A STUDY ON FINANCIAL DERIVATIVES (FUTURES & OPTIONS)

With reference to ICICI BANK.

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ABSTRACT

The emergence of the market for derivatives products, most notably forwards, futures and options, can be traced back to the willingness of risk-averse economic agents to guard themselves against uncertainties arising out of fluctuations in asset prices. Derivatives are risk management instruments, which derive their value from an underlying asset. Derivatives market has gained importance in terms of their vital role in the economy. The increasing investments in stocks (domestic as well as overseas) have attracted my interest in this area. Numerous studies on the effects of futures and options listing on the underlying cash market volatility have been done in the developed markets. The derivative market is newly started in India and it is not known by every investor, so SEBI has to take steps to create awareness among the investors about the derivative segment. In cash market the profit/loss of the investor depends on the market price of the underlying asset. The investor may incur huge profit or he may incur huge loss. But in derivatives segment the investor enjoys huge profits with limited downside. Derivatives are mostly used for hedging purpose. In order to increase the derivatives market in India, SEBI should revise some of their regulations like contract size, participation of FII in the derivatives market. In a nutshell the study throws a light on the derivatives market.

I. INTRODUCTION

The emergence of the market for derivatives products, most notably forwards, futures and options, can be traced back to the willingness of risk-averse economic agents to guard themselves against uncertainties arising out of fluctuations in asset prices. By their very nature, the financial markets are marked by a very high degree of volatility. Through the use of derivative products, it is possible to partially or fully transfer price risks by locking-in asset prices. As instruments of risk management, these generally do not influence the fluctuations in the underlying asset prices. However, by locking-in asset prices, derivative product minimizes the impact of fluctuations in asset prices on the profitability and cash flow situation of risk-averse investors.

Derivatives are risk management instruments, which derive their value from an underlying asset. The underlying asset can be bullion, index, share, bonds, currency, interest, etc. Banks, Securities firms, companies and investors to hedge risks, to gain access to cheaper money and to make profit, use derivatives. Derivatives are likely to grow even at a faster rate in future.

OBJECTIVES OF THE STUDY:

- To analyze the operations of futures and options.
- To find the profit/loss position of futures buyer and seller and also the option writer and option holder.
- To study about risk management with the help of derivatives.

NEED FOR STUDY:

In recent times the Derivative markets have gained importance in terms of their vital role in the economy. The increasing investments in derivatives (domestic as well as overseas) have attracted my interest in this area. Through the use of derivative products, it is possible to partially or fully transfer price risks by locking-in asset prices. As the volume of trading is tremendously increasing in derivatives market, this analysis will be of immense help to the investors.
SCOPE OF THE STUDY:

The study is limited to “Derivatives” with special reference to futures and option in the Indian context and the Inter-Connected Stock Exchange has been taken as a representative sample for the study. The study can’t be said as totally perfect. Any alteration may come. The study has only made a humble attempt at evaluation derivatives market only in India context.

LITERATURE REVIEW

Behaviour of Stock Market Volatility after Derivatives
Golaka C Nath, Research Paper (NSE)

Financial market liberalization since early 1990s has brought about major changes in the financial markets in India. The creation and empowerment of Securities and Exchange Board of India (SEBI) has helped in providing higher level accountability in the market. New institutions like National Stock Exchange of India (NSEIL), National Securities Clearing Corporation (NSCCL), National Securities Depository (NSDL) have been the change agents and helped cleaning the system and provided safety to investing public at large. With modern technology in hand, these institutions did set benchmarks and standards for others to follow. Microstructure changes brought about reduction in transaction cost that helped investors to lock in a deal faster and cheaper. One decade of reforms saw implementation of policies that have improved transparency in the system, provided for cheaper mode of information dissemination without much time delay, better corporate governance, etc. The capital market witnessed a major transformation and structural change during the period. The reforms process have helped to improve efficiency in information dissemination, enhancing transparency, prohibiting unfair trade practices like insider trading and price rigging. Introduction of derivatives in Indian capital market was initiated by the Government through L.C Gupta Committee report. The L.C. Gupta Committee on Derivatives had recommended in December 1997 the introduction of stock index futures in the first place to be followed by other products once the market matures. The preparation of regulatory framework for the operations of the index futures contracts took some more time and finally futures on benchmark indices were introduced in June 2000 followed by options on indices in June 2001 followed by options on individual stocks in July 2001 and finally followed by futures on individual stocks in November 2001.

