

ARBITRAGE



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Understanding 'Arbitrage'
– By Prof. *Simply Simple*™



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Let me tell you a story about a
“Chalu Chaiwala”!

He was truly chalu or shall we say,
“Extra Smart”!!



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He would provide tea at Rs 5 per cup and his cost of preparing the same was Rs 4.

Thus he made a profit of Rs 1.

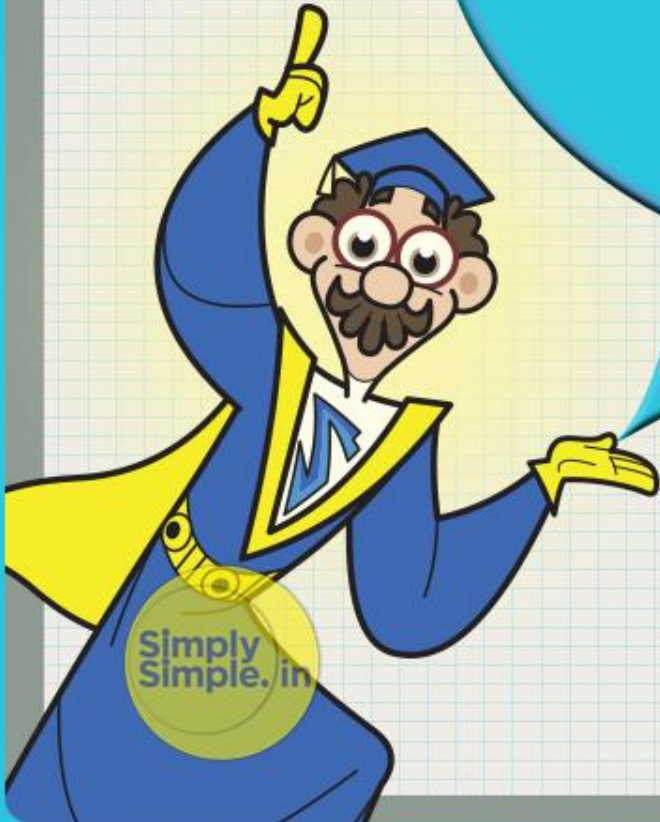
But he was not happy with making a profit of just Rs 1.



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So he thought about how he could increase his profit.

It was then that he had a brainwave out of the blue!



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He identified a Government canteen which offered tea at Rs 2.

BIG IDEA! Wasn't it?

He could now simply buy tea for Rs 2 and sell it for Rs 5 and make a much better gain of Rs 3!



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This buying of a thing in one market and selling in another market at a higher price is known as “Arbitrage”.

Similarly if arbitrage opportunities exist, stocks too can be purchased in one market at a lower cost and sold in another at a higher cost.



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So for the next few days, our Chaalu Chaiwala had a field day earning happily as he served his daily chai.

But Alas! Such arbitrage opportunities do not last long. As information flow increases and the arbitrage opportunity gets known, it soon starts to disappear.



And this is exactly what happened in the case of our “chaiwala”.



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The chaiwala had an assistant who one day spilled the beans about the “arbitrage” advantage being enjoyed by the chaiwala.

Soon after that, the chaiwala was rounded up and he confessed about the arbitrage opportunity he had spotted.



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Since his customers, in a sense, had been paying a fair price all this while since Rs 5 had been the standard retail price in all canteens, the chaiwala was forgiven but was warned against adopting this practice again.

So the arbitrage opportunity too vanished in thin air as the very next day, he was back in his own canteen making tea at Rs 4 and selling it at Rs 5.



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- ❑ Thus it's important to understand that “arbitrage” opportunities are short-lived.
- ❑ It is essentially a short window of opportunity that can be exploited by taking action at the right time.
- ❑ As information flow gets efficient, this opportunity vanishes as we saw in the case of the chaiwala.



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Hope this story succeeded in clarifying the concept of 'Arbitrage'



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