Risk management in options trading: Case studies of male and female traders in Delhi.

Gangmumei Kamei

Assistant Professor
School of Human Studies
Ambedkar University, Delhi (AUD)

Abstract

The paper looked into the different risk management strategies employed by stock market traders and its importance while trading in options. For the study, 50 participants (25 male and 25 female) traders from Delhi were chosen. For the purpose of data collection, semi-structured interview was used and thematic analysis for analysing the data. Since trading in financial market involves financial capital which could either lead to profits or losses, most of the participants have the knowledge of risk management but failed to implement it during actual trading. Some of the risk management strategies used by the participants were setting appropriate stop losses (SL); reducing lot size; avoiding multiple strategies; clear entry and exit plan; maintaining trading journals; following appropriate trading levels etc. It was observed that maximum of the participants (both male and female) incurred net losses despite having risk management plan due to lack of implementing their trading plan and following the appropriate levels. Only few traders who have been in the market, experienced the volatility and follow the appropriate trading plans and levels for some years had managed to survive in the market. Controlling the emotions, mind and greed in trading were reflected as crucial in addition to the physical risk management in options trading.

Keywords: *Options trading, stock market, risk management; volatility, emotions*

INTRODUCTION:

Risk management in stock market trading is a crucial aspect that every investor and trader must understand and implement to safeguard their capital and achieve long-term success. It involves identifying, assessing, and mitigating the various risks associated with trading stocks. Risk in stock market trading refers to the potential for financial loss or deviation from expected returns. It can arise from various factors such as market volatility, economic conditions, company-specific events, and geopolitical events. Risk management is a cornerstone of trading in financial markets, representing a systematic approach to identifying, assessing, and mitigating risks inherent in investment activities. With the proliferation of electronic trading platforms and the globalization of financial markets, traders are exposed to a myriad of risks, including market volatility, credit defaults, operational failures, and regulatory uncertainties. Effective risk management is crucial for preserving capital, achieving investment objectives, and maintaining long-term sustainability in trading endeavours.

The study of risk management in trading is multifaceted, encompassing various disciplines such as finance, economics, mathematics, and behavioural psychology. Scholars and practitioners alike have devoted considerable attention to understanding the complexities of risk in trading and developing strategies to manage it effectively. From theoretical models to empirical studies, a rich body of literature exists that explores different aspects of risk management in trading and its implications for market participants. At its core, risk management in trading involves a proactive and systematic approach to identifying and assessing potential risks, followed by the implementation of appropriate risk mitigation strategies. Market risk, for instance, refers to the potential for losses due to adverse movements in asset prices or volatility fluctuations. Credit risk involves the risk of counterparty default or credit deterioration, particularly in derivative transactions or margin trading. Operational risk encompasses a broad range of risks arising from internal processes, systems, or human error, such as settlement failures, technological disruptions, or compliance breaches.

Furthermore, risk management in trading extends beyond the realm of quantitative analysis to encompass behavioural aspects of decision-making and risk-taking behaviour. Behavioural biases, rooted in cognitive and emotional factors, can influence traders' perceptions, judgments, and actions, leading to deviations from rational decision-making and exacerbating risk exposure. Understanding these behavioural dynamics is essential for designing effective risk management strategies that account for the psychological dimensions of trading. Despite advancements in risk management techniques and technology, challenges persist in effectively managing risks in trading. The rapid pace of technological innovation, for instance, introduces new sources of risk, such as algorithmic trading errors or cyber threats, that require continuous adaptation and vigilance. Moreover, the interconnectedness of global financial markets amplifies the propagation of risks across borders, necessitating a coordinated and holistic approach to risk management on a global scale.

Risk management in trading is a multifaceted and dynamic field that plays a crucial role in navigating the uncertainties of financial markets. By integrating theoretical insights, empirical research, and practical strategies, scholars and practitioners strive to develop robust risk management frameworks that enhance resilience, protect capital, and promote sustainable trading practices. As trading continues to evolve in response to technological advancements and market dynamics, the study of risk management remains paramount in ensuring the stability and integrity of financial markets. Effective risk management in stock market trading involves understanding the various types of risks, assessing risk factors, setting risk tolerance levels, diversifying investments, sizing positions appropriately, using stop-loss orders, and regularly monitoring and adjusting risk management strategies. By implementing sound risk management practices, investors can protect their capital and increase the likelihood of achieving long-term investment success.

