Speculation, Hedging and Arbitrage

By: Vinay Hegde

Speculation???

Speculation is the practice of engaging in risky financial transactions in an attempt to profit from short term fluctuations in the market value of a tradable financial instrument.

Speculator???

Speculator is the one who takes higher than average risk with the intention to make profits by the temporary price fluctuations of financial instruments in the market.

Types of Speculators

1. Bull:

A bull is an optimistic speculator who expects a rise in the price of the securities in near future.

He buys the securities when the price is low and sell the same when the price goes up and make profit.

Bull's anticipation of rise of stock prices:

On 24th Oct 2017 Union Finance minister of India has announced ₹2.11 lakh crore market capitalisation for PSBs.

Due to high speculation the indexes has gone up like below.

Date	Price	Vol.	Change %
24 October 2017	3093.4	85.13K	3.79%
25 October 2017	4009.8	823.55K	29.63%
26 October 2017	3988.5	423.85K	-0.53%

2. Bear

A bear is a pessimistic speculator who expects a sharp fall in the prices of certain securities.

Bear sells the shares expecting that the price will go down in near future and buy the shares when price go down and thus get the price difference.

How Bear takes advantage of falling price

Mr A is anticipating that the shares of Company PQR will fall down to $10 from $15 in next 5 trading days.

A goes to Mr B, a current shareholder of the company PQR and borrows 100 shares on agreement to return those shares after 5 days.

Once Mr A got delivery of 100 shares, he sell the shares in market for $15 each (Current price) and will have the cash of $1500. And on the 5th day when the price comes down to $10, Mr A buys 100 shares back for $10 each and return them to B.

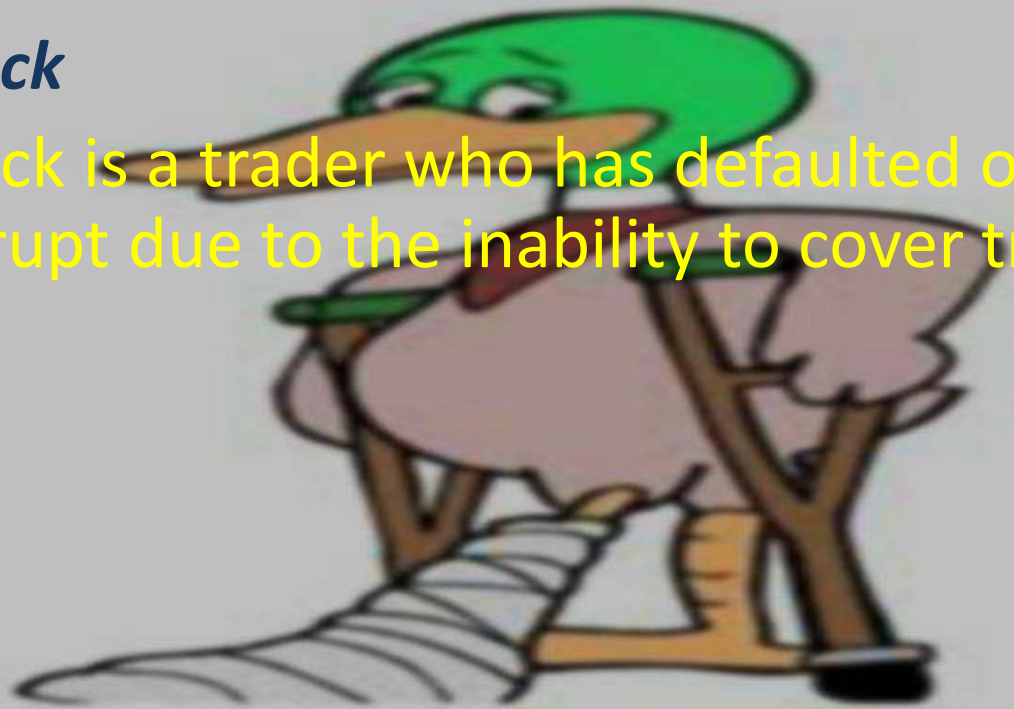
By taking the advantage of bearish market Mr A makes a profit of $5 for each share.

3. Stag

Stag is the one who attempts to make profit from short-term market movements by quickly moving in and out of positions.

4. Lame Duck

Lame Duck is a trader who has defaulted on a debt or gone bankrupt due to the inability to cover trading losses.



Difference Between Speculator and investor

Speculator

- High risk bearer
- High rate of return
- technical charts and market psychology
- Speculation is of Short term

Investor

- Less or average risk
- Modest rate of return
- Fundamental factors, performance of the company.
- Investments are for Long term

Hedge:

Hedge is a risk management technique used to reduce any substantial losses or gains suffered by an individual or an organization.

Hedging:

Hedging is the practice of taking a position in one market to offset and balance against the risk adopted by assuming a position in a contrary or opposing market or investment.

How Hedging helps to mitigate the Future uncertainty

Amazon wants an application and ask the Infosys to develop and deliver the product by exact after one year and in return agrees to pay $100 for the product.

Current exchange rate for $1 is ₹70 and there is a possibility that INR may not hold the same value after one year.

Infosys decides to hedge its funds which will be delivered in dollars and enters to an Option contract with a third party Share khan that after one year Share Khan will have to exchange $100 at the rate of ₹69 each and the Infosys will buy an option by paying some premium.

With this strategy Infosys now mitigated the exchange risk and ensured that after one year it can exchange its dollars to Rupees at minimum ₹69 per Dollar.

Arbitrage

Arbitrage is a kind of trade where trader makes profit using the price differences of the same product or security in the different markets.

Trader buys an asset or the security in the market where the price is low and sell the same asset or security in the different market where the price is high. The price difference in those two markets will be the trader's profit.

Use of Arbitrage in Foreign Exchange

Mr Z is a Forex trader and finds an opportunity to enter in to an arbitrage trade and the exchange rate of the currencies in which he is interested is as below.

$1 = ₹70
€1 = ₹50
$1 = €1.2

Simultaneously Mr Z buys €12 at ₹600 and Exchange that €12 with $10 and that $10 with ₹700.

In this trade which he executed simultaneously he made a profit of ₹100.

Thank You!