CHAPTER 1

WHAT ARE DERIVATIVES?

1.1 Meaning
1.2 Classes of core assets
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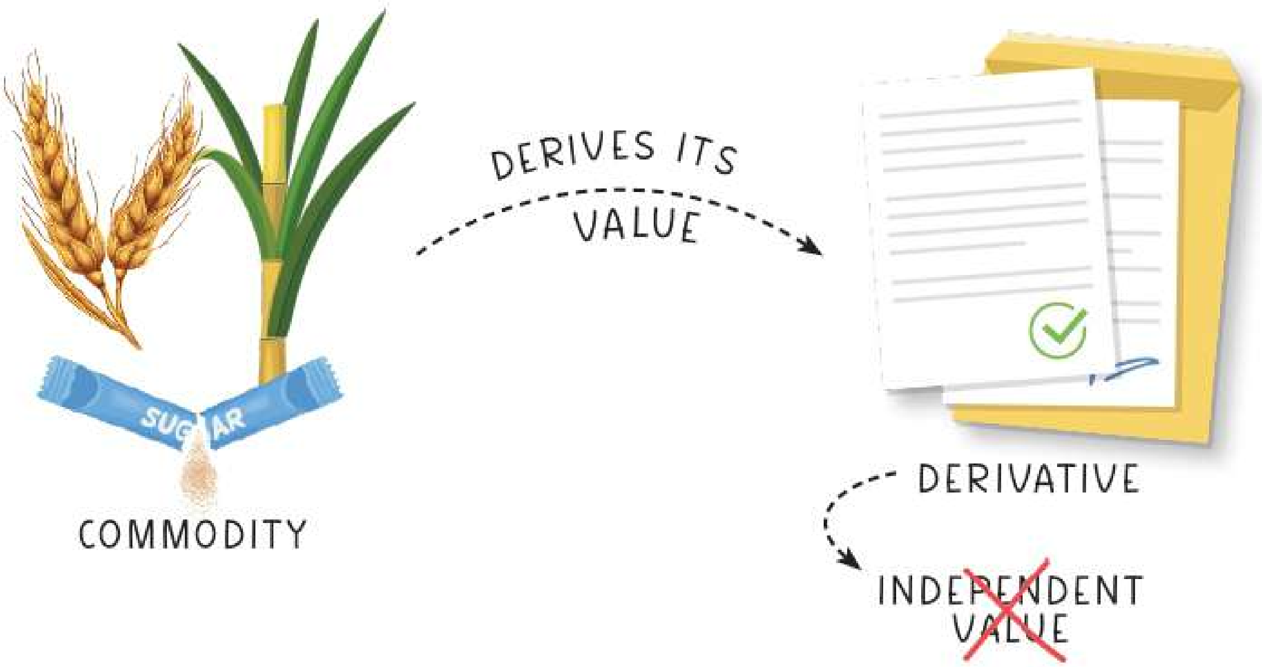
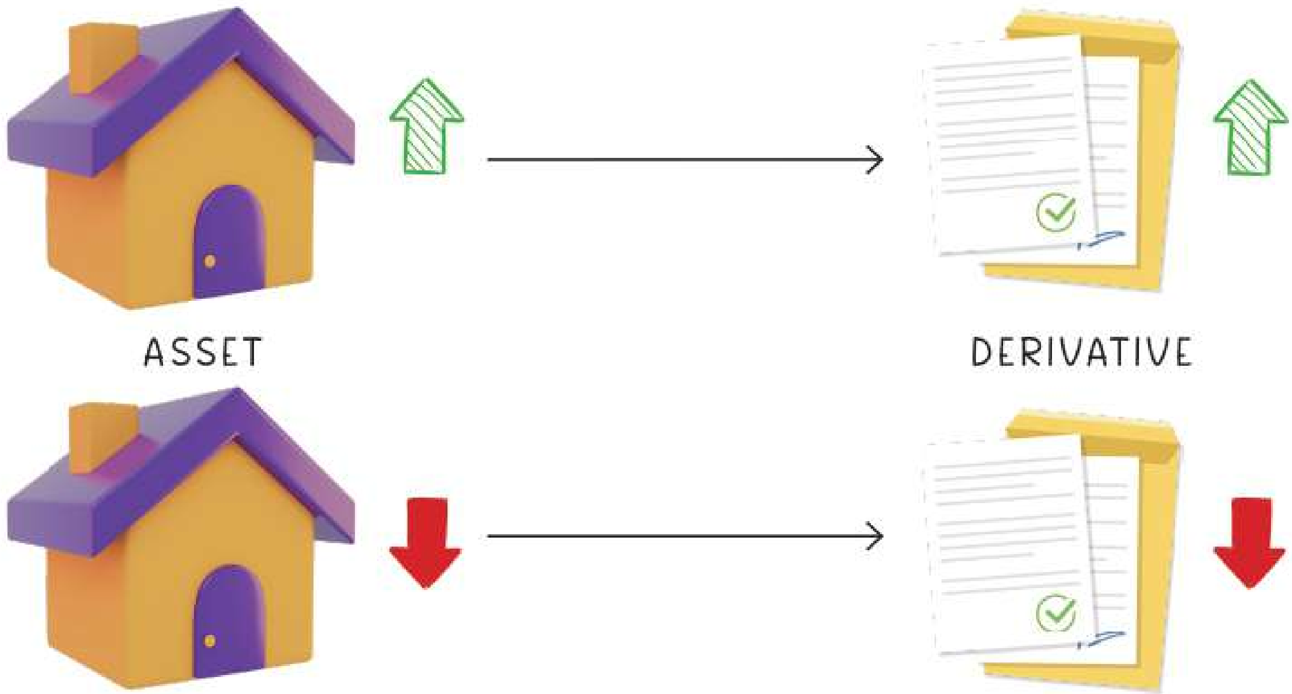
1.1 MEANING

