A study on Investors Preferences towards various investment avenues in Capital Market with special reference to Derivatives

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Abstract

In India, generally all capital market investment avenues are perceived to be risky by the investors. But the younger generation investors are willing to invest in capital market instruments and that too very highly in Derivatives segment. Even though the knowledge to the investors in the Derivative segment is not adequate, they tend to take decisions with the help of the brokers or through their friends and were trying to invest in this market. This study was undertaken to find out the awareness level of various capital market instruments and also to find out their risk preference in various segments. This Study Intends 1) to find our the preference level of investors on various Capital Market instruments 2) to find out the type of risk which are considered by the investors 3) to find out the ways through which the investors on various minimizes their risk 40 to find out the preferences of Investors in derivatives market. About 100 samples were collected from Chennai city from various investors through a structured questionnaire and awareness about derivatives and the investor risk preference in an elaborate way

Introduction

In India, generally all capital market investment avenues are perceived to be risky by the investors. But the younger generation investors are willing to invest in capital market instruments and that too very highly in Derivatives segment. Even though the knowledge to the investors in the Derivative segment is not adequate, they tend to take decisions with the help of the brokers or through their friends and were trying to invest in this market. This study was undertaken to find out the awareness level of various capital market instruments and also to find out their risk preference in various segments.

Need for the study:

- To educate investors who are risk averse for trade in derivatives
- Awareness about the various uses of derivatives can help investors to reduce the risk and minimize the losses

Overview of the study:

Derivatives have fundamentally changed financial management by providing new tool to manage risk. What makes derivatives important is not so much the size of the activity, as the role it plays in fostering new ways to understand,

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measure and manages risk. Through derivatives the complex risks that are bound together in traditional instruments can be teased apart and managed independently and often more efficiently. A remarkable growth in the derivatives markets has caused many consequences on the players associated with them. Some got advantages out of it; other became victims of the adverse results of investing in it.

Derivative securities have been recently blamed as culprits for huge financial loses at firms like Gibson, P & G, Barring etc. they are sometimes viewed as bad because, they are complex instruments, highly leveraged and difficult to understand. The development of derivatives has occurred in response to a search for higher yields and lowers funding costs and demand for tools to manage risk.

DEFINITION

Derivatives may be defined as "A security or contract designed in such a way that its price is derived from the price of an underlying asset".

The price of the derivative security is not arbitrary. It is linked to the price of underlying asset. Changes in the price of underlying asset affect the price of derivative security. A true derivative instrument requires no movement of principal funds. It is this characteristic that makes them such useful tool to hedge and to take risk.

Another definition explains derivatives, as "Derivatives are financial instruments whose returns are derived from those of other financial instruments"

Their performance depends on how other instruments perform.

Factors Affecting Growth of Derivatives:

Growths of derivatives are affected by a number of factors. Some of the important factors are stated below.

1. Increased volatility in asset prices in financial markets.
2. Increased integration of national financial markets with the international markets.
3. Marked improvement in communication facilities and sharp decline in their costs.
4. Development of more sophisticated risk management tools, providing economic agents, a wider choice of risk management strategies.
5. Innovation in the derivative markets, which optimally combine the risk and returns, reduced risks as well as transactions costs as compared to individual financial assets.

Evolution of derivatives

1) Forward Trading :

It is not clearly established when and where the first forward market came into existence. There are reports that forward

trade existed in India as far back as 2000BC and in Roman times. Forward trading is believed to have been in existence in the 12th century English and French fairs. There was forward trade in rice in the 17th century in Japan. The first organized forward market came into existence in late 19th and early 20th century in Kolkatta (jute & jute goods) and in Mumbai (cotton).

2) Futures Trading

The Dojima rice market can be considered as the first future market in the sense of an organized exchange. The first futures in the western hemisphere were developed in United States in Chicago. First they were started as spot markets and gradually evolved into futures trading. First stage was starting of agreements to buy grain in future at a predetermined price with the intention of actual delivery. Gradually these contracts became transferable and during American civil war, it became commonplace to sell and resell agreements instead of taking delivery of physical produce. Traders Found that the agreements were easier to but and sell. This is how modern futures contracts came into being.

