



Derivative terms Demystified: Basis, OI and CoC

Indian markets have seen explosive growth in derivatives market recently. Cash markets volumes are stagnating while derivatives are hitting newer highs day by day. For the last financial year, 90% of the volumes were in derivatives while only 10% of the rest of the volumes were in cash markets.

Whether you are a long-term investor or a trader, it is imperative to understand the nitty-gritty of this market. We would like to stress that these instruments should be used wisely. They can help you garner super normal returns on your capital, and if misused it can prove to be the prime cause of financial ruin.

Derivatives are contracts whose outcome depends on some other instrument, commonly referred as “underlying”. Tradable instruments like stocks or non-tradable instruments like weather could be used as underlying. Let us understand few terms common to derivative markets.

Basis:

In the context of financial futures, basis can be defined as the futures price minus the spot price. There will be a different basis for each delivery month for each contract. In a normal market, basis will be positive. This reflects that futures prices normally exceed spot prices.

Open Interest (OI)

Open interest is the total number of contracts that are not closed out on a particular day, that is contracts that have been purchased and are still outstanding and not been sold and vice versa.

A common misconception is that open interest is the same thing as volume of options and futures trades. This is not correct since there could be huge volumes but if the volumes were just because of participants squaring off their positions then the open interest would not be large.

On the other hand, if the volumes were large because of fresh positions being created then the open interest would also be large.

Cost of carry (CoC):

The relationship between futures prices and spot prices can be summarized in terms of what is known as the cost of carry. This measures the storage cost plus the interest that is paid to finance the asset less the income earned on the asset.

Now that you know few basic terms of the derivatives, try your hand at a book or NCFM derivative module and learn more about it. Master the jargon; apply it on paper before venturing out in real world. Warren Buffet once wrote: “Derivatives are financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal”!