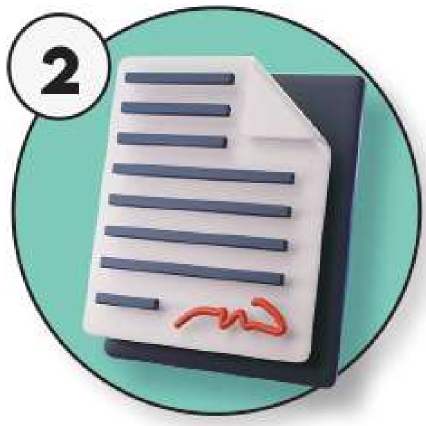
1.6 TYPES OF DERIVATIVES

Derivatives contracts are of different types. Each of these different type of derivative contracts has a different purpose. They differ in their construct, risk, reward, payoffs, terms and many more aspects. One needs to pick the correct type of derivative based on what asset class do they want to hedge or trade in.

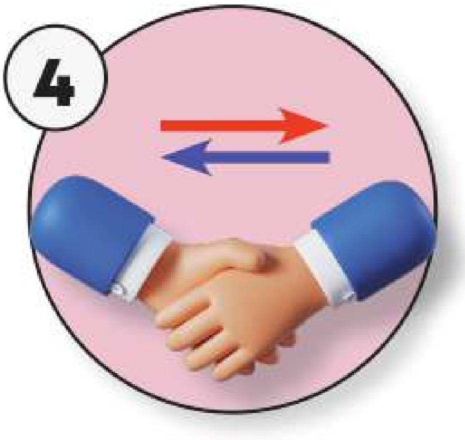
THE COMMON TYPES OF DERIVATIVES ARE:

FORWARDS CONTRACT



FUTURES CONTRACT

OPTIONS



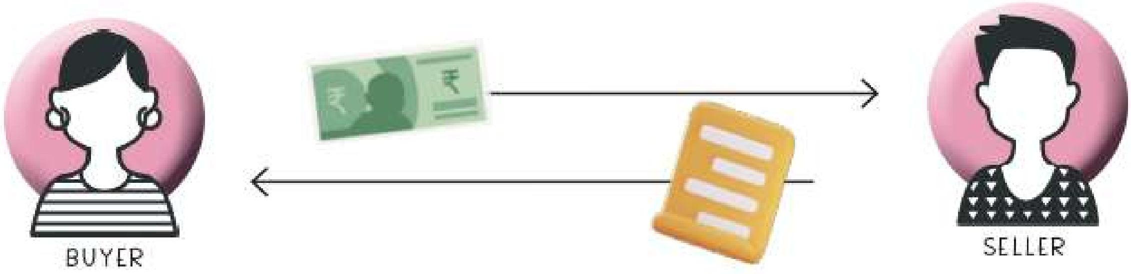
SWAPS

Although we have dedicated chapters, in this book, for each of these derivatives, let us quickly understand the basics of these kinds before we move further. Also, in this book, we will mainly focus on Futures and Options from a trading point of view and go in lot of detail for these.

FORWARDS CONTRACT

Explainer Video

Forward contracts are an agreement between a buyer and a seller to trade the underlying asset at a future date at a predetermined price. Here, the trade is to be executed in the future irrespective what the market price is on the pre-determined date. These are not traded over exchange i.e. we cannot buy forward contracts on BSE and NSE. These are to be done in person by finding a counter-part.



TRADE UNDERLYING ASSET AT A PREDETERMINED PRICE

- ☑ FUTURE DATE
- ☑ PREDETERMINED PRICES
- ☒ EXCHANGE TRADED

FUTURES CONTRACT

Explainer Video

Futures contracts are an agreement to buy/sell an underlying asset at a future date decided today and at a predetermined price but these are exchange-traded. They work in a manner similar to Forward contracts except for the fact that they can be bought and sold over BSE and NSE. Also, these require daily settlement of profits and losses. We will learn more about these going ahead.

Therefore, for each contract, there is a middle person, i.e., BSE or NSE, with whom the contract is done.

