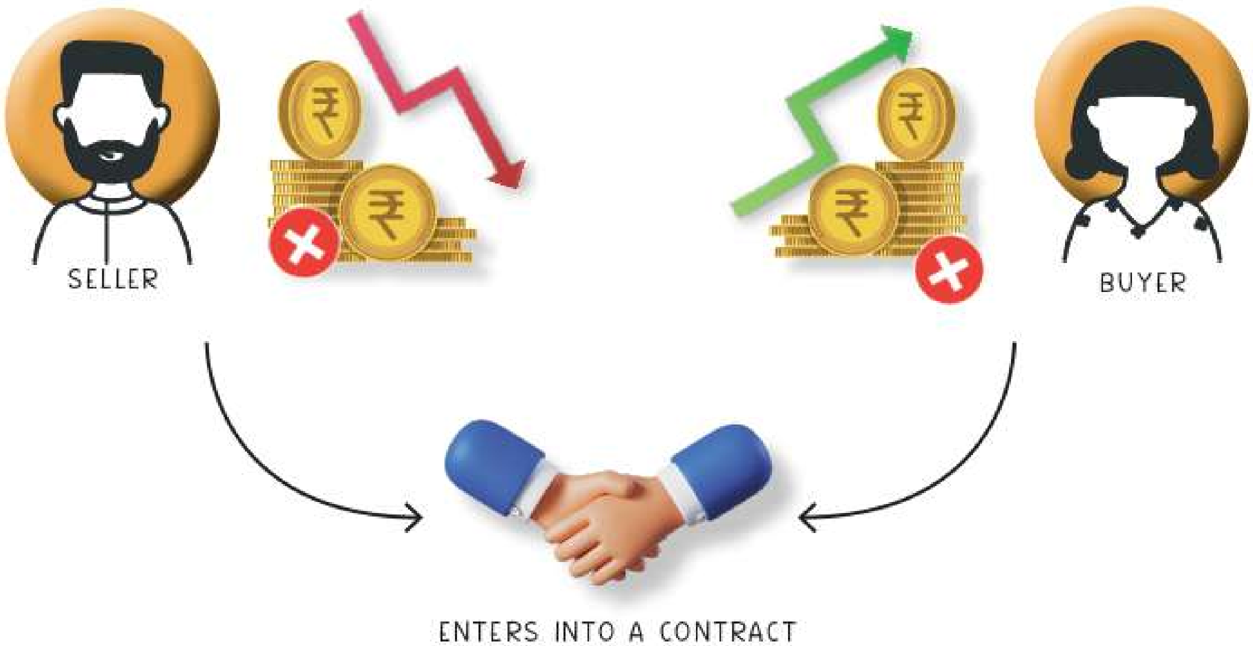
1.7 WHO USES DERIVATIVES?

WHO ARE HEDGERS?

Hedgers, as the name suggests, are traders that want protection against the risk of price movement or price uncertainty that is not in their favor. The primary motive here is not to profit from the derivative contracts but reduce the risk of major losses due to change in prices.

For instance, a sugar seller would not want the price of sugar to fall and therefore is looking to hedge/protect herself against a major price drop in the future.

On the other hand, a sugar buyer (say for bakery raw material) would not want the price of sugar to rise and therefore is willing to hedge himself against the price rise in the future.