DERIVATIVES:-

The emergence of the market for derivatives products, most notably forwards, futures and options, can be traced back to the willingness of risk-averse economic agents to guard themselves against uncertainties arising out of fluctuations in asset prices. By their very nature, the financial markets are marked by a very high degree of volatility. Through the use of derivative products, it is possible to partially or fully transfer price risks by locking-in asset prices. As instruments of risk management, these generally do not influence the fluctuations in the underlying asset prices. However, by locking-in asset prices, derivative product minimizes the impact of fluctuations in asset prices on the profitability and cash flow situation of risk-averse investors.

Derivatives are risk management instruments, which derive their value from an underlying asset. The underlying asset can be bullion, index, share, bonds, currency, interest, etc. Banks, Securities firms, companies and investors to hedge risks, to gain access to cheaper money and to make profit, use derivatives. Derivatives are likely to grow even at a faster rate in future.

DEFINITION

Derivative is a product whose value is derived from the value of an underlying asset in a contractual manner. The underlying asset can be equity, forex, commodity or any other asset.

1) Securities Contracts (Regulation) Act, 1956 (SCR Act) defines “derivative” to secured or unsecured, risk instrument or contract for differences or any other form of security.

2) A contract which derives its value from the prices, or index of prices, of underlying securities.

Emergence of financial derivative products

Derivative products initially emerged as hedging devices against fluctuations in commodity prices, and commodity-linked derivatives remained the sole form of such products for almost three hundred years. Financial derivatives came into spotlight in the post-1970 period due to growing instability in the financial markets. However, since their emergence, these products have become very popular and by 1990s, they accounted for about two-thirds of total transactions in derivative products. In recent years, the market for financial derivatives has grown tremendously in terms of variety of instruments available, their complexity and also turnover. In the class of equity derivatives the world over, futures and options on equity indices have gained more popularity than on individual stocks, especially among institutional investors, who are major users of index-linked derivatives. Even small investors find these useful due to high correlation of the popular indices with various portfolios and ease of use. The lower costs associated with index derivatives vis-à-vis derivative products based on individual securities is another reason for their growing use.
PARTICIPANTS:
The following three broad categories of participants in the derivatives market.

HEDGERS:
Hedgers face risk associated with the price of an asset. They use futures or options markets to reduce or eliminate this risk.

SPECULATORS:
Speculators wish to bet on future movements in the price of an asset. Futures and options contracts can give them an extra leverage; that is, they can increase both the potential gains and potential losses in a speculative venture.

ARBITRAGERS:
 Arbitrageurs are in business to take of a discrepancy between prices in two different markets, if, for example, they see the futures price of an asset getting out of line with the cash price, they will take offsetting position in the two markets to lock in a profit.

FUNCTION OF DERIVATIVES MARKETS:
The following are the various functions that are performed by the derivatives markets. They are:

- Prices in an organized derivatives market reflect the perception of market participants about the future and lead the price of underlying to the perceived future level.
- Derivatives market helps to transfer risks from those who have them but may not like them to those who have an appetite for them.
- Derivatives trading acts as a catalyst for new entrepreneurial activity.
- Derivatives markets help increase saving and investment in long run.

TYPES OF DERIVATIVES:
The following are the various types of derivatives. They are:

FORWARDS:
A forward contract is a customized contract between two entities, where settlement takes place on a specific date in the future at today’s pre-agreed price.

FUTURES:
A futures contract is an agreement between two parties to buy or sell an asset in a certain time at a certain price, they are standardized and traded on exchange.

