The Professional Commodities Trader

Your **a**ccurate, **a**uthentic and **a**ffordable guide to commodities trading

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New age techniques in risk management

We are all familiar with the cliché – nothing is life is constant but change. The same is applicable to the financial markets which are undergoing a rapid phase of evolution as more and more products are available for trading for the present day investor / trader. Yet, rarely does an average investor / trader think of utilizing the plethora of choices available to hedge his / her bets and cut down risk considerably. Speaking of risk, I feel winning in the markets is a dual pronged strategy of cutting risk and maximizing returns. With this objective in mind, I present the inter exchange hedging tactics that will cut your risks considerably, while sacrificing your returns insignificantly.

Why inter-exchange at all ?

Statistics prove that trades on the exchanges are tilted towards cash settled (speculative) rather than delivery settled (investment) in nature. Therefore, traders will prefer to trade those scrips where margin calls are lower (leverage) is higher and the commensurate risk is higher. This explains why the Nifty futures attract the lions share of trading volumes on the exchanges. The margins are the lowest and impact costs are wafer thin. Risk averse traders are hedging their positions by taking a contrarian position in options and therefore insulating themselves partly. In the bargain however, the return on investment falls. Take the following example –

Security	Margin outflow	Premium outflow	Profit / loss at 2650
Nifty futures long @ 2600 /-	26,000	nil	+ 5000
Nifty 2500 put long @ 30 /-	nil	3,000 (not refundable)	- 3000

As we can see, the minute you try to cut down risk by taking a contrarian position on the same security in the options vis-à-vis futures segment, the absolute return takes a hit. Also note, since the hedge is on the same underlying instrument, one of the two positions **must** result in a loss. But a naked exposure means you take an all or nothing approach - which is highly risky ! You may even try taking positions on two different instruments – oil stock versus automobile stocks, but the recent past has resulted in both the instruments resulting in a capital bleed for a trader. Clearly, a more refined and mature solution Is needed to cut risk and yet not erode returns significantly.

I feel taking an inter exchange approach is a far more intelligent strategy as the entry barrier in terms of capital deployment is negligible and risks are defined. What is needed is a clear understanding of the nuts and bolts of the deal and the way the strategy is structured. A disciplined approach and patience will be the final requirement that will tie up the loose ends and see you through to the logical end. We will take up the issue of learning the nitty gritty in the next part of this three part series.

Till then, have a profitable day.

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