Explainer Video

The word derivatives speak for itself about its meaning. It is an instrument that derives its value from something else and does not have a value independent of that underlying (the asset on which the derivative depends for its value).



Derivatives are anything that derives its value from an underlying asset. This means that as the underlying asset changes, so do the value/price.

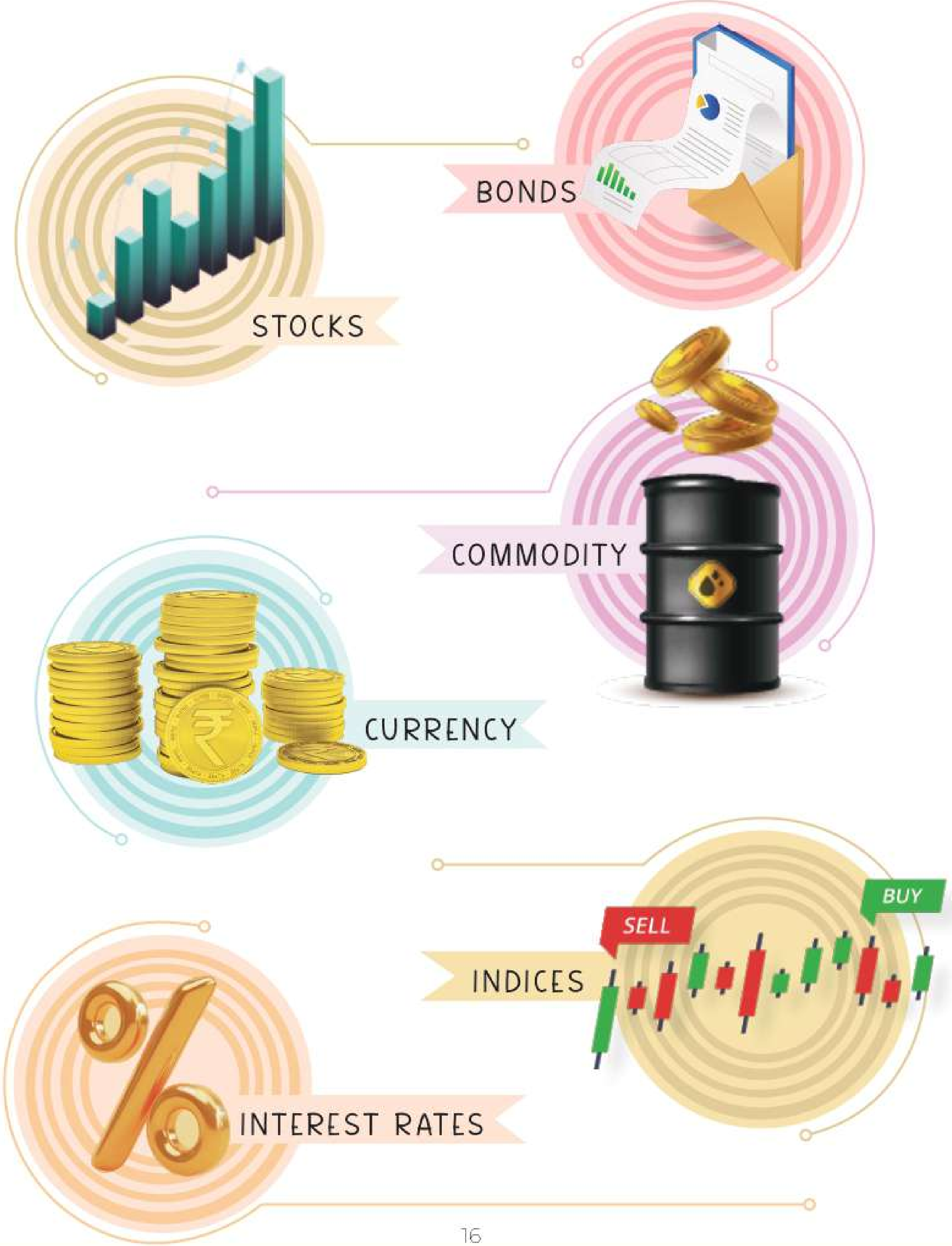


Hence the derivative is directly proportional to the underlying asset for its value.

For instance,
