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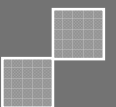
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COMPARATIVE ANALYSIS OF CASH MARKET AND DERIVATIVE MARKET***Dr. Keyur M Nayak****ABSTRACT**

The study aimed to analyze the comparison between cash market and derivatives. The study also attempts to provide the insight on the hedging tools in the hands of Indian investors. The cash market is a commodities or securities market in which goods are sold for cash and delivered immediately. Contracts bought and sold on these markets are immediately effective. Cash markets can operate wherever the infrastructure exists to conduct the transaction. The spot market for most securities exists primarily on the Internet. Derivatives are the most dynamic, complex and multifaceted products in the modern financial management. They offer risk transfer facility for hedgers, give leverage to do more turnover for speculators, help the market players to cash the arbitrage opportunities between cash and Future and Options, among future and options segment. It is a product whose value is derived from the value of one or more basic variables, called bases (underlying asset, index, or reference rate), in a contractual manner. The underlying asset can be equity, forex, commodity or any other asset. The price of this derivative is driven by the spot price of the “underlying”. The research methodology to be followed is the Descriptive study and Exploratory Study. The data used in this is both primary and secondary type. The method of primary data collection is with the help of a Structured Questionnaire.

Keywords: Cash Market, Underlying Assets, Derivatives, Hedgers, Forex, Commodity

INTRODUCTION

The cash market is a commodities or securities market in which goods are sold for cash and delivered immediately. Contracts bought and sold on these markets are immediately effective. Cash markets can operate wherever the infrastructure exists to conduct the

transaction. The spot market for most securities exists primarily on the Internet.

Financial innovation that led to the issuance and trading of derivative products has been an important boost to the development of financial markets. While the benefits stemming from

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the economic functions performed by derivative securities have been discussed and proven by academics, there is increasing concern within the financial community that the growth of the derivatives markets - whether standardized or not - destabilizes the economy.

So now the question arises, do Indian investors need futures trading? If trading in index futures is advocated on the basis of hedging needs of investors, one must assess the market demand and supply source for trading in the market risk before introducing the index futures.

The desirability of successful derivatives, such as futures trading, depends crucially on the solidity and maturity of cash markets in underlying securities. To make cash markets robust and effective, first let us put in place the mechanism of margin trading, short sale, dematerialized settlement and electronic transfer of funds among market participants.

OBJECTIVES OF THE STUDY

- ✓ The study attempts to provide the insight on the hedging tools in the hands of Indian investors.
- ✓ To study the different Future and Option strategies and applying those strategies by using different underlying
- ✓ To find out the investors' perception on derivatives and cash market

LITERATURE REVIEW

Cash Market

The cash market is a buying strategy in which the buyer makes an immediate payment that is equal to the current market price for commodities and other types of securities. Upon the receipt of the payment, the seller relinquishes all claims to the property and bestows ownership upon the buyer. In a sense, any type of retail transaction such as the purchase of groceries could be considered a cash market, as the goods are received by the buyer upon rendering a cash payment for the products.

One of the characteristics that sets the cash market apart from a futures market is this immediate satisfaction and transfer of ownership. Futures markets involve a longer period for the transaction to be considered complete. With a cash market, the investor immediately assumes ownership and is free to do with the commodity or security as he or she wishes. While both approaches are capable of helping an investor realize a return on an investment, the cash market approach may offer a level of speed and excitement that will attract investors who prefer to be constantly on the move with the investment portfolio.

WITH the SEBI board giving clearance for adding more securities in the derivatives segment, trading volumes are expected to overtake the cash market, stock brokers and analysts said.

Traditionally the cash contract has consisted of a producer entering into a contract with a specific buyer (local elevator or meat packer). The producer promises to deliver a specified quantity by some future date for an agreed upon price. Since the contract is a legal and binding instrument, the contract sale is generally final and actual delivery is the normal route by which the producer fulfills his commitment.

Generally a contract will contain some provisions for a financial settlement if the producer is unable to make delivery.

Uses of Equity Derivatives

In November '96 a committee under the chairmanship of L.C Gupta was appointed by the Securities and Exchange Board of India, to develop appropriate regulatory framework for derivatives trading in India. The Committee made an assessment of the nature of felt-need and interest in the various types of financial derivatives among potential market participants through a Questionnaire-based survey. The survey covered all types of potential players in the derivatives market, such as

mutual funds, other financial institutions, commercial banks, investment bankers and stockbrokers (Shah & Thomas, 1998).

