

Equity Derivatives

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Equity Derivatives Latest News

SEBI has come out with a new framework for monitoring intraday positions in equity index derivatives, a move aimed at preventing risks caused by large exposures.

What are Derivatives?

- Derivatives are **financial contracts** that **derive value from an underlying asset**.
- Derivatives **allow traders to bid on the direction of the underlying asset's price change without owning them**.
- They allow investors to speculate on price movements, **hedge against risks**, or enhance portfolio returns.

About Equity Derivatives

- Equity derivatives are **financial instruments** whose **value is derived from the movements of a stock or a stock index**.

- Equity derivatives serve various purposes for investors and traders, including **risk management, speculation, and portfolio optimisation.**

Equity Derivative Types

- **Futures Contracts:** These **obligate the buyer to purchase and the seller to sell** an underlying **equity asset** at a **predetermined price and future date**. Equity index futures, like the BSE S&P and Nifty IT, are popular examples.
- **Options:** Equity options **give the holder the right, but not the obligation, to buy (call option) or sell (put option)** an underlying stock or index at a specified price before or on a specific expiration date.
- **Swaps:** Equity swaps involve **exchanging cash flows based on the return** of an underlying equity asset. These can be **used for hedging or investment purposes.**
- **Forwards:** Forwards are the **same as futures**, where the **parties are obligated to perform the contract**. But forwards are **non-standardised, over-the-counter contracts** that **don't trade on the stock exchanges.**

Advantages of Equity Derivatives

- **Leverage:** Equity derivatives typically require a smaller upfront investment compared to buying the underlying assets directly. This allows investors to control a larger position in the underlying asset with a smaller investment, magnifying potential gains (but also losses).
- **Hedging against price volatility:** They provide a means to protect against adverse price movements in the stock market, reducing the risk of financial losses.
- **Access to premium assets:** By investing in these derivatives, investors can gain exposure to high-value, unaffordable or inaccessible assets.
- **Cost efficiency:** Trading equity derivatives typically requires lower transaction costs than directly investing in the underlying assets, making it a cost-effective choice.
- **Arbitrage opportunities:** They can be utilised to exploit price discrepancies between different markets, enabling investors to profit from market inefficiencies.
- **Portfolio diversification:** Including these derivatives in an investment portfolio can diversify risk by adding different asset classes and strategies.
- **Flexibility:** They offer various strategies and contract types, allowing investors to adapt their positions based on market conditions and investment objectives.
- **Liquidity:** The derivatives market tends to have high liquidity, ensuring ease of buying and selling positions without significant market impact.
- **Risk management:** They provide tools for managing risk exposure, allowing investors to mitigate losses and protect their portfolios.
- **Income generation:** Through option writing or other derivative strategies, investors can generate income from their equity positions, enhancing overall returns.

Source: TH