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Derivatives 101

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Derivatives Strategies - "Speculation"

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Executive Summary

- The first three issues of our **Derivatives 101** series gave a brief overview of **derivatives instruments, derivatives trading process** and **derivatives strategies – "Hedging".**
- The third issue gives an in-depth explanation of **speculation** as a strategy that can be used to make a profit from a security's price change.
- Our report begins with a definition of speculation and gives types of speculators.
- We also discuss the advantages and disadvantages of speculation in the stock market.
- Finally, the report gives an example to demonstrate how to make a profit with speculation.

What is speculation?

- **Speculation** entails buying of a financial instrument with the hope that the price will increase in the future.
- Speculative investors tend to be more active market traders, often seeking to profit from short-term price fluctuations as opposed to being "buy and hold" investors.
- A futures contract allows a trader to speculate on the direction of movement of a commodity's (stock) price.

Who are speculators?

- Speculators are primary participants in the futures market.
- A speculator is a trader who approaches the financial markets with the intention to profit from price changes in the market by either going long or short.
- Speculators can achieve these profits by buying low and selling high.
- Speculators aiming to profit in the futures market at the Nairobi Securities Exchange (NSE) can be individual traders, portfolio managers or market makers.
- The main difference between investors and speculators as follows:
  - An **investor** is concerned with the fundamental value of his investment, whereas a **speculator** is only concerned with market price movement.
  - A speculator does not care if a company is performing well or poorly, only about whether or not he can profit from trading the company's stock.

Types of speculators

1) Bull speculator

- A bull is an optimistic speculator who expects a rise in the price of the securities in the future.
- He buys securities with a view to sell them in future at a higher price and thereby earns profits.
- In case the prices of securities fall, he loses.

2) Bear speculator

- A bear is a pessimistic speculator who expects prices to fall in the future.
- He sells securities at present with a view to purchase them at lower prices in future.
- He enters into selling contracts in certain securities on a future date.
- If the price of the security falls as he expects he shall get the price difference.

Advantages of speculation to the market

1) Market Liquidity

- Speculators provide much-needed liquidity to markets by actively trading and are thus a vital component of market efficiency.
- This ensures that market orders can be placed very quickly as there are always buyers and sellers of futures contracts.
- For this reason, it is unusual for prices to suddenly jump or fall dramatically, especially on the nearer contracts (those which will expire in the next few weeks or months).

Disadvantages of speculation to the market

1.) Unreasonable Prices

- Speculation can sometimes push prices beyond reasonable levels, to excessively high or low valuations that do not accurately reflect an asset or security's true intrinsic value.
- This means that speculation may lead to price fluctuations that, even though they are merely temporary, can have a long-term impact on the fortunes and stability of a company or an industry.

Example: Speculation on single stock futures contracts

- **Note: For simplicity we will be using one contract. Commissions and transaction fees are not taken into account.**
- Suppose an investor is bullish on Safaricom (SCOM) shares.
- One SCOM futures contract equals 1,000 underlying shares.
- The investor can speculate on the shares by **going long (buying)** one 3-month futures contract on SCOM at KES.27.
- At some point in the near future, Safaricom share price rises to KES.30.
- At that point, the investor sells the contract at KES.30 to offset the open long position and makes **KES.3,000** [(30-27) X 1,000 X 1 = KES.3,000] **gross profit** on the position.
- The trader with the **short position** (the seller in the contract) would have a **loss of KES.3,000**.
- If the opposite is true, the buyer suffers a loss, and the seller makes a profit.
- Single stock futures are cash settled meaning there is no delivery of the underlying asset at the end of the contract.

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