OPTIONS:
Options are of two types—calls and puts. Calls give the buyer the right but not the obligation to buy a given quantity of the underlying asset, at a given price on or before a given future date. Puts give the buyer the right, but not the obligation to sell a given quantity of the underlying asset at a given price on or before a given date.

WARRANTS:
Options generally have lives of up to one year; the majority of options traded on options exchanges having a maximum maturity of nine months. Longer-dated options are called warrants and are generally traded over-the-counter.

LEAPS:
The acronym LEAPS means long-term Equity Anticipation securities. These are options having a maturity of up to three years.

BASKETS:
Basket options are options on portfolios of underlying assets. The underlying asset is usually a moving average of a basket of assets. Equity index options are a form of basket options.

SWAPS:
Swaps are private agreements between two parties to exchange cash flows in the future according to a prearranged formula. They can be regarded as portfolios of forward contracts. The two commonly used Swaps are:

a) Interest rate Swaps:
These entail swapping only the related cash flows between the parties in the same currency.

b) Currency Swaps:
These entail swapping both principal and interest between the parties, with the cash flows in on direction being in a different currency than those in the opposite direction.

**SWAPTION:**

Swaptions are options to buy or sell a swap that will become operative at the expiry of the options. Thus a swaption is an option on a forward swap.

**RATIONALE BEHIND THE DEVELOPMENT OF DERIVATIVES:**

Holding portfolios of securities is associated with the risk of the possibility that the investor may realize his returns, which would be much lesser than what he expected to get. There are various factors, which affect the returns:

1. Price or dividend (interest)
2. Some are internal to the firm like-
   - Industrial policy
   - Management capabilities
   - Consumer’s preference
   - Labour strike, etc.

These forces are to a large extent controllable and are termed as non systematic risks. An investor can easily manage such non-systematic by having a well-diversified portfolio spread across the companies, industries and groups so that a loss in one may easily be compensated with a gain in other.

There are yet other of influence which are external to the firm, cannot be controlled and affect large number of securities. They are termed as systematic risk. They are:

1. Economic
2. Political
3. Sociological changes are sources of systematic risk.

For instance, inflation, interest rate, etc. their effect is to cause prices of nearly all-individual stocks to move together in the same manner. We therefore quite often find stock prices falling from time to time in spite of company’s earning rising and vice versa.

Rational Behind the development of derivatives market is to manage this systematic risk, liquidity in the sense of being able to buy and sell relatively large amounts quickly without substantial price concession.

In debt market, a large position of the total risk of securities is systematic. Debt instruments are also finite life securities with limited marketability due to their small size relative to many common stocks. Those factors favour for the purpose of both portfolio hedging and speculation, the introduction of a derivatives securities that is on some broader market rather than an individual security.

**REGULATORY FRAMEWORK:**

The trading of derivatives is governed by the provisions contained in the SC R.A, the SEBI Act, and the regulations framed there under the rules and byelaws of stock exchanges.

**Introduction to futures and options**

In recent years, derivatives have become increasingly important in the field of finance. While futures and options are now actively traded on many exchanges, forward contracts are popular on the OTC market. In this chapter we shall study in detail these three derivative contracts.

**Forward contracts**

A forward contract is an agreement to buy or sell an asset on a specified future date for a specified price. One of the parties to the contract assumes a long position and agrees to buy the underlying asset on a certain specified future date for a certain specified price. The other party assumes a short position and agrees to sell the asset on the same date for the same price. Other contract details like delivery date, price and quantity are negotiated bilaterally by the parties to the contract. The forward contracts are normally traded outside the exchanges. The salient features of forward contracts are:

- They are bilateral contracts and hence exposed to counter–party risk.
- Each contract is custom designed, and hence is unique in terms of contract size, expiration date and the asset type and quality.
- The contract price is generally not available in public domain.
- On the expiration date, the contract has to be settled by delivery of the asset.
If the party wishes to reverse the contract, it has to compulsorily go to the same counterparty, which often results in high prices being charged.

However forward contracts in certain markets have become very standardized, as in the case of foreign exchange, thereby reducing transaction costs and increasing transactions volume. This process of standardization reaches its limit in the organized futures market.