- ☑ FUTURE DATE
- ☑ PREDETERMINED PRICES
- ☑ EXCHANGE TRADED

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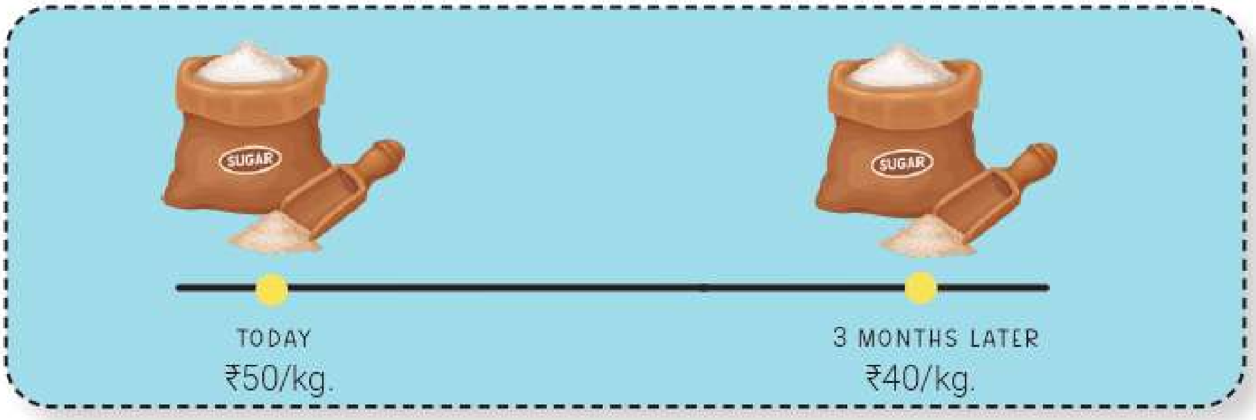
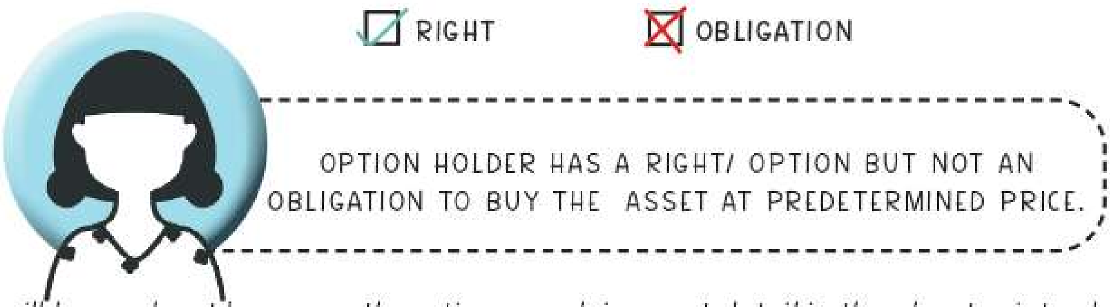
OPTIONS

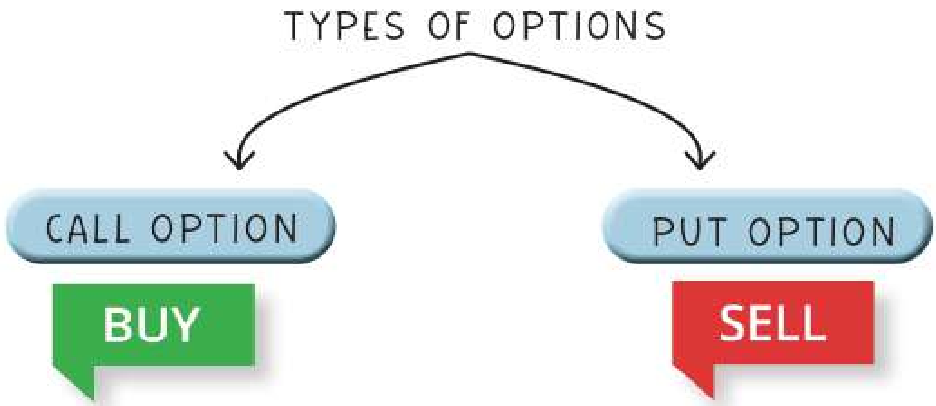
Explainer Video

Options are, as by their name, an option or right to buy or sell an underlying asset at an agreed price in a specific period of time. This basically means that, a buyer can enter into a contract and exercise only if they are making profits from the same and let it go un-exercised if they are not making profits. Options are basically a contract where the buyer is not obligated to exercise the contracts.





We will learn about how exactly options work in great detail in the chapter introducing Options. You do not need to understand the complete working right away. We will learn more going ahead.