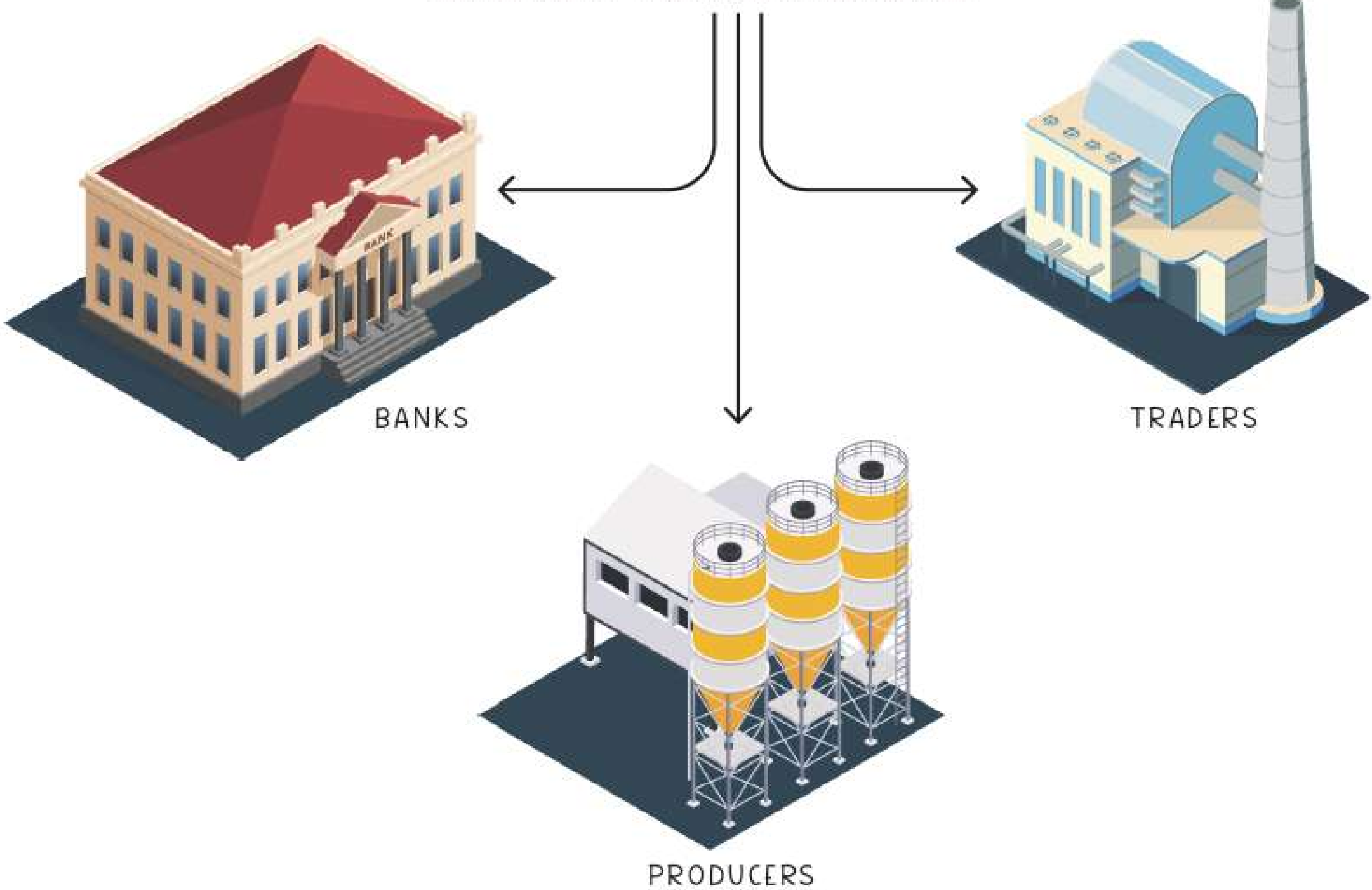


Both are willing to enter a forward contract (derivative) to

- LOCK THE PRICE AT A MUTUALLY PREDETERMINED AMOUNT
- QUANTITY TO BE SOLD
- AT A PREDEFINED FUTURE DATE, DECIDED TODAY.

In financial markets, hedging is an activity undertaken to reduce overall portfolio risk that a company may have. For example, a portfolio that has lot of shares linked directly to movement o Crude oil might want to hedge it using derivative contracts. Banks might want to reduce interest rate exposures in uncertain times. The idea here is to not make profits from derivatives but to avoid large losses that they might otherwise face.They are seeking safety and protection by entering this contract and are therefore called **Hedgers.**