LITERATURE REVIEW:

Stock market risk management is essential for investors, traders, and financial institutions to mitigate potential losses and safeguard investments in dynamic and uncertain market environments. This literature review synthesizes research findings, methodologies, and emerging trends in stock market risk management, encompassing various approaches, models, and best practices.

Scholars such as Markowitz (1952) and Sharpe (1964) laid the foundation for modern portfolio theory and the Capital Asset Pricing Model, which introduced concepts of risk-return trade-offs and portfolio diversification. Jorion (1997) contributed to the development of Value-at-Risk (VaR), a widely used measure of market risk, while Rockafellar and Uryasev (2000) introduced Conditional Value-at-Risk (CVaR) as an extension of VaR. Behavioral finance theories by Kahneman and Tversky (1979) and Thaler (2015) shed light on the psychological aspects of risk-taking behavior and decision-making biases in stock market trading.

Empirical research by Fama and French (1992) explored factors influencing stock returns, contributing to our understanding of market risk and the efficacy of risk management strategies. Engle (1982) introduced Autoregressive Conditional Heteroskedasticity (ARCH) models, revolutionizing the modeling of volatility and risk in financial markets. Further empirical studies by Lo (2004) and Longin (1996) investigated the relationship between market volatility and risk management practices, providing insights into the impact of risk on trading performance.

Challenges in risk management include model risk, data limitations, regulatory constraints, and behavioural biases. Authors such as Dowd (2005) and Taffler and Tuckett (2016) highlighted the need for robust risk governance frameworks and the integration of qualitative factors into risk management practices. Moreover, the emergence of new risks, such as technological disruptions and cyber threats, poses additional challenges to effective risk management in stock market trading.

Best practices in risk management emphasize comprehensive risk assessments, stress testing, scenario analysis, and contingency planning. Authors like Taffler and Tuckett (2016) advocate for integrated risk management approaches that consider both quantitative and qualitative factors. Future research directions include the development of advanced risk management models, the integration of machine learning and artificial intelligence techniques, and the exploration of the implications of environmental, social, and governance (ESG) factors on risk management in stock market trading.

OBJECTIVES:

The objectives of the study are:
1. To understand risk management strategies in options trading in the stock market.
2. To see the different factors that affect the trader's mindset in actual trading.

Following are the research questions which were formulated to address the research objectives:
1. What are the different risk management strategies employed by traders to mitigate the losses in options trading?
2. How do traders actually implement the risk management strategies in actual trading?
3. What could be the potential factors that could affect the trader's mindset while trading?

METHODOLOGY:

The primary focus of this study is to qualitatively understand how traders manage their risks in options trading. Case study involving 50 (fifty) participants (25 male and 25 female) were selected from the National Capital Delhi whose age group are between 18 to 60 years. Data were collected from the participants using Semi-structured interview during a period of one year to qualitatively understand the deeper aspects of trading in the stock market. Much of the knowledge related to stock market risk management is tacit and difficult to capture through quantitative methods alone. Semi-structured interviews allow researchers to access participants' tacit knowledge, including intuitive insights, personal experiences, and practical wisdom gained from navigating the complexities of the stock market. The effectiveness of risk management strategies in the stock market can be influenced by various contextual factors, including market conditions, regulatory frameworks, and organizational cultures. Semi-structured interviews facilitate the exploration of these contextual nuances, providing researchers with rich insights into the situational factors shaping risk management practices.

Stock market risk management involves intricate processes, such as risk assessment, mitigation strategies, and decision-making under uncertainty. Semi-structured interviews enable researchers to delve deep into these complex processes, allowing participants to elaborate on their experiences, strategies, and decision-making rationale. Risk management in the stock market involves a variety of stakeholders, including traders, investors, financial analysts, and regulators. Semi-structured interviews allow researchers to gather insights from diverse perspectives, capturing a comprehensive understanding of risk management practices and challenges. Stock market risk management is dynamic, with practices evolving in response to changing market conditions, technological advancements, and regulatory developments. Semi-structured interviews support iterative inquiry, enabling researchers to adapt their questioning strategies based on emerging themes and insights uncovered during the data collection process.