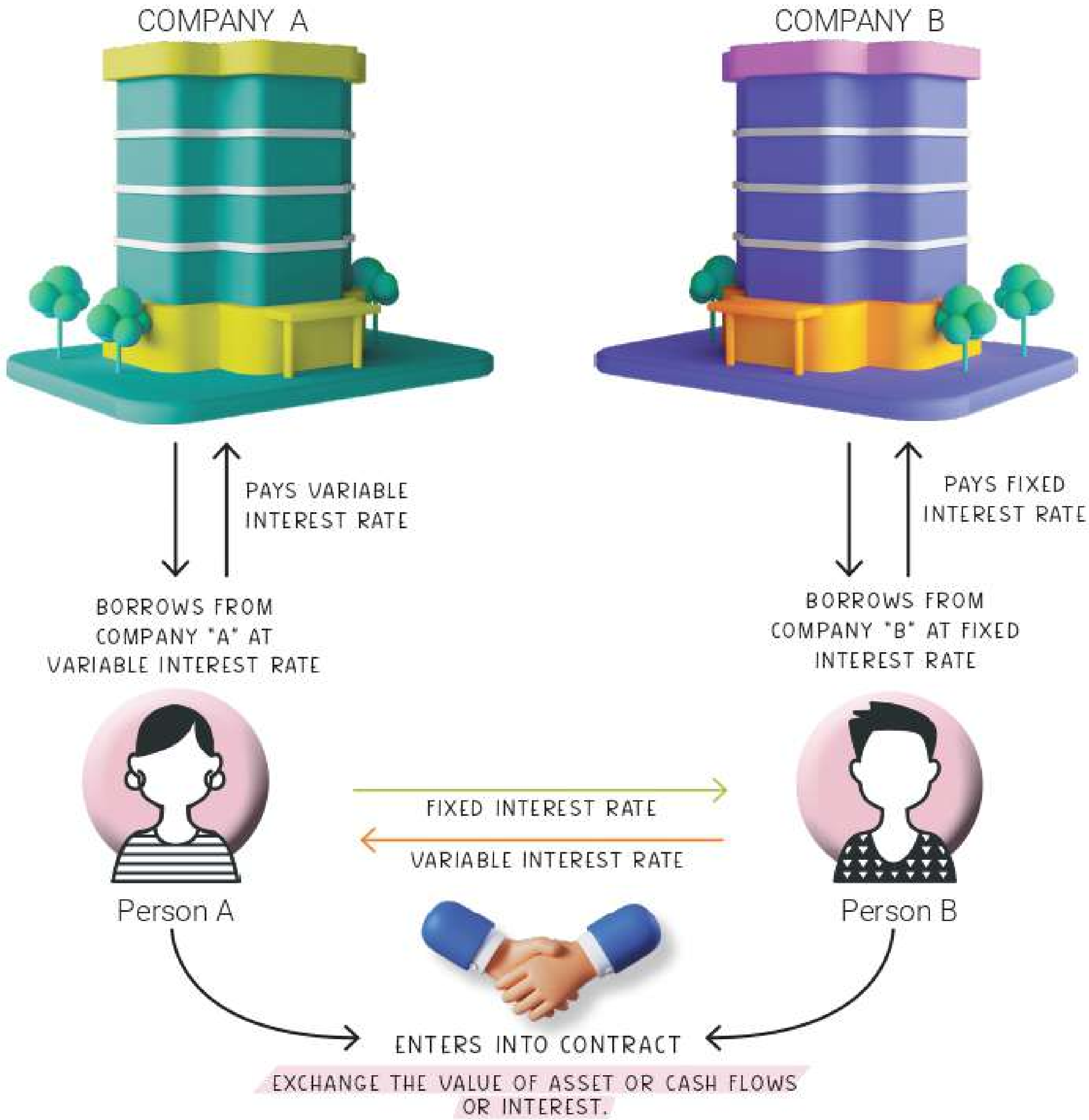
In the Call Option, the buyer has the option/right - but not the obligation, to purchase the underlying asset at a fixed price. Here, the buyer profits when the price of the underlying asset goes up.

In the Put Option, the buyer has the option/right - but not the obligation, to sell the underlying asset at a fixed price. Here, the buyer of the Put option profits when the price of underlying asset goes down. We will understand this in great detail going ahead.

SWAPS

Swaps contracts are one of the most complex ones. These are, to a great degree, used by - large corporations and financial institutions. Swaps are when two parties exchange their liabilities on agreed terms and then the change in value of the liability is their profit or loss.

Explainer Video



Here for example, person B had to pay Fixed Interest rate to Company B. However, after the swap they have to pay Variable Interest Rate. Now imagine if the interest rate in the economy goes down. Without the swap they would still be paying a fixed rate but after the swap they would have to pay a reduced rate of interest. The vice versa is true with if the interest rate goes up as well. In that case person B would incur losses due to the Swap arrangement. This is how Swaps work on interest rates. Swaps are traded over the counters and not over the Exchanges i.e. not over BSE and NSE. They are customized - per the unique requirements of the parties involved in the contract.