the financial industry, and examines the possibilities for applying methods of imperfect hedging at the Russian forward market.

Shaik Mahaboob Basha (2013): In these Survey objectives to don't forget its effectiveness in financial risk management in project finance region and whether the concern over its use nowadays is justifiable. Delays in finishing touch would involve extra interest payments and the extension of reimbursement time. Also, as electricity is a critical application, the host government many impose penalties for delays.

Ravichandran. K. Dr (2008): A Survey turned into undertaken to find out the awareness stage of numerous capital market instruments and additionally to discover their hazard preference in numerous segments.1) Preference level of buyers on different capital market place tools. 2) The form of risk which might be taken into consideration by way of the investors. 3) The approaches via which the buyers on various minimizes their hazard 40 to discover the preferences of investor in derivatives market.

Peter Paul Carr and Dilip Madan (1999): According to these authors this optimal derivative contracts are written on successive rate relatives, paying a characteristic of these relatives, ones constantly through time. For statistical volatilities under risk-neutral ones, they show that the most optimal derivative contract for intermediate levels of hazard aversion is collar that finance drawback protection by using disposal off upside gain.

Statement of Problem

Hedging Strategy influence derivative are seen as a pathway to those who wish to earn quick money. It is understood that the relative high risk factors involved in derivative securities Contracts leads to more chances of losing money and facing losses while trading with derivative contracts because of high market volatility and non stability conditions. The investor to the contract need to study the market well and should understand the market fluctuations of the same and invest the amount at right time and trade carefully to minimize the losses this can be done by using hedging strategy. Therefore the study of derivative trading strategy becomes very important to an investor.

Objective of the Study

1. To know the risk factors affecting to the derivative investors.
2. To analyse and present the classification of risk actual to derivative securities.
3. To Study the various investment avenues and the investors risk preference, and
4. Approach it.

Methodology

Data for this study is purely based on secondary sources such as books, journals,
Articles and also internet.

Analysis

The key assumption of the Hedging strategy on derivative securities theories is that investors who participant in derivative securities or financial market are risk factor, derivative security, futures contracts and options contracts who are in turn investing in derivatives with the major objective or target is profit maximization. If to glance through the records, contemporary financial derivatives have been to be had for more than a century, but the fundamental elements of derivative contracts were available for Millennia. Some parts of derivatives contracts were already found in Babylon (1800 BC), in ancient Japan futures on rice have been usually traded in 1740 (Scalcione, 2011). Elements of derivatives have also been observed in historical textbooks in Greece. The description of the first speculative method using factors of derivatives was brought within the work of Aristotle. Origins of derivative contracts have been analysed via many authors (Hung et al., 2011; Carruthers, 2013; Miffre and Brooks, 2013). All of them emphasize that derivative securities from the start have been at first used to hedge commodities merchandise including agricultural manufacturing and metals. Raimonda Martinkute-Kauliene

(2014) the evaluation led to the realization, that important hazard real to derivatives contracts and their buyers are market risk, liquidity risk, credit and counterparty risk, legal risk and transactions risk. Pricing threat and systemic risk is also quite major. Market hazard occurs whilst the investor is wrong approximately the market and counterparty risk takes place while he's right about the market course, but wrong about whom to do business enterprise with. Some kind of risk are highly applicable for hedgers, some of them are highly relevant for speculators. Some risk is not unusual for all kinds of derivatives. Risk of derivative contracts may be related with the subsequent factors: foremost characteristics of contracts, trading conditions, role taken in the contract, complexity of the contract. Financial derivatives are vital equipment that can help organizations meet their unique risk-control targets. It is important that the user is aware the capabilities and the essential safety precautions before the usage of derivatives in his hazard management method.

The concept of the hedging financial options has enabled the compilation of a running type of the primary thrust of foreign research into the methods of the imperfect hedging of monetary alternatives. Varvara Nazarova (2014) analysed that methods of the imperfect hedging of financial options reduce the price of the hedging portfolio with the aid of virtue of feasible losses. And also he analysed that quintiles hedging method has certain drawbacks. The methods of imperfect hedging which will defend towards financial hazard, it is better to apply the expected-shortfall method, insofar as this method takes into account each the probability of feasible losses in addition to their amount. In his course of observe he constructed the algorithm for the implementation of hedging method in keeping with strategies of the imperfect hedging of monetary options: Step 1. Identification of the structure of a hit hedging set primarily based on alternative type and parameters inclusive of volatility, common growth rate and the financial institution interest fee. Step 2. Determination of hedging method payout in the hedging approach set. Step 3. Selection of the method of replication for hedging method payouts. Ravichandran. K. Dr (2008). He made descriptive studies in Chennai city pattern of approximately 100 he accrued. He concluded through indicating that evaluation forecast accuracy extended and that sudden earning has been integrated into next earnings forecasts to a more volume. Subsequent to disclosure of sustained hedging interest. Additionally, his findings suggest an increase inside the profits go back relation inside the hedging activity duration. From the demographic elements it is located most of the traders are of age 31-40 and more often than not entrepreneurs and operating executives, so the establishments dealing in capital marketplace can take these factors and broaden appropriate attract for them and entice them to make investments more in capital markets. He additionally based that the buyers are making an investment up to 10% for their income on numerous investments and also they said that the marketplace risk and the credit hazard are the 2 important parameters they look in to before making an investment.

