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Trading Preferences of Equity Derivative Traders in Kerala

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ABSTRACT
The trading preferences of equity derivative traders has been examined in this study. The examination of objectives and preferences of equity derivative traders shows that earning speculative profit is the most preferred trading objective of derivatives traders, and the options market, index options and intra-day trade are the most preferred; market, instrument and trade respectively. Most of the options traders are showing interest in weekly expiring contracts and ATM options along with different market-based strategies while trading in the options market. Among 300 respondents, more than one-third of traders, square off their position when the market moves adversely without waiting for stop-loss, whereas a small majority reported that they modify their strategies in the event of adverse movement in the market.

Keywords: Equity Derivatives, Trading Preferences, Derivatives Market, Futures and Options

1. Introduction and Research Problem

Derivatives have become increasingly important in finance. Derivative traders have certain preferences and patterns of trading in the derivative market. Their preferences towards the trading objective, market, contract, type of trade, maturity of the contract, strike price and type of strategy etc. have been analyzed and presented in this study. Within a short span of eight years, derivative trading in India has surpassed the cash segment in terms of turnover and the number of traded contracts. The derivatives market received a great deal of attraction nowadays and a lot of people are attracted to derivative trading which motivates the present study. Many skills are required for trading successfully in the derivatives market like trading knowledge, strategies, trading psychology, etc. This study examines the trading preferences of equity derivative traders in Kerala.

2. Literature Review

Nuruzzaman, (2011) found that behavioural biases are observed in the investor's trading preferences and behaviour. *Raghavendra, (2013)* examined the amount of awareness of retail investors regarding financial derivatives, as well as their impression of derivatives as an investment opportunity. The survey results, the majority of respondents believe that trading in derivatives is riskier than trading in the equities market. *Aravind, (2013)* discovered that the majority of investors learned about derivatives through broking businesses, indicating that broking firms in south Kerala are taking an active interest and making efforts to promote financial derivatives. *Thamotharan & Prabakaran, (2013)* suggests that appropriate governmental actions will assist investors in perceiving derivative investments and making sound decisions. *Santhini, (2013)* found that the majority of capital market investors invest more than half of

their overall investment in the derivative market. *Tripathi, (2014)* discovered that education, profession, and gender have little effect on derivative trading behaviour, but income has a considerable effect on derivative investing. According to *Manrai, (2015)* there has been an increase in trading knowledge of derivatives trading among ordinary investors in India. This was owing to an increase in the number of trading agents or organizations in the market that allow regular investors to trade derivatives on exchanges such as MCX and NCDEX. *Ansari et al., (2015)* founds that gender, age, income and education do not have a significant effect on the perception of derivatives products. *Jacob,(2016)* assessed stock market investors' perceptions and experiences with derivatives. According to the study's findings, small investors do not view derivatives as a risk-hedging instrument. *Vattoli, (2018)* pointed out individual investors' illogical trading preferences and practices, which resulted in large losses. *Anu, (2018)* discovered that the introduction of stock futures and options has a considerable impact on stock market volatility.
After reviewing the literature, it is found that studies relating to the trading preferences of equity derivative traders are very rare and there is a scope for conducting new research. This research is being carried out to explain the trading preferences of equity derivative traders in Kerala.

3. Methodology

The questionnