

## DERIVATIVES VS. CASH



vEcoSys

**Understanding**  
**'Derivatives vs. Cash'**  
**– By Prof. *Simply Simple*™**



## DERIVATIVES VS. CASH



**Why is 'derivative trading' a form of high gain - high loss trading with minimum investment ?**



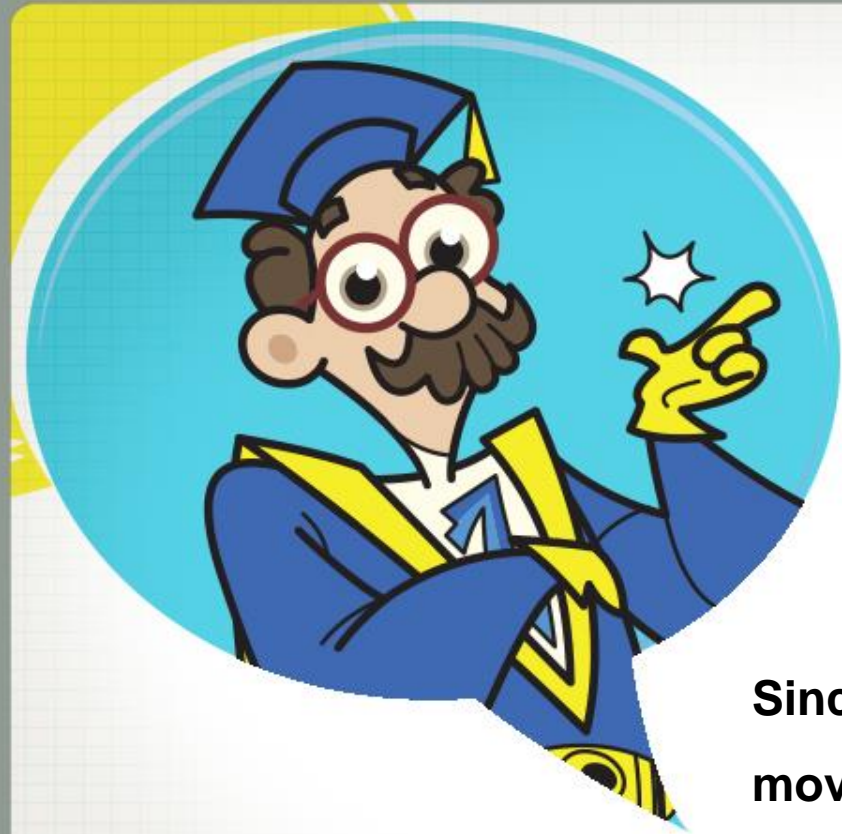
## DERIVATIVES VS. CASH

For the sake of understanding, you may replace “futures” with price of share.

So one has to take a bet on the movement of the share price at the end of the period.



## DERIVATIVES VS. CASH



Since one is looking at price movements, one may presume that the share price would perhaps go up or down by a maximum of 10% in this period.



## DERIVATIVES VS. CASH

The margin money required to take a bet on price movements would be 10%.

Let's say the price of the share is Rs 100.

Hence, if you want to take a bet on the price movement at the end of say 20 days, you will need to deposit margin money of Rs 10 for a share of Rs 100.





## DERIVATIVES VS. CASH

Let's say after 20 days, the share value goes up to Rs 120.

*(For the sake of understanding, we are ignoring the mark to market impact where daily debit / credit entries are made)*

The buyer of the future makes Rs 10

(Rs. 120 – margin Rs.10 – original price of Rs 100 = Rs.10) as net profit per share.



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He thus makes a profit of Rs 10 on an investment of Rs 10 which means that the return on investment is 100%.





## DERIVATIVES VS. CASH

However, please bear in mind that while you can invest in a single share of a company in the spot or cash market, the requirement in the derivative markets is to invest in a diverse basket or lots of the same shares . For example, a basket (which is generally termed used lot size) of say stock “A” would contain 10 stocks per lot.



## DERIVATIVES VS. CASH

Lets say the cost of “A” in the spot market is Rs. 100;  
your investment too would be Rs 100 in the spot market whereas  
in the derivatives market, you would have to invest in a group of  
say 10 shares which would be valued at Rs 1000 but since you  
only need to invest the margin money of say 10,% your investment  
would be the same Rs 100.



## DERIVATIVES VS. CASH

However, in this case, you get the opportunity to take a bet on the price movement of 10 shares valued at Rs 100.





# DERIVATIVES VS. CASH



Investment in a group of shares in derivative market

Thus...

Investment of single share in spot market



Spot / Cash Market

Future lot of Shares A



Futures or Derivative Market

# DERIVATIVES VS. CASH

Now...

Cost of investment is equal to market price of share in spot market

Cost of investment in spot or cash market = margin money for the lot size in derivative market.

At Rs 100 per share the cost of the group would be Rs 1000 but since cost of investment is equal to margin money, which are assuming to be 10%, then cost of investment is Rs 100 in derivatives market



Rs.100 for one share

Hence for a Rs 100 stock the cost of investment is Rs 100 in spot market



Rs.100 as margin for 10 shares



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So...



In spot market if price rises by 10% you make 10% profit (Rs 10 on an investment of Rs 100)



In derivative market if price rises by 10% you make a profit of Rs 100 on the entire group for your investment of Rs 100. Thus you make a 100% profit





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However in case of a loss, you get badly hit in derivative trading as seen below...

In spot market if price falls by 10% to Rs 90, you make 10% loss ( Rs 10 on an investment of Rs 100)



But in derivative market if price falls by 10% to Rs. 90 per share you make a loss of Rs 100 on the entire group of shares for your investment of Rs 100. Thus you make a 100% loss as you lose your entire investment in this example



## DERIVATIVES VS. CASH

Hence, derivative trading is a high gain and high loss trading as compared to trading in a spot market.

Also, in derivative trading you do not deal with a single stock, but in a group of shares.

In derivatives trading, you do not take ownership of the group of shares. You only get the rights to bet on price movements of the entire group of shares.



## DERIVATIVES VS. CASH



Hope this story succeeded in clarifying the concept of “Margin Money / Margin Funding” further and how derivative trading is a form of high gain - high loss trading as compared to trading in the spot market.





Thinking of Investment

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