3) Options Trading

Options trading are of more recent origin. It is estimated that they existed in Greece and Rome as early as 400 BC. Options trading in agriculture products and shares came in US from the 1860s. The first options market was started by Chicago BOARD OF trade (CBOT) in 1973. Standard maturities, standard strike prices, standard delivery arrangements were evolved. The risk of default was removed by introducing a clearinghouse and margin system. The introduction of traded options opened the way for the evolution of more complex derivatives.

4) SWAP Trading

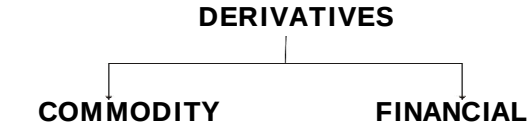
The first SWAP transaction took place between World Bank and IBM (International business machine). They were currency Swaps. Interest rates swaps also commenced in 1981.

5) Other Derivatives

Other derivatives like Forward Rate Agreements (FRAs), Range forwards, Collars evolved in second half of 1980s.

TYPES OF DERIVATIVES

One way of classifying derivatives is as,



Commodity Derivatives

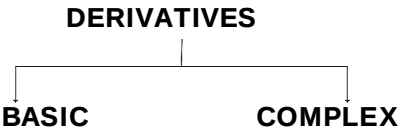
These deals with commodities like sugar, gold, wheat, pepper etc. thus, futures or options on gold, sugar, pepper, jute etc are commodity derivatives.

Financial Derivatives

Futures or options or Swaps on currencies, gilt edged securities, stocks

and shares, stock market indices, cost of living indices etc are financial derivatives.

Another way of classifying Derivative is.

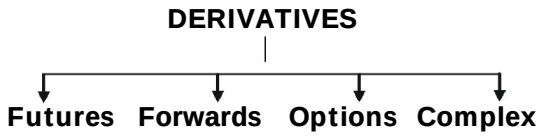


Basic Derivatives

They are forward / futures contracts and option contracts.

Complex Derivatives

Other derivatives, such as SWAPS are complex ones because they are built up from either forward / future contracts or options contracts or both. Generally derivatives can be classified as follows:



Futures

A futures contract is a contract to "buy or sell a standard amount of or predetermined grades of certain commodity (i.e. commodity futures) or financial instruments or currency (that is financial futures) on a predetermined future day at an agreed prize."

Forwards

It is "an agreement between two parties to buy or sell a commodity or financial instrument at a predetermined future date at a prize agreed when the contract is a made". The forward contracts are normally traded outside the exchanges. Forward contracts are very useful in hedging and speculation.

Options

They are the second, most important group of derivative securities, first being futures. It is "a contract between two parties where by one party acquires the right, but not the obligation to buy or sell a particular commodity or financial instrument at a specified date". Options are of two types

(a) Call option (b) Put option

Call Option: Call option gives the holder the right but not the obligation to buy an asset by a certain date for a certain price.

Put Option: Put option gives the holder the right but not the obligation to sell an asset by a certain date for a certain price.

Complex Derivatives

Using futures and options it is possible to build number of complex derivatives. IT is designed to suit the particular needs and circumstances of a client

Example: SWAPS, Credit Derivatives

Weather Derivatives

This is a new tool for risk management. This is a contract between 2 parties that stipulate how payment will be exchanged between parties depending on certain meteorological conditions during the contract period. They are based on data such as temperature, rainfall,

snowfall etc. The primary objective of this derivative is to initiate the volume risks, which will influence the Balance Sheet and Profit and Loss figures.