For the purpose of analysing the data, Thematic Analysis was used to extract pertinent themes from the transcribed data. Risk management in the stock market involves numerous complex factors, including market dynamics, regulatory frameworks, investor behaviour, and financial instruments. Thematic analysis allows researchers to explore these multifaceted factors by identifying and analysing recurring themes and patterns within qualitative data, providing a comprehensive understanding of the risk management landscape. Risk management in the stock market involves various stakeholders, including traders, investors, financial analysts, regulators, and policymakers. Thematic analysis enables researchers to capture diverse perspectives and experiences by systematically organizing and interpreting qualitative data collected through methods such as interviews, focus groups, or textual analysis.

The effectiveness of risk management strategies in the stock market can be influenced by contextual factors such as market conditions, industry trends, organizational cultures, and regulatory environments. Thematic analysis facilitates the exploration of these contextual nuances by identifying key themes and insights relevant to risk management practices within specific contexts, helping researchers uncover the situational factors that shape risk management decisions and behaviours. Thematic analysis allows researchers to generate in-depth insights into risk management practices, challenges, and strategies employed by stakeholders in the stock market. By systematically coding and categorizing qualitative data into themes, researchers can uncover

underlying meanings, motivations, and decision-making processes, providing rich and nuanced insights that complement quantitative analyses of risk metrics and performance indicators.

ANALYSIS:

By examining risk management practices in the stock market through a multidimensional lens, this study aims to contribute to the body of knowledge on financial risk management, challenges, opportunities and provide practical insights for market participants. By enhancing our understanding of how risks are identified, assessed, and managed in the stock market, we can work towards building a more resilient and sustainable financial system that fosters investor confidence and market stability. Detailed analysis of the data using Thematic Analysis (TA) are presented below.

Participant Ris W (29/M):

"I think risk management is an integral part of options trading. This also applies to those who are investing as well. Once we participate in the financial market, profit and loss is imminent. Without proper risk management, we are completely exposed to the market volatility which may dent and wipe out our capital quickly. Understanding the market trend and volatility is a must along with proper risk management strategies to stay alive in the financial market".

The above narrative alludes the importance of knowing and applying proper risk management in trading. Market volatility and unexpected spike in the market could adversely affect the trader if proper risk management is not maintained. The downside of market volatility may adversely affect the capital of the trader and many a times it may blow the trader's account quickly.

Participant Ris B (18/M):

"As a young trader, I both participate in the stock market as an investor and as well as a trader. In terms of the risk factor, options trading is 100 times or more riskier than investing in equities due to high volatility of market. I am more of an intraday trader than an investor because the returns in intraday are far much higher than equities. With higher returns come along with its own risk factor which is much higher and sometimes quite difficult to comprehend".

Young traders and investors like the participant above showed more interest in options trading due to higher returns but hugely exposed to the market volatility. Risk factor becomes much higher with huge and haphazard market movement without underlying assets. Though equities are less exposed to market volatility, many traders like the participant here prefers options trading which reflects the trend of the present young traders entering the stock market.

Participant Ris F (40/M):

"There are many risk management strategies such as setting proper Stop Loss (SL); following Price Action; RSI; Fibonacci retracement; Trend line etc etc. In an active market, what is more important is how one effectively use these strategies to minimise loss and maximise gain. Random application of such strategies won't work without properly knowing the exact use of such strategies in live market. Market is designed in such a way that buyers loose most of the time and seller's gain. Without proper risk management, it is suicide in stock market particularly in options trading".

Despite having multiple choices of risk management strategies, the participant above highlighted the action side of applying such strategies in the live market. One needs proper understanding of the application side of strategies to maximise profits and minimise potential loss. The participant also cautions traders about the design of the market which favours sellers more than the buyers. Theoretical knowledge of the strategies might not work properly unless traders take quick decisions and choose specific as well as appropriate risk management strategies in live market.

Participant Ris S (33/F):

"To me, the mindset of the trader is more important than anything else in the market. Market might be absolutely volatile; completely dead or stuck in a range. We need to know how to reboot and set our mind and emotions according to the market movements. Not all the strategies work in stock market. More than the strategies is the person's mindset who is operating the strategies behind the scene which is crucial for a successful trader. Once we know how to regulate, manage and set out mind and emotions, I am sure we will be able to survive and grow in the financial market".

The importance of trader's psyche and emotions behind the market is clearly reflected in the participant's narrative. It is important that the trader know how to regulate the mindset and tune accordingly with the market movements rather than depending solely on to the strategies which might probably fail. To be successful in the market, the participant suggests that the traders need to be mentally and emotionally strong.