if the value of a derivative is directly proportional to an underlying asset, say wheat, then if the price of wheat is seeing an increase in its value (up move), so will the derivative.

To understand the effect of wheat i.e., the underlying asset, we first need to know and understand the core assets (the asset on which the derivative depends for its value) that a derivative might be dependent on for its value.

1.2 CLASSES OF CORE ASSETS



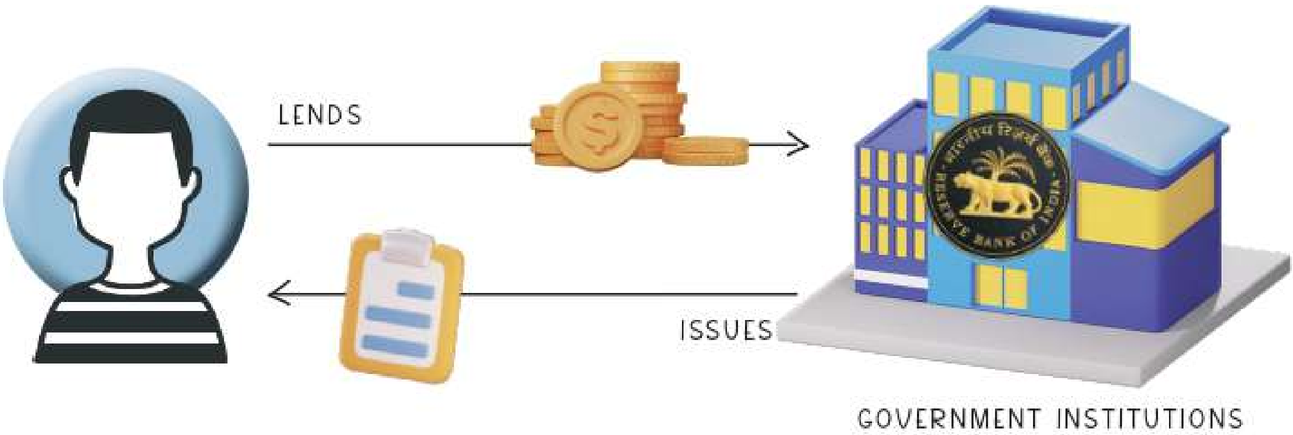
STOCKS

Stocks of any corporation consist of shares of the ownership of the company like RELIANCE, TCS, IDEA, IDFCFIRSTB, TATASTEEL, BHEL, COAL INDIA, VOLTAS, etc.