In addition, the Committee held a fully day session to interact with groups representing each of the above categories of interests. A total of about 35 persons attended the group-wise discussions (Rajendra Chitale, 2003).

- There was wide recognition of the need for all the three major types of financial derivatives, viz., equity derivatives, interest rate derivatives and currency derivatives. The results of the survey are summarized in Table 1 given at the end of this chapter.
- Interestingly, the survey findings showed that stock index futures ranked as the most popular and preferred type of equity derivative, the second being stock index options and the third being options on individual stocks. Considerable interest exists in all the three types of equity derivatives mentioned above. The fourth type, viz., individual stock futures, was favoured much less.
- The survey also showed that there exists widespread demand for hedging facility, as indicated by the finding that nearly 70% of the respondents in the sample indicated that they would like

to use the various types of equity derivatives for hedging purpose.

- In terms of contract duration of Stock Index futures and options, the 3 months duration was the most favoured, as may be expected. As regards the choice between the American and European types of options, the former was favoured overwhelmingly.
- As regards expectations of growth of stock index futures and options trading in India, about 33% of respondents expected it to grow very fast, 41% expected it to grow moderately and the remaining 16% expected slow growth of trading. On the whole, the survey findings were very positive about the need and prospects of equity derivatives trading in India.

RESEARCH METHODOLOGY

Methodology:

The research methodology to be followed is the Descriptive study. The data used in this study is both primary and secondary type. The method of primary data collection is with the help of a Structured Questionnaire. The population is the Investors of futures and option segment in south Gujarat Region. The secondary Information is collected from various Books, Databases and Web sites.

Sample size:

The sample size for collecting the primary data from the investors is 50. The sample size of 50 Investors were chosen from the universe. The Convenience random sampling approach was adopted in the selection of the sample. Accordingly this method was utilized for collection of information. For future and option strategies the most active stocks were selected from the 52 stocks and 2 Indices available for trading in the future and option segment of NSE.

The questionnaire consists of 19 questions which were carefully designed and revised according to the study. The questionnaire consists of the following type of questions.

- Closed End Questions
- Open End Questions
- Multiple Choice Questions

Frame work of analysis

Analysis of Data was done very carefully. The data collected for the study were processed using Percentage Analysis. The other tools were found necessary were also used for the research. Tables on the basis were constructed to summarize the data for easy interpretation. This percentage analysis as a statistical technique was utilized for arriving at valid and reliable conclusion.

DATA ANALYSIS AND INTERPRETATION

1. Age group

Table (1):

Age	Total	% of Respondents
<30 Years	23	46%
30 - 40 years	17	34%
40 - 50 Years	5	10%
50 - 60 years	2	4%
> 60 years	3	6%

Inference:

Out of the total respondents 46% were of less than 30 years age, 4% were between 50-60 years.

2. Education

Table (2):

Education	Total	% of Respondents
U.G.	15	30%
P.G.	28	56%
Others	7	14%

Inference:

Out of the total F&O Investors 56% were Post Graduates, 14% did other courses.

3. Occupation:

Table (3):

Occupation	Total	% of Respondents
Business	9	18%
Employee	34	68%
Professional	7	14%
Others	0	0%

Inference:

Out of the total F&O investors 68% of the respondents were Employees, 14% were professionals.

4. Average monthly investible income

Table (4):

Average Monthly Investible Income	Total	% of Respondents
<Rs 10000	34	68%
Rs 10000 - 20000	7	14%
Rs 20000 - 30000	3	6%
> Rs 30000	6	12%

Inference:

Out of the total F&O Investors 68% of the total respondents had their average monthly investible income of less than Rs.10, 000; 6% had the average monthly investible income in the range of Rs. 20, 000 – 30, 000.

5. Current Investment Distribution

A) Fixed income:

Table (5):

Fixed income	Total	% of Respondents
0-25%	33	66%
25-50%	11	22%
50-75%	6	12%
75-100%	0	0%

Inference:

Out of the total F&O Investors, 66% of the respondents were investing (0-25%) of their AMII in fixed income securities. 12% of the respondents were investing (50 – 75%) of their AMII in fixed income securities.