Forward contracts are very useful in hedging and speculation. The classic hedging application would be that of an exporter who expects to receive payment in dollars three months later. He is exposed to the risk of exchange rate fluctuations. By using the currency forward market to sell dollars forward, he can lock on to a rate today and reduce his uncertainty. Similarly an importer who is required to make a payment in dollars two months hence can reduce his exposure to exchange rate fluctuations by buying dollars forward.

If a speculator has information or analysis, which forecasts an upturn in a price, then he can go long on the forward market instead of the cash market. The speculator would go long on the forward, wait for the price to rise, and then take a reversing transaction to book profits. Speculators may well be required to deposit a margin upfront. However, this is generally a relatively small proportion of the value of the assets underlying the forward contract. The use of forward markets here supplies leverage to the speculator.

### Limitations of forward markets

Forward markets world-wide are afflicted by several problems:

- Lack of centralization of trading,
- Illiquidity, and
- Counterparty risk

In the first two of these, the basic problem is that of too much flexibility and generality. The forward market is like a real estate market in that any two consenting adults can form contracts against each other. This often makes them design terms of the deal which are very convenient in that specific situation, but makes the contracts non-tradable.

Counterparty risk arises from the possibility of default by any one party to the transaction. When one of the two sides to the transaction declares bankruptcy, the other suffers. Even when forward markets trade standardized contracts, and hence avoid the problem of illiquidity, still the counterparty risk remains a very serious

### Introduction to futures

Futures markets were designed to solve the problems that exist in forward markets. A futures contract is an agreement between two parties to buy or sell an asset at a certain time in the future at a certain price. But unlike forward contracts, the futures contracts are standardized and exchange traded. To facilitate liquidity in the futures contracts, the exchange specifies certain standard features of the contract. It is a standardized contract with standard underlying instrument, a standard quantity and quality of the underlying instrument that can be delivered, (or which can be used for reference purposes in settlement) and a standard timing of such settlement. A futures contract may be offset prior to maturity by entering into an equal and opposite transaction. More than 99% of futures transactions are offset this way.

### TYPES OF FUTURES:

On the basis of the underlying asset they derive, the financial futures are divided into two types:

- **Stock futures:**
- **Index futures:**

### Parties in the futures contract:

There are two parties in a future contract, the buyer and the seller. The buyer of the futures contract is one who is LONG on the futures contract and the seller of the futures contract is who is SHORT on the futures contract.

The pay off for the buyer and the seller of the futures of the contracts are as follows:
PAY-OFF FOR A BUYER OF FUTURES:

CASE 1:- The buyer bought the futures contract at (F); if the future price goes to S1 then the buyer gets the profit of (FP).

CASE 2:- The buyer gets loss when the future price goes less then (F), if the future price goes to S2 then the buyer gets the loss of (FL).

PAY-OFF FOR A SELLER OF FUTURES:

CASE 1:- The seller sold the future contract at (F); if the future goes to S1 then the seller gets the profit of (FP).

CASE 2:- The seller gets loss when the future price goes greater than (F), if the future price goes to S2 then the seller gets the loss of (FL).

PRICING THE FUTURES:

The Fair value of the futures contract is derived from a model known as the cost of carry model. This model gives the fair value of the contract.

Cost of Carry:

\[ F = S (1+r-q)^t \]

Where
INTRODUCTION TO OPTIONS:

Option is a type of contract between two persons where one grants the other the right to buy a specific asset at a specific price within a specific time period. Alternatively the contract may grant the other person the right to sell a specific asset at a specific price within a specific time period. In order to have this right. The option buyer has to pay the seller of the option premium.

The assets on which option can be derived are stocks, commodities, indexes etc. If the underlying asset is the financial asset, then the option are financial option like stock options, currency options, index options etc, and if options like commodity option.

TYPES OF OPTIONS:
The options are classified into various types on the basis of various variables. The following are the various types of options.

1. On the basis of the underlying asset:

- INDEX OPTIONS
  The index options have the underlying asset as the index.