HEDGERS CAN BE ANYONE



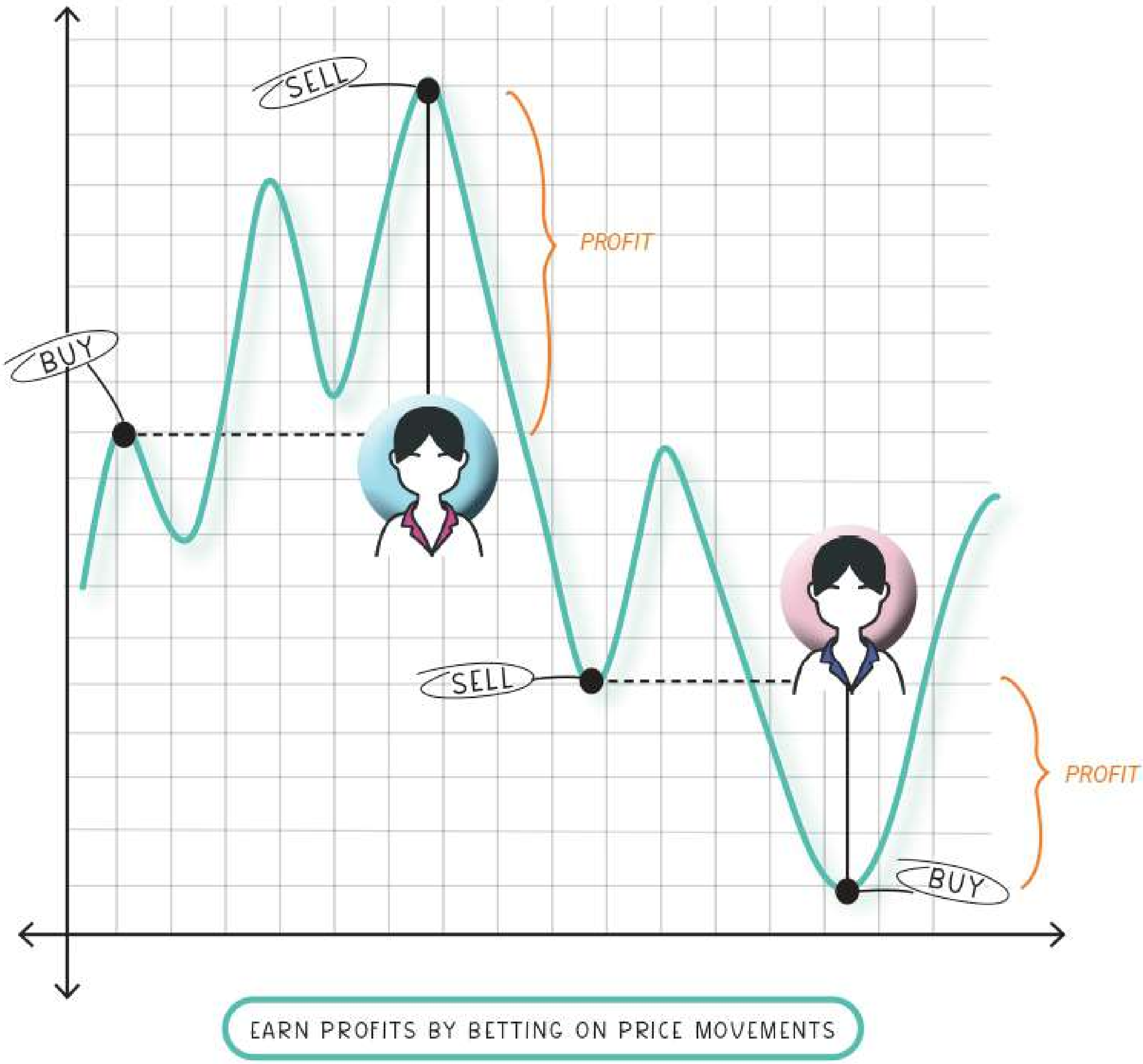
As per the fundamental rule of finance -

HIGHER THE RISK, HIGHER IS THE REWARD.

With hedging, the person is trying to reduce risk and as a result will have to let go of some of the profits that they might have made without the hedge. Hedgers are not concerned with profitability when it comes to derivatives- related transactions.

WHO ARE SPECULATORS?

Speculators, as the name suggests, are individuals that take on additional risk to profit from the market movements using derivative contracts. They are looking for opportunities to profit from. Profit making is the main objective here.

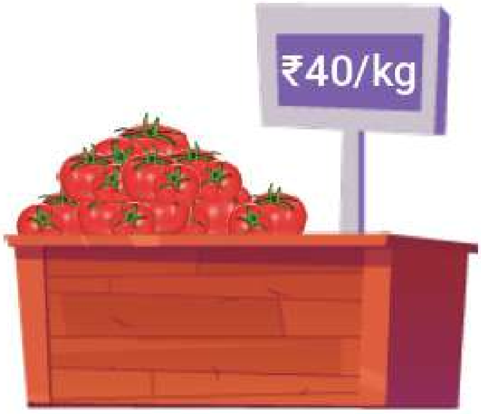


Most traders fall in this category. They are not looking for hedges for their main portolio. They are actively looking to earn using their trading strategies.

WHO ARE ARBITRAGEURS?

Arbitrageurs are people who keep a close watch on the price discrepancies in the market for an asset. Arbitrage opportunities basically means that there is a market inefficiency that is there to benefit from. However, arbitrage opportunities are difficult to spot in general. Let us understand arbitrage using a simple example.

For instance, let us say the price of 1 kg tomatoes in your Market A is ₹50



And the price of the same 1 kg tomatoes in your friend's area i.e. Market B is ₹40.

Here as an arbitrageur, you may see an opportunity to buy from Market B and sell in Market A at a profit of ₹10 per kg .

In theory, arbitrage opportunities are risk-less i.e. they have no risk involved. Here similar assets are bought and sold in different markets at the same time. Here the trader tries to benefit from such differences.