B) Mutual Funds

Table (6):

Mutual Funds	Total	% of Respondents
0-25%	38	76%
25-50%	12	24%
50-75%	0	0%
75-100%	0	0%

Inference:

Out of the total F&O Investors, 76% of the respondents were investing (0-25%) of their AMII in Mutual Funds. 24% of the respondents were investing (25 – 50%) of their AMII in Mutual funds.

C) Equity

Table (7):

Equity	Total	% of Respondents
0-25%	3	6%
25-50%	21	42%
50-75%	6	12%
75-100%	20	40%

Inference:

Out of the total F&O Investors, 42% of the respondents were investing (25 – 50%) of their AMII in Equities. 12% of the respondents were investing (50 – 75%) of their AMII in Equities.

Table (8):

others	Total	% of Respondents
0-25%	50	100%
25-50%	0	0%
50-75%	0	0%
75-100%	0	0%

Inference:

Out of the total F&O Investors, 100% of the respondents were investing (0-25%) of their AMII in other investments.

6. Distribution of Equity Investments

A) Intra Day:

Table (9):

Intra day	Total	% of Respondents
0-25%	45	90%
25-50%	3	6%
50-75%	2	4%
75-100%	0	0%

Inference:

Out of the total F&O Investors, 90% of the respondents were investing (0-25%) of their Equity investment in Intra Day trading. 4% of the respondents were investing (50 – 75%) of their Equity investment in Intra Day trading.

B) Short term (< 3 months)

Table (10):

Short term (<3 months)	Total	% of Respondents
0-25%	23	46%
25-50%	14	28%
50-75%	6	12%
75-100%	7	14%

Inference:

Out of the total F&O Investors, 46% of the respondents were investing (0-25%) of their Equity investment in short term Investments. 12% of the respondents were investing (50 – 75%) of their Equity investment in short term Investments.

C) Equity Medium term

Table (11):

Medium Term(3-6 months)	Total	% of Respondents
0-25%	36	72%
25-50%	14	28%
50-75%	0	0%
75-100%	0	0%

Inference:

Out of the total F&O Investors, 72% of the respondents were investing (0-25%) of their Equity investment in medium term Investments. 28% of the respondents were investing (25 – 50%) of their Equity investment in medium term Investments.

D) Equity long Term

Table (12):

Long term (>6 months)	Total	% of Respondents
0-25%	30	60%
25-50%	12	24%
50-75%	6	12%
75-100%	2	4%

Inference:

Out of the total F&O Investors, 60% of the respondents were investing (0-25%) of their Equity investment in Long term Investments. 4% of the respondents were investing (75 – 100%) of their Equity investment in Long term Investments.

7) Distribution in Equity Investments

A) Cash Market

Table (14):

Cash Market	Total	% of Respondents
0-25%	2	4%
25-50%	8	16%
50-75%	18	36%
75-100%	22	44%

Inference:

Out of the total F&O Investors, 4% of the respondents were investing (0-25%) of their Equity investment in Cash Market. 44% of the respondents were investing (75 – 100%) of their Equity investment in Cash Market.

B) F&O Segment

Table (15):

Derivatives	Total	% of Respondents
0-25%	22	44%
25-50%	18	36%
50-75%	8	16%
75-100%	2	4%

Inference:

Out of the total F&O Investors, 44% of the respondents were investing (0-25%) of their Equity investment in F&O Segment. 4% of the respondents were investing (75 – 100%) of their Equity investment in F&O Segment.

8) Experience

Table (16):

Experience in Equity Investment	Total	% of Respondents
<1 Year	24	48%
1-5 Years	20	40%
5-10 Years	3	6%
>10 Years	3	6%

Inference:

Out of the total F&O Investors 48% of the respondents had less than 1 year experience; 6% of the respondents had experience in the range of 5 – 10 Years experience in equity investment.

9) Investment in Derivatives

Table (18):

Investment in Derivatives	Total	% of Respondents
Only in Futures	8	16%
Only in Options	5	10%
Combination of the two	37	74%

Inference:

Out of the total F&O Investors 10% of the total respondents were investing only in options; 74% of the total respondents were investing only in both futures and options.