BONDS

By issuing bonds a company borrows money from us. Think of bonds as an FD with govt. (Treasury-bond) or any other institution or corporation, which as a bond instrument can be traded in the market as well.

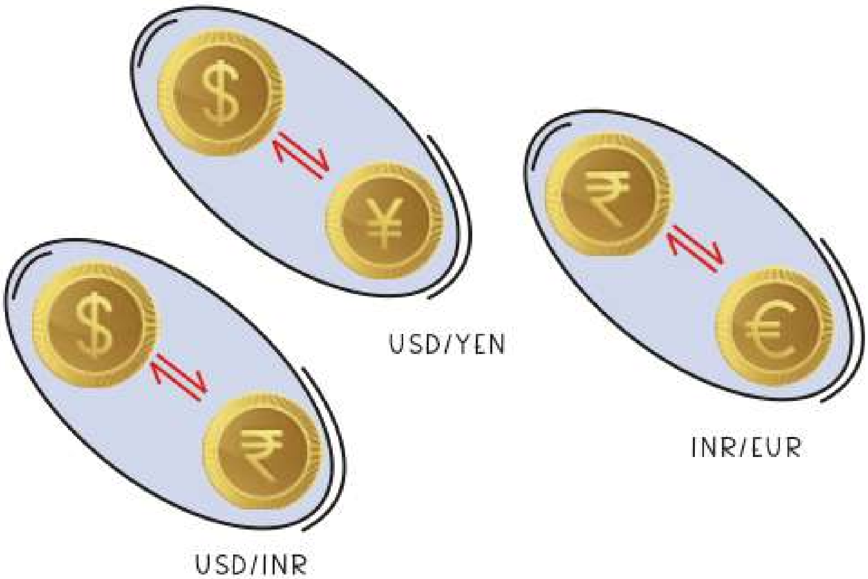
These are less heard of by retail investors since they are used by more institutional or more sophisticated investors.



A DOCUMENT THAT CERTIFIES THAT YOU HAVE LENT AMOUNT X TO A PARTICULAR COMPANY, GOVERNMENT, OR INSTITUTION (RBI, NABARD, ETC.).

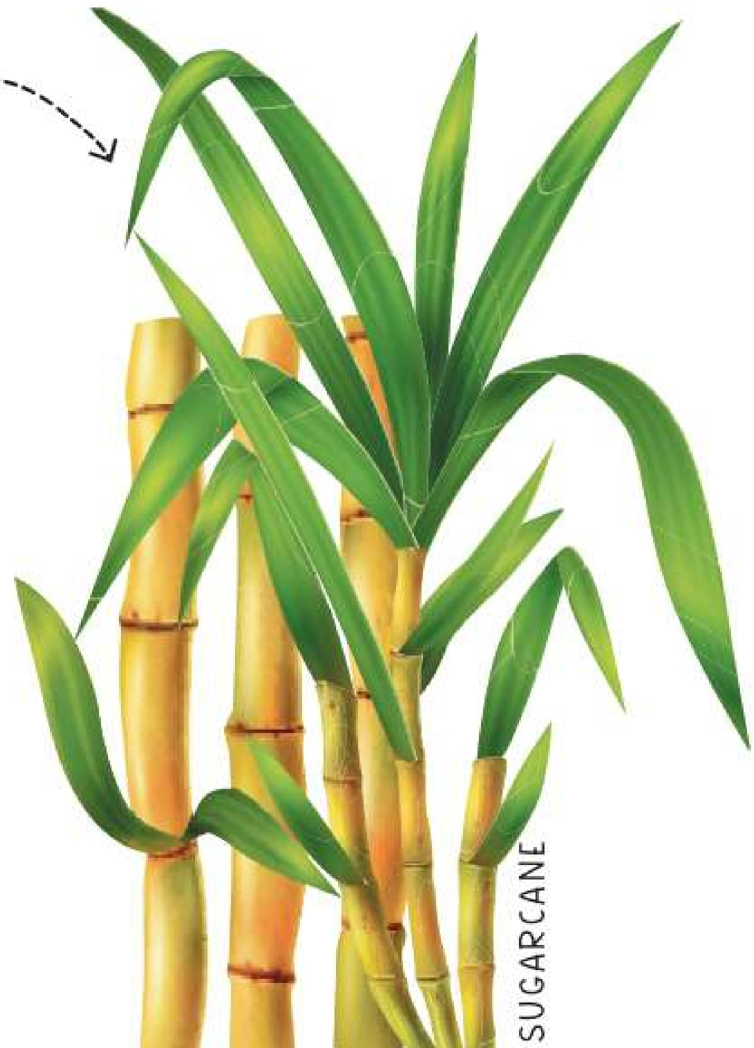
CURRENCY

Currencies in pairs like USD/INR, USD/YEN, INR/EUR, etc. Any two currencies for that matter.