Participant Ris M (47/M):

"What I love about trading is its rhythm and the opportunities that it provides to me every day! All of us are here in the market to make profits and not here for loss. Reducing the lot size when I have doubt in the market direction; setting reasonable targets for the day; playing with my rule book and trading within the levels have significantly contributed to my capital gains over the last many years in the market".

The participant's narrative above alludes that one needs to play safely with one's own capital within the rule book of the trader. Safe trading and appropriate risk management can reduce trading losses and contribute in the capital gains over time. Market provides lots of opportunities for the traders but many fails due to lack of knowledge about the market and greediness.

DISCUSSIONS:

Options trading is a sophisticated financial activity that offers investors and traders unique opportunities for profit and risk management. However, the complex nature of options contracts and their sensitivity to various factors require robust risk management strategies. Risk management in trading is a multifaceted topic that warrants critical discussion due to its crucial role in the financial markets and the complexities involved in effectively managing risks. Below are several key points for critical discussion: A critical aspect of risk management in trading is the integration of both quantitative and qualitative approaches. While quantitative methods like Value-at-Risk (VaR) and statistical models provide valuable insights into numerical probabilities and potential losses, qualitative techniques such as scenario analysis and expert judgment offer insights into non-quantifiable risks and subjective perceptions. However, there can be challenges in effectively combining these approaches, including discrepancies in risk assessments and biases in expert judgment.

Trading often relies on complex mathematical models and algorithms to assess and manage risks. However, these models are not immune to errors or inaccuracies, leading to the phenomenon of model risk. Critical discussions should address the limitations and uncertainties associated with these models, including assumptions, data quality issues, and the potential for model misspecification. Moreover, the dynamic nature of financial markets introduces inherent uncertainties that can challenge the reliability of risk models. The field of behavioural finance has highlighted the role of psychological biases in influencing trading decisions and risk management practices. Critical discussions should explore how cognitive biases such as overconfidence, loss aversion, and herd mentality impact risk perception and decision-making in trading. Furthermore, addressing these biases requires a deeper understanding of human behaviour and effective strategies for mitigating their effects on risk management.

Regulatory frameworks play a crucial role in shaping risk management practices in trading, aiming to protect investors and maintain market integrity. Critical discussions should assess the effectiveness of regulatory requirements and oversight mechanisms in addressing systemic risks, preventing market abuse, and promoting transparency. Moreover, debates may arise regarding the balance between regulatory compliance and innovation, as overly stringent regulations can stifle market efficiency and innovation. The advent of technological advancements, including algorithmic trading, high-frequency trading, and blockchain technology, has transformed the landscape of trading and risk management. Critical discussions should

evaluate the opportunities and challenges posed by these technologies, including concerns related to algorithmic errors, cyber threats, and market fragmentation. Moreover, debates may arise regarding the adequacy of risk management practices in addressing the evolving nature of technological risks in trading.

It is also important to consider ethical considerations and the promotion of responsible trading practices. This includes issues such as market manipulation, insider trading, and conflicts of interest, which can undermine market integrity and investor confidence. Critical discussions should explore the ethical dimensions of risk management decisions and advocate for ethical conduct and accountability among market participants. Critical discussions on risk management in trading should encompass a wide range of factors, including the integration of quantitative and qualitative approaches, model risk and uncertainty, behavioural biases, regulatory compliance, technological advancements, and ethical considerations. By addressing these key points, scholars and practitioners can gain a deeper understanding of the complexities and challenges inherent in managing risks in trading and work towards developing more robust and effective risk management practices. Empirical research provides valuable insights into the effectiveness of options trading strategies and their impact on portfolio risk and performance. By adhering to best practices, options traders can navigate market uncertainties, optimize risk-adjusted returns, and achieve long-term success in options trading.

CONCLUSION:

The study of risk management in options trading is a dynamic and interdisciplinary field that requires a holistic approach encompassing qualitative assessment, behavioural insights, and ethical considerations. By prioritizing effective risk management practices, options traders can enhance their trading performance, preserve capital, and navigate the complexities of financial markets with confidence and resilience. The study of risk management in options trading is essential for navigating the complexities of financial markets and maximizing trading performance while minimizing potential losses. Options trading presents unique opportunities and challenges due to the leverage and flexibility inherent in derivative instruments. Effective risk management strategies are crucial for options traders to identify, assess, and mitigate various types of risks, including market risk, volatility risk, and liquidity risk.

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