10) The preferred type in options

Table (19):

The preferred type in Options	Total	% of Respondents
Call	27	54%
Put	4	8%
Both	19	38%

Inference:

Out of the total F&O investors 54% of the respondent's preferred type in options was Call; 8% of the respondent's preferred type in options was put.

11) The preferred Underlying

Table (20):

The preferred underlying in Derivatives	Total	% of Respondents
Index	12	24%
individual stock	15	30%
Both	23	46%

Inference:

Out of the total F&O investors 24% of the respondent's preferred underlying was Index; 46% of the respondents preferred both Index and Individual stock as underlying in the derivative contracts.

12) The preferred position in derivatives

Table (21):

The preferred position in derivatives	Total	% of Respondents
Buyer	29	58%
Seller	4	8%
Both	17	34%

Inference:

Out of the total F&O investors 58% of the respondent's preferred position was to be a buyer; 8% of the respondent's preferred position was to be a seller.

13) Factors to be considered before taking investment decision

Table (22):

Factors to be considered before taking investment decision	Total	% of Respondents
Company fundamentals	30	60%
daily price fluctuations	10	20%
Affordable closing price	0	0%
News /Rumours	10	20%

Inference:

Out of the total F&O investors 60% of the respondents were considering company fundamentals; 20% of the respondents were considering daily price fluctuations; 20% of the respondents were considering News/rumors before taking investment decisions.

14) Persons to be consulted before taking investment decisions

Table (23):

persons to be consulted before taking investment decision	Total	% of Respondents
Family members	0	0%
Friends & Fellow investors	26	52%
Brokers	16	32%
self	8	16%

Inference:

Out of the total F&O investors 52% of the respondents were consulting friends and fellow investors; 32% were consulting brokers before taking investment decisions; 16% were taking decisions on their own.

15) Sources of information

Table (24):

Sources of information	Total	% of Respondents
News Papers & Other Print Media	13	26%
T.V & other electronic media	11	22%
Trading terminal & Brokers tips	26	52%

Inference:

Out of the total F&O investors 22% of the respondents' sources of information were T.V. and other Electronic media; 52% of the respondents' sources of information were trading terminal and broker's tips.

16. Factors influenced to trade in cash market

Table (25):

Factors influenced to trade in cash market	Total	% of Respondents
Claim of ownership	3	6%
Eligible for all benefits due to corporate action	12	24%
Availability of large number of Scrips	19	38%
Broker's advice	16	32%
Others	0	0%

Inference:

Out of the total F&O investors 6% of the respondents were investing in Cash market for the claim of ownership and have long term outlook on the stock 38% of the respondents due to the availability of large number of scrips; 32% of the respondents due to the brokers advice.

Factors influenced to trade in Equity derivatives market

Table (26):

Factors influenced to trade in Equity derivatives market	Total	% of Respondents
Leverage to do more turnover	23	46%
limited loss	11	22%
Risk transfer	7	14%
Broker's advice	9	18%
Others	0	0%

Inference:

Out of the total F&O investors 46% of the respondents were trading in derivatives due to the leverage to do more turnover (Speculators); 22% due to limited loss, 14% for risk transfer (36% hedgers); 18% due to brokers advice.

FINDINGS

Major Findings

1. Out of the total respondents 46% of them are of less than 30 years age, 4% of them are between 50-60 years.
2. Out of the total F&O Investors 56% are Post Graduates, 14% did other courses.
3. Out of the total F&O investors 68% of the respondents are Employees, 14% are professionals.
4. Out of the total F&O Investors 68% of the total respondents has their average monthly investible income of less than Rs.10, 000; 6% has the average monthly investible income in the range of Rs. 20, 000 – 30, 000.
5. Out of the total F&O Investors, 66% of the respondents are putting (0-25%) of their AMII in fixed income securities. 12% of the respondents are putting (50 – 75%) of their AMII in fixed income securities.
6. Out of the total F&O Investors, 76% of the respondents are putting (0-25%) of their AMII in Mutual Funds. 24% of the respondents are putting (25 – 50%) of their AMII in Mutual funds.
7. Out of the total F&O Investors, 6% of the respondents are putting (0-25%) of their AMII in Equities. 42% of the respondents are putting (25 – 50%) of their AMII in Equities..
8. Out of the total F&O Investors, 100% of the respondents are putting (0-25%) of their AMII in other investments.
9. Out of the total F&O Investors, 90% of the respondents are putting (0-25%) of their Equity investment in Intra Day trading. 4% of the respondents are putting (50 – 75%) of their Equity investment in Intra Day trading.
10. Out of the total F&O Investors, 46% of the respondents are putting (0-25%) of their Equity investment in short term Investments. 12% of the respondents are putting (50 – 75%) of their Equity investment in short term Investments.
11. Out of the total F&O Investors, 72% of the respondents are putting (0-25%) of their Equity investment in medium term Investments. 28% of the respondents are putting (25 – 50%) of their Equity investment in medium term Investments.
12. Out of the total F&O Investors, 60% of the respondents are putting (0-25%) of their Equity investment in Long term Investments. 4% of the respondents are putting (75 – 100%) of their Equity investment in Long term Investments.