Functions of derivatives

- **Risk Management:** It involves structuring of financial contracts to produce gains or losses that counter balances the losses or gains arising from movements in financial prices. Thus risks are reduced and profit is increased of a financial enterprises.
- **Price Discovery:** This represents the ability to achieve and disseminate price information without price information investors; consumers and producers cannot make decisions. Derivatives are well suited for providing price information.
- **Transactional Efficiency:** Transac tional efficiency is the product of liquidity. Inadequate liquidity results in high transaction costs. This increases investment and causes accumulation of capital. Derivatives increases market liquidity, as a result transactional costs are lowered, and the efficiency in doing business is increased.

RISK OF DERIVATIVES

Any comment about derivative would be inadequate without a word of caution. There are 4 inherent risks associated with derivatives. These risks should be clearly understood before establishing position in derivatives market.

a) **Credit Risk:** The exposure to the possibility of loss resulting from a counter party's failure to meet its financial obligation.

b) **Market Risk:** Adverse movements in the price of financial asset or commodity.

c) **Legal Risk:** An action by a court or by a regulatory body that could invalidate a financial contract.

d) **Operations Risk:** Inadequate Controls, Human error system failure of fraud.

REVIEW OF LITERATURE

"Investment property portfolio management and financial derivatives" by Patrick McAllister, John R. Mansfield. His study on Derivatives has been an expanding and controversial feature of the financial markets since the late 1980s. They are used by a wide range of manufacturers and investors to manage risk. This paper analyses the role and potential of financial derivatives investment property portfolio management. The limitations and problems of direct investment in commercial property are briefly discussed and the main principles and types of derivatives are analysed and explained. The potential of financial derivatives to mitigate many of the problems associated with direct property investment is examined.

"Derivatives, risk and regulation: chaos or confidence?" by R. Dixon, R.K. Bhandari said that there has been an extraordinary increase in the use of

financial derivatives in the capital markets. Consequently derivative instruments can have a significant impact on financial institutions, individual investors and even national economies. This relatively recent change in the status of derivatives has led to calls for regulation. Using derivatives to hedge against risk carries in itself a new risk was brought sharply into focus by the collapse of Barings Bank in 1995. The principal concerns of regulators about how legislation may meet those concerns are the subject of current debate between the finance industry and the regulators. Recommendations have been made and reviewed by some of the key players in the capital markets at national and global levels. There is a clear call for international harmonization and its recognition by both traders and regulators. There are calls also for a new international body to be set up to ensure that derivatives, while remaining an effective tool of risk management, carry a minimum risk to investors, institutions and national/global economies. Having reviewed derivatives and how they work, proceeds to examine regulation. Finds that calls for regulation through increased legislation are not universally welcome, whereas the regulators' main concern is that the stability of international markets could be severely undermined without greater regulation. Considers the expanding role of banks and securities houses in the light of their sharp reactions to increases in interest rates and the effect their presence in the derivatives market may have on market volatility. Includes the reaction of some 30 dealers and users to the recommendations of the G-30 report and looks at some key factors in overcoming potential market volatility.

"Management's disclosure of hedging activity: An empirical investigation of analysts and investors reactions" by JenniferReynolds-Moehrle. This study aims to examine how market participants changed the way they process earnings information after learning of the implementation of hedging activities. **Design/methodology/approach** – Using a sample of derivative user and non-user firms, this study empirically compares earnings predictability, forecast revision behavior, and the earnings response coefficients before and after the disclosure of hedging activity.

Findings – The findings indicate that analysts' forecast accuracy increased and that unexpected earnings were incorporated into subsequent earnings forecasts to a greater extent subsequent to disclosure of sustained hedging activity. Additionally, the findings indicate an increase in the earnings-return relation in the hedging activity period.

Research limitations/implications – This evidence empirically supports the claim that, when a company communicates that hedging activities have been started, market participants are better able to forecast earnings and view subsequent earnings announcements as providing greater information about future earnings. The results may be understated due to the minimal disclosures required during the sample period. Future research could

revisit these tests for the SFAS 133 time period as a way of evaluating the usefulness of more detailed disclosures.

Practical implications – The models used in the tests of forecast revisions and earnings response coefficients could easily be adapted to other settings where the research question compares different time periods.