- STOCK OPTIONS:
  A stock option gives the buyer of the option the right to buy/sell stock at a specified price. Stock options are options on the individual stocks, there are currently more than 150 stocks, there are currently more than 150 stocks are trading in the segment.

II. On the basis of the market movements:

- CALL OPTION:
  A call option is bought by an investor when he seems that the stock price moves upwards. A call option gives the holder of the option the right but not the obligation to buy an asset by a certain date for a certain price.

- PUT OPTION:
  A put option is bought by an investor when he seems that the stock price moves downwards. A put option gives the holder of the option right but not the obligation to sell an asset by a certain date for a certain price.

III. On the basis of exercise of option:

- AMERICAN OPTION:
  American options are options that can be exercised at any time up to the expiration date, all stock options at NSE are American.

- EUROPEAN OPTION:
  European options are options that can be exercised only on the expiration date itself. European options are easier to analyze than American options. All index options at NSE are European.

PAY-OFF PROFILE FOR BUYER OF A CALL OPTION:
The pay-off of a buyer options depends on a spot price of a underlying asset. The following graph shows the pay-off of buyer of a call option.
Profit

CASE 1: (Spot price > Strike price)
As the spot price (E1) of the underlying asset is more than strike price (S), the buyer gets profit of (SR), if price increases more than E1 then profit also increase more than SR.

CASE 2: (Spot price < Strike price)
As a spot price (E2) of the underlying asset is less than strike price (S) the buyer gets loss of (SP), if price goes down less than E2 then also his loss is limited to his premium (SP).

PAY-OFF PROFILE FOR SELLER OF A CALL OPTION:
The pay-off of seller of the call option depends on the spot price of the underlying asset. The following graph shows the pay-off of seller of a call option:

CASE 1: (Spot price < Strike price)
As the spot price (E1) of the underlying is less than strike price (S) the seller gets the profit of (SP), if the price decreases less than E1 then also profit of the seller does not exceed (SP).

CASE 2: (Spot price > Strike price)
As the spot price (E2) of the underlying asset is more than strike price (S) the seller gets loss of (SR), if price goes more than E2 then the loss of the seller also increase more than (SR).
PAY-OFF PROFILE FOR BUYER OF A PUT OPTION:

The pay-off of the buyer of the option depends on the spot price of the underlying asset. The following graph shows the pay-off of the buyer of a call option.

**CASE 1:** (Spot price < Strike price)

As the spot price (E1) of the underlying asset is less than strike price (S), the buyer gets the profit (SR), if price decreases less than E1 then profit also increases more than (SR).
CASE 2: (Spot price > Strike price)

As the spot price (E2) of the underlying asset is more than strike price (S), the buyer gets loss of (SP), if price goes more than E2 than the loss of the buyer is limited to his premium (SP).

**PAY-OFF PROFILE FOR SELLER OF A PUT OPTION:**

The pay-off of a seller of the option depends on the spot price of the underlying asset. The following graph shows the pay-off of seller of a put option:

```
<table>
<thead>
<tr>
<th>Profit</th>
<th>Loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>SP</td>
<td>SR</td>
</tr>
<tr>
<td>E1</td>
<td></td>
</tr>
<tr>
<td>S</td>
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<td>ITM</td>
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<td>E2</td>
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<td></td>
</tr>
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</tbody>
</table>
```

**CASE 1: (Spot price < Strike price)**

As the spot price (E1) of the underlying asset is less than strike price (S), the seller gets the loss of (SR), if price decreases less than E1 than the loss also increases more than (SR).

**CASE 2: (Spot price > Strike price)**

As the spot price (E2) of the underlying asset is more than strike price (S), the seller gets profit of (SP), if price goes more than E2 than the profit of seller is limited to his premium (SP).