13. Out of the total F&O Investors, 4% of the respondents are putting (0-25%) of their Equity investment in Cash Market. 44% of the respondents are putting (75 – 100%) of their Equity investment in Cash Market.

14. Out of the total F&O Investors, 44% of the respondents are putting (0-25%) of their Equity investment in F&O Segment. 4% of the respondents are putting (75 – 100%) of their Equity investment in F&O Segment.

15. Out of the total F&O Investors 48% of the respondents have less than 1 year experience; 6% of the respondents have experience in the range of 5 – 10 Years; 6% of the respondents have experience in the range of above 10 Years experience in equity investment.

16. Out of the total F&O Investors 10% of the total respondents are investing only in options; 74% of the total respondents are investing only in both futures and options.

17. Out of the total F&O investors 54% of the respondent's preferred type in options is Call; 8% of the respondent's preferred type in options is put; 38% of the respondents preferred type in options is both call and put.

18. Out of the total F&O investors 24% of the respondent's preferred underlying is

Index; 30% of the respondent's preferred underlying is Individual stock; 46% of the respondents preferred both Index and Individual stock as underlying in the derivative contracts.

19. Out of the total F&O investors 58% of the respondent's preferred position is to be a buyer; 8% of the respondent's preferred position is to be a seller; 34% of the respondents preferred position is to be both as buyer and seller.

20. Out of the total F&O investors 60% of the respondents are considering company fundamentals; 20% of the respondents are considering daily price fluctuations; 20% of the respondents are considering News/rumors before taking investment decisions.

21. Out of the total F&O investors 52% of the respondents are consulting friends and fellow investors; 32% are consulting brokers before taking investment decisions; 16% are taking decisions on their own.

22. Out of the total F&O investors 22% of the respondents' sources of information are T.V. and other Electronic media; 52% of the respondents' sources of information are trading terminal and broker's tips.

23. Out of the total F&O investors 6% of the respondents are investing in Cash

market for the claim of ownership and have long term outlook on the stock; 24% of the respondents to get the eligibility for all benefits due to corporate action; 38% of the respondents due to the availability of large number of scrips; 32% of the respondents due to the brokers advice.

24. Out of the total F&O investors 46% of the respondents are trading in derivatives due to the leverage to do more turnover (Speculators); 22% due to limited loss, 14% for risk transfer (hedgers); 18% due to brokers advice.

25. There is a significance difference between current investment distribution in equity and factors influenced to trade in derivatives market.

26. There is a significant difference between Occupation and factors influenced to trade in derivatives market.

27. There is a significant difference between Average monthly investible income and factors influenced to trade in derivatives market.

28. There is no significance difference between distribution of equity investments intra day and factors influenced to trade in derivatives market.

29. There is a significant difference between distribution of equity investments

in derivatives and factors influenced to trade in derivatives market.

30. There is a high positive correlation between Experience in equity investment and factors influenced to trade in equity derivatives.

31. There is a significant difference between investments in derivatives and factors influenced to trade in derivatives market.

32. There is a positive correlation between the preferred type in options and the factors influenced to trade in derivatives market.

33. There is a positive correlation between the preferred underlying in derivatives and the factors influenced to trade in derivatives market.

34. There is no significance difference between the preferred position in derivatives and factors influenced to trade in derivatives market.

35. There is a significant difference between factors to consider before taking investment decisions and factors influenced to trade in derivatives market.

36. There is a significant difference between persons to be consulted before taking investment decisions and factors influenced to trade in derivatives market.