Originality/value – This study adds to the empirical evidence regarding the effects of hedging activity by providing direct evidence of analysts' use of and investors' reactions to earnings surprises following the disclosure of the implementation of hedging activities

OBJECTIVES OF THE STUDY

PRIMARY OBJECTIVE

- To Study the various investment avenues and the investors risk preference towards it.

SECONDRY OBJECTIVES

- To find out the general demographic factors of the investors dealing in capital market.
- To find out the preference level of investors on various Capital Market instruments.
- To find out the type of risk which are considered by the investors
- To find out the ways through which the investors minimizes their risk
- To find out the preferences of Investors in derivatives market.

RESEARCH METHODOLOGY

Research Design

A Research design is purely and simply the framework of plan for a study that guides the collection and analysis of data. The study is intended to find the investors preference towards cash market and derivatives. The study design is descriptive in nature.

TYPE OF RESEARCH-DESCRIPTIVE RESEARCH

Descriptive study is a fact-finding investigation with adequate interpretation. It is the simplest type of research and is more specific. Mainly designed to gather descriptive information and provides information for formulating more sophisticated studies.

Sampling Design

1. **Selection of study area :** The study area is in Chennai.
2. **Selection of the sample size :** 100

Sampling Methods

Convenience method of sampling is used to collect the data from the respondents. Researchers or field workers have the freedom to choose whomever they find, thus the name "convenience". About 100 samples were collected from Chennai city and most of the respondents were customers coming in to stock broker's office and certain addresses were collected from reputed brokers.

Formulation of the questionnaire

Data collection

(a) Primary data – collected through Structured Questionnaire.

(b) Secondary data – Earlier records from journals, magazines and other sources.

Tools used for analysis

Percentage analysis

1. Chi-square test
2. Kendall test
3. ANOVA
4. Correlation Analysis
5. Multiple Response Table

LIMITATIONS OF THE STUDY

- Understanding the nature of the risk is not adequate unless the investor or analyst is capable of expressing it in some quantitative terms. Expressing the risk of a stock in quantitative terms makes it comparable with other stocks.
- Measurement cannot be assured of cent percent accuracy because risk is caused by numerous factors such as social, political, economic and managerial efficiency.
- Time was a limiting factor.
- Only those investors who deal in capital markets are considered.
- Respondent's bias was another limiting factor.

SUMMARY OF FINDINGS

1. Most of the respondents (44%) are of the age group 31-40.
2. Majority of the respondents (65%) are male.
3. Most of the respondents (38%) are graduates followed by Post graduates.
4. Most of the respondents (29%) are entrepreneurs and Working Executives.
5. Most of the respondents (38%) are having an Income level of 1- 5alcs followed by respondents having income level 5-10 lacs.
6. Most of the respondents (40%) are influenced by friends and relatives followed by brokers.
7. Most of them (29%) are highly favourable towards the cash market.
8. Most of them (30%) are highly favourable towards the Futures market.
9. Most of them (26%) are favourable towards the Options market.
10. Most of them (30%) stayed neutral towards the Commodities market.
11. Majority of the respondents (37%) wanted to invest in short term funds followed by both short term and long term funds.

12. Majority of the respondents (36%) preferred wealth maximization instruments followed by steady growth instruments.

13. Most of them (43%) invested about 5-10% of their income on investments and only 9% invested more than 20% of their income on investments.

14. Respondents perceived that Market Risk and Credit risk are the two major risk observed in capital markets.

15. Most of the respondents (82%) wanted to minimize their risk involved in the capital market.

16. Most of the respondents (49%) said that News Papers and Financial Experts help them to minimize their risk.

17. Most of the respondents (63%) said that high Margin charged was their main barrier while dealing in Derivatives market.

18. Most of the respondents (38%) feel that the margin amount charged in derivatives market should be in between 5000-10000 and if it is less than 5000, they are very much happy.

19. In Derivatives market, Most of the respondents (29%) preferred to invest in Stock Index futures, followed by stock index option and futures on individual stocks.