Sathya. S (2015) noticed on this theory the risk and return associated with derivatives used in equity, commodity and currency market in India. They locate the average and Standard deviation to get right of entry to the risk and return aspect and additionally comparative tool for correlation evaluation were used discover relationship among risk and return. She interpreted the risk premium of equity (5.65) is essentially similar to commodity (5.23) and double the forex (2.22). The return of equity (0.93) is basically the same as commodity (0.89) and single time excessive in foreign money (0.64). Holding duration extra than 5 years the return of equity (-0.25) and commodity (-0.42) is negatively correlated but currency (0.45) is positively correlated. In the have a look at has been to investor examined among various kinds of derivatives for reducing threat and growth the return. This is essential if one desires to recognize the determinants of use of every form of derivatives, because of the truth that buyers of derivatives regularly use more than 1 sort of derivatives. The results suggests negatively correlated with equity, commodity, and currency returns. Morteza Nagahi, Mohammad Nagahisarchoghaei, Nadia Soleimani and Raed M Jaradat (2018) the author's studies, data turned into gathered for the top 30 firms situated and looked after by capital market share in USA and India throughout 2012-2013. After the use of regression procedures, five fundamental variables were elicited for the firm features which include company profitability, growth opportunities, size, leverage, and ownership concentration. The average standard deviation and coefficient of version for all of characteristics factors for both nations were calculated. The proof primarily based on multivariate empirical relation between hedging in American firms and firm's characteristics gives one support for profitability proxy measured with the aid of dividend yield. It has been showed that hedging relies upon on dividend yields within the US firms. They finish that the relationship between hedging and dividend yield inside the proposed model is negative. It means that firms with greater dividend yield are more likely to have less incentive to engage in risk-shifting and hedging. Consequently, a firm with higher profitability (dividend yields is a proxy for profitability) could put money into a proper position and foremost company operation greater, so it reduces hedging activity.

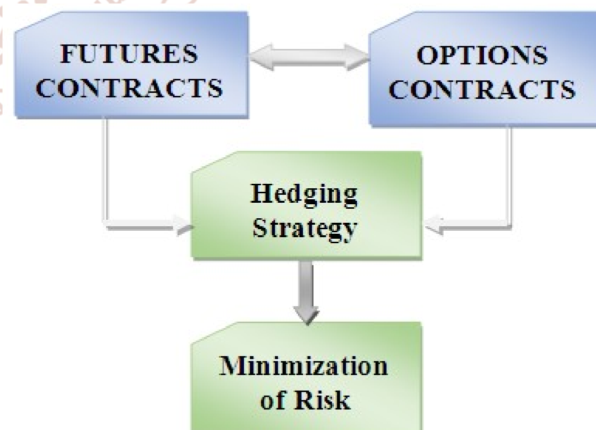

Figure 1: Conceptual Model of Hedging Strategy in Derivatives

The above figure mentions that hedging strategy stated certain theories for derivative investment on investors analyzing the situations where individuals must make decisions without knowing which outcomes may result from that decisions which is taken under uncertainty. The investors should analyze the risks such as market risk, liquidity risk, credit and counterparty risk, legal risk and transactions risk. Pricing risk and systemic risk is also very important. Market liquidity risk refers to situations while a

market player may not be able to exit or offset positions quickly, and in sufficient quantities, at a reasonable rate. Credit risk occurs in all transactions traded within the market. It is an important element in the array of risks facing the derivatives broker and the derivatives end user. This risk implies that one party may also default at the contract. The risks that counterparty in a derivatives settlement will not satisfy its responsibilities under the contract. Insufficient or unfit documentation, insufficient capability or authority of counterparty, illegality of a contract, can cause another kind of risks. Legal risk presents in all financial activities, including traditional lending and buying and selling undertakings and it takes on added importance within the context of derivatives transactions because they are relatively novel and complicated. Derivatives acts as a main tool for minimize the risk involved in making an investment in futures contracts for getting the excellent outcomes out of it. The investors should be aware of the options contracts with the aid of hedging strategy, which and be used for reducing the risk. Awareness about the various uses of derivatives can help traders to minimization of risk and maximization of profits. Though the futures contracts are subjected to high risk the loss may be minimized to an extent by using the hedging strategy.

Conclusion

Generally speaking in India Derivative contracts have not been majorly focused by Investors, because of certain myths in the minds of people. Therefore investment is not taken largely as on investment option by individual investors. Derivatives essentially have a high level of manage; therefore, a small value change can result in causes to profits or losses. This could make derivatives appear unattractive. It becomes certain risky for any investors, when derivatives are used without sufficient knowledge of its application and the extent it can be used.

The analytical shows that Derivative investors should analyze the market situations and must make decisions, without knowing which outcomes may result that decision which is taken under uncertainty. In spite of the purpose to hedge from risks, derivative contracts are risky as every financial activity in the market. The main risk in derivatives is market risk, liquidity risk, credit and counterparty risk, legal risk and transactions risk.

Derivatives plays a major role for reducing the risk involved in making an investment in futures contracts for getting the excellent result. The investors should use the options contracts which help the hedging strategy, used for reducing the risk and maximization of profits. Though the futures contracts are subjected to high level the loss can be reduced to an extent by using the hedging strategy.

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