COMMODITY

Commodities have the most extensive futures, forwards, and options market. For instance, farmers use these to lock wheat, sugarcane, steel or other crop or commodity prices, to foresee the price uncertainty.



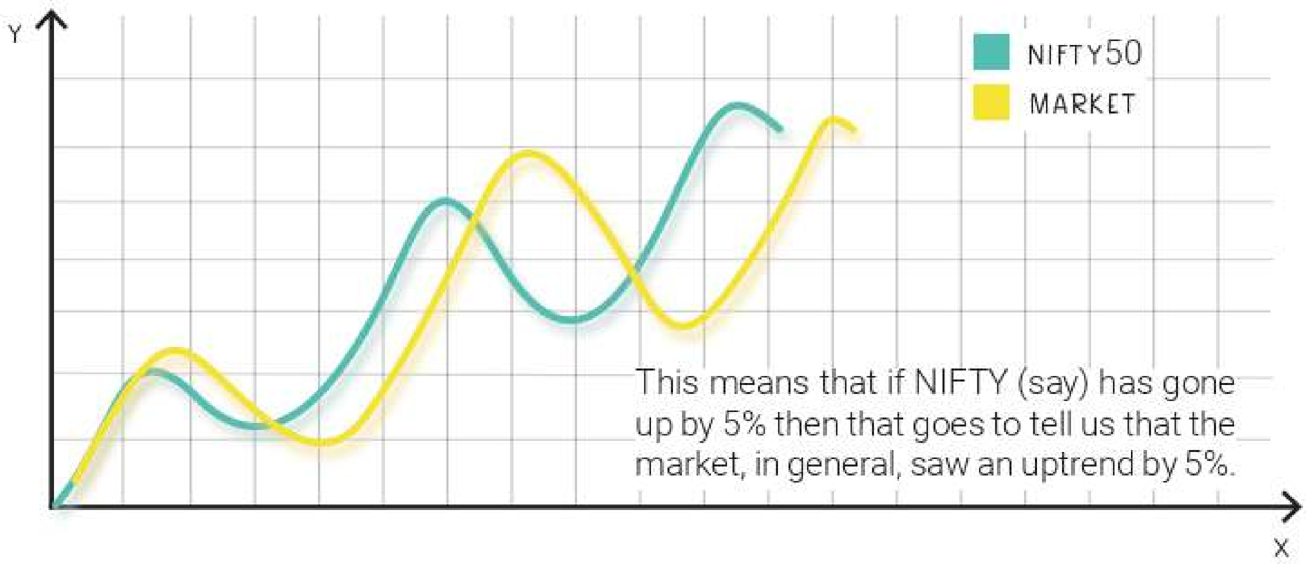
INTEREST RATES

This is part of interest rate swap derivatives. One party here agrees to pay a **fixed interest rate in exchange for the variable interest rate** (LIBOR i.e., London Interbank Offer Rate + x%, x is constant here and LIBOR is variable).

THESE ARE USED BY MUCH LARGER CORPORATIONS OR FINANCIAL INSTITUTIONS, AND BANKS.

INDICES

Indices are a collection of stocks that represent the complete set of stocks. Some indices namely are **Sensex, NIFTY 50, Sensex small cap, etc.**



Note:
It is alright to not understand this fully, focus on understanding the types of core assets here and not their working. For the scope of this curriculum, we will be sticking with an in-depth understanding of derivatives with stocks, currencies, commodities, and indices.)