**PRICING OPTIONS**

The black-scholes formula for the price of European calls and puts on a non-dividend paying stock are:

**CALL OPTION:**

\[ C = SN(D1) - Xe^{-r}N(D2) \]

**PUT OPTION**

\[ P = Xe^{-r}N(-D2) - SN(-D2) \]

Where

- \( C \): VALUE OF CALL OPTION
- \( S \): SPOT PRICE OF STOCK
- \( N \): NORMAL DISTRIBUTION
- \( V \): VOLATILITY
- \( X \): STRIKE PRICE
- \( r \): ANNUAL RISK FREE RETURN
- \( t \): CONTRACT CYCLE


\[ d_1 = \frac{1}{\sigma \sqrt{t}} \ln \left( \frac{S}{X} \right) + (r + \frac{\sigma^2}{2})t \]

\[ d_2 = d_1 - \sigma \sqrt{t} \]

**DATA ANALYSIS AND INTERPRETATION**

**ANALYSIS OF ICICI:**

The objective of this analysis is to evaluate the profit/loss position of futures and options. This analysis is based on sample data taken of ICICI BANK scrip. This analysis considered the Jan 2017 contract of ICICI BANK. The lot size of ICICI BANK is 175, the time period in which this analysis done is from 28-12-2016 to 31.01.17.

**Table 1**

<table>
<thead>
<tr>
<th>Date</th>
<th>Market price</th>
<th>Future price</th>
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<td>31-Jan-17</td>
<td>1147</td>
<td>1145.9</td>
</tr>
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</table>

If a person ICICI sells on 31st of 1145.9, he will get a loss of 14201.25 i.e. -81.15 \* 175.

If he sells on 16th Jan, 2017 then he will get a profit of 1420.75-1227.05 = 193.7 i.e. a profit of 193.7 per share. So his total profit is 33897.5 i.e. 193.7 \* 175

The closing price of ICICI BANK at the end of the contract period is 1147 and this is considered as settlement price.

**OBSERVATIONS AND FINDINGS:**

buys 1 lot i.e. 175 futures of BANK on 28th Dec, 2017 and Jan, 2018 then he will get a loss 1227.05 = -81.15 per share. So...
The following table explains the market price and premiums of calls.

- The first column explains trading date
- Second column explains the SPOT market price in cash segment on that date.
- The third column explains call premiums amounting at these strike prices: 1200, 1230, 1260, 1290, 1320 and 1350.

**Call options:**

*Table 2*

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<th>Date</th>
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**CALL OPTION**

**BUYERS PAY OFF:**
Those who have purchase call option at a strike price of 1260, the premium payable is 39.65
On the expiry date the spot market price enclosed at 1147. As it is out of the money for the buyer and in the money for the seller, hence the buyer is in loss.
So the buyer will lose only premium i.e. 39.65 per share.
So the total loss will be 6938.75 i.e. 39.65 * 175

SELLERS PAY OFF:
As Seller is entitled only for premium if he is in profit.
So his profit is only premium i.e. 39.65 * 17 = 6938.75

PUT OPTIONS

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OBSERVATIONS AND FINDINGS  PUT OPTION

BUYERS PAY OFF:
As brought 1 lot of ICICI that is 175, those who buy for 1200 paid 39.05 premium per share.
Settlement price is 1147
Strike price 1200.00
Spot price 1147.00

53.00

Premium (-) 39.05

13.95 x 175 = 2441.25

Buyer Profit = Rs. 2441.25

Because it is positive it is in the money contract hence buyer will get more profit, incase spot price decreases, buyer’s profit will increase.

SELLERS PAY OFF:

❖ It is in the money for the buyer so it is in out of the money for the seller, hence he is in loss.
❖ The loss is equal to the profit of buyer i.e. 2441.25.

CONCLUSION

➢ In bullish market the call option writer incurs more losses so the investor is suggested to go for a call option to hold, whereas the put option holder suffers in a bullish market, so he is suggested to write a put option.
➢ In bearish market the call option holder will incur more losses so the investor is suggested to go for a call option to write, whereas the put option writer will get more losses, so he is suggested to hold a put option.

References

BOOKS:
- Derivatives Dealers Module Work Book - NCFM (October 2005)

WEBSITES:
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- http://www.nseindia/content/equities/eq_historicaldata.htm
- http://www.bseindia/about/derivati.asp#typesofprod.htm