20. Most of them (37%) felt that derivatives market is growing very slowly.

21. From Chi-Square test it is found that, the risk factor is highly considered in the financial market.

22. From Kendall's W test, it is found that there is no difference of opinion towards their preference in financial market.

23. From Correlation test, it is found that there exist a positive correlation between the percentage of income for investment in financial market and the margin investment in derivative market.

24. From Correlation test , it is found there exist a negative correlation between the income percentage on investment and the participation in derivative market

25. From One Way ANOVA it is found that there is significant difference between the annual income and the income percentage towards investment.

26. From the Multiple Response test, it is found that the investors who invest around 5-10% of their investment mostly considers the market risk(18%) as the major risk which prevails in the market.

27. From the Multiple Response test, it is found that the investors whose investment is around 10% of their income, consider that the affordable margin amount for investment in Derivatives is up to Rs10000/-.

SUGGESTIONS & RECOMMENDATIONS

1) From the demographic factors it is found most of the investors are of age 31-40 and are mostly entrepreneurs & working executives, so the institutions dealing in capital market can take these factors and develop suitable marketing activities for them and attract them to invest more in capital markets.

2) Also it is found that the friends and relatives followed by brokers are the most influential persons to pull the investors into the capital market. So the Institutions should develop some referral programs and rewards for referrals, so that the existing investors can actively bring in more number of investors. Also brokers should be duly acknowledged.

3) Most of the respondents should positive sign in investing into Derivatives market, since most of them preferred short term investments and instruments leading to wealth maximization. So the Institutions dealing in Derivative market must develop products which suit the above said requirements of the investor.

4) It is also found that the investors are investing up to 10% of their income on various investments and also they said that the market risk and the credit risk are the two main parameters they look in to before investing. So the Institutions should develop products which are of less market risk and the credibility of the institution should be briefly explained to the investors.

5) Most of them felt that they want to reduce their market risk and they also said that they follow the ideas given by the financial experts and tips given in the news paper to reduce their risk. So the institutions should keep informed about their institutions developments to these groups by which it can reach the investors in a positive way.

6) Investors felt that high margin in derivative segment was the main barrier for investing, so the Institutions should work on this to reduce the margin.

7) In Derivatives market, most of the investors prefer stock index futures, followed by stock index options, so the institutions should develop more number of above said products by which it can attract more number of investors.

CONCLUSION

In the current scenario, investing in stock markets is a major challenge ever for professionals. Derivatives acts as a major tool for reducing the risk involved in investing in stock markets for getting the best results out of it. The investors should be aware of the various hedging and speculation strategies, which can be used for reducing their risk. Awareness about

the various uses of derivatives can help investors to reduce risk and increase profits. Though the stock market is subjected to high risk, by using derivatives the loss can be minimized to an extent.

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IMPORTANT TABLE REFERENCES

Influencer

Influencer	No. of Respondents	Percent
brokers	36	36.0
Friends & relatives	40	40.0
Advertisement	9	9.0
banks	15	15.0
Total	**100**	**100.0**

Perception towards Capital Market Instruments

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Statement	Cash Market	Options Market	Commodities Market	Futures Market
Highly favorable	29	20	27	30
Favorable	28	26	18	24
Neutral	27	26	30	18
unfavorable	9	18	17	18
Highly favorable	7	10	8	10
Total	100	100	100	100

Basis of overcoming risk

Basis of overcoming risk	No. of Respondents	Percent
financial experts	24	24.0
newspaper	49	49.0
friends	18	18.0
others	9	9.0
Total	**100**	**100.0**

Investment options in derivatives

Investment options in derivatives	No. of Respondents	Percent
stock index futures	29	29.0
stock index option	27	27.0
futures on individual stocks	26	26.0
options on individual stocks	18	18.0
Total	**100**	**100.0**

Perception towards derivative trading in India

Perception of Investors	Frequency	Percent
Grow very fast	17	17.0
Grow moderately	37	37.0
Grow slowly	37	37.0
cant say anything	9	9.0
Total	**100**	**100.0**