37. There is no significance difference between the sources of information and factors influenced to trade in derivatives market.

38. There is a significance difference between occupation and distribution of equity investments in intra day.

39. The F&O strategies are classified into Bullish strategies, Bearish Strategies, Neutral strategies based on their payoff profiles shown in the graphs.

40. Long calls, Covered calls, Protective put, Bull call spread, Bull put spread, Call back spread, Naked put are classified as Bullish strategies.

41. Long put, Naked Call Put back spread, Bear call spread, and Bear put spread are classified as Bearish Strategies.

42. Reversal, Conversion, collar, Long straddle, Short straddle, Long strangle, Short strangle, Butterfly, Ratio spread, Condor, Calendar spread are classified as Neutral strategies.

CONCLUSION AND RECOMMENDATIONS

The desirability of successful derivatives, such as futures trading, depends crucially on the solidity and maturity of cash markets in underlying securities. To make cash markets robust and effective, first let

us put in place the mechanism of margin trading, short sale, dematerialized settlement and electronic transfer of funds among market participants. Undue haste may well result in a major scandal that may undermine both the confidence in and acceptance of equity derivatives in the country, as well as the reputation of the entities involved in introducing these products.

Well, all said and done derivatives are still a two edged weapon and have their share of drawbacks. But they can be overcome to some extent by following certain basic rules by the regulating body. Summarized below are the near term prospects for Indian domestic derivatives.

- ✓ First of all enhancing the confidence and knowledge among all market participants is a necessary condition in order to maintain the stability of the derivative market.
- ✓ Information regarding the derivatives should be standardised so that it can be understood by every class of users and should also be disclosed at all levels of the derivative industry.
- ✓ The reputation of the market participants in the derivative business should be used as a monitoring device to prevent them from adopting excessively risky

- policies or from engaging in an irregular transaction.
- ✓ Introduction of vanilla rupee currency derivatives as currency deregulation continues.
 - ✓ Introduction of onshore, and gradual expansion of offshore , equity derivatives as FII restrictions are loosened, local currency becomes more accessible , and foreign derivative technologies are imported.
 - ✓ Very gradual expansion of IRS activity as the domestic debt market continues to grow and a floating rate benchmark is established.
 - ✓ Conversion of certain agricultural forward contracts into formal futures contracts.
 - ✓ Further expansion of domestic warrants and convertibles as the Indian equity market grows and the need for domestic financing increases; deeper liquidity in both instruments as exchanges are consolidated and trading is focussed on fewer locations
 - ✓ Limited growth in forward equity trading given the restrictive nature of the new badla system.
 - ✓ Development of listed equity options.
- ✓ Separate the derivatives from the cash market.
 - ✓ Client positions should be segregated from proprietary position.
 - ✓ Role of the trading member and clearing member should be segregated leading to weaker members affecting the system.
 - ✓ With index futures having been introduced, the need for an electronic fund transfer system has become more glaring. This is because brokers have to compulsory collect daily mark to market margins from clients, both institutional and retail, in index futures trading.

The best regulations are those that guard against the misuse of derivatives, as opposed to those that severely restrict, or even ban, their use. Supervisory reforms by SEBI should focus on increasing disclosure of derivatives holdings and the strategies underlying their use, appropriate capital adequacy standards, and sound risk-management guidelines. And for once, SEBI should learn from the mistakes of other economies and not wait for the Indian bourses to teach it a lesson. If the above points are taken care of then the

derivatives would be a major boost for entrepreneurship ,particularly for India.

Based on the findings of the study, the investors are also classified into Speculators, Hedgers. The majority of the investors are consulting brokers for getting the information and to take investment decisions. The brokers should take the necessary steps to increase the awareness level of investors towards investments in future and option segment. The future and option strategies and their Payoff profiles were observed with graphical representation. The future and option strategies are classified into Bullish, Bearish and Neutral strategies. The very bullish and very bearish strategies can be applicable for speculators. The strategies that give profit in the range bound market can be applicable to hedgers.

This study aims to design the future and option strategies as per the investors risk level. As the investor community is very large and diverse this study made an attempt to classify them based on the perception towards derivatives. The large number of future and option strategies was also classified based on their payoff profile. Finally this was a small attempt to link the investor perception with the designing of future and option strategies in Indian Stock Markets.

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