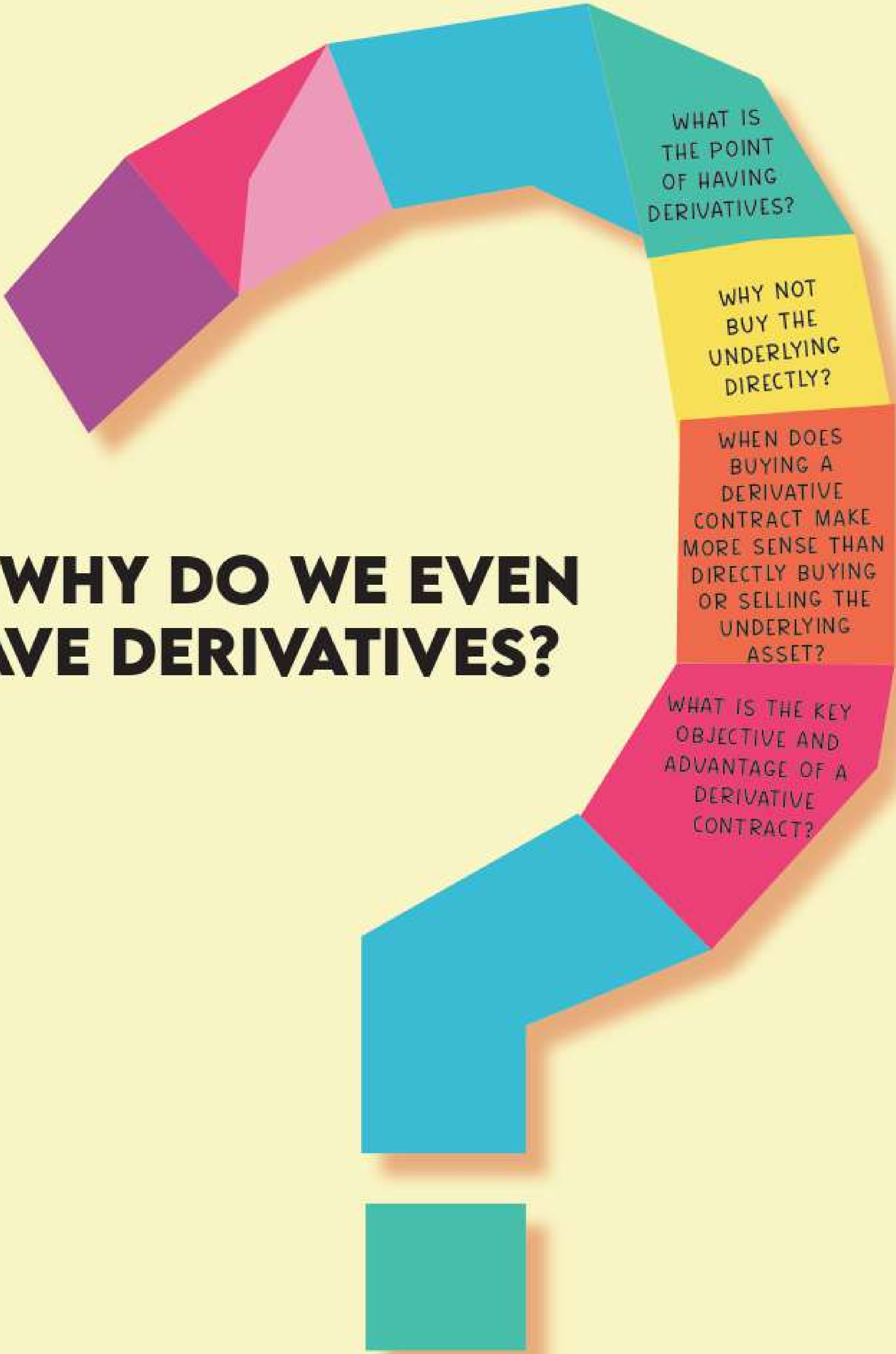
NSE Indices

NIFTY50

NIFTY50 FUTURES

We will see that the movement of the underlying asset and the derivate is related. We will learn how different types of derivative contracts move differently based on the movement of the underlying asset prices. For instance, NIFTY and NIFTY Futures move in an identical manner.

Source: https://in.tradingview.com/



1.3 WHY DO WE EVEN HAVE DERIVATIVES?

To answer the above questions, let us understand the difference between buying an asset through the spot market against buying the asset through a derivative contract i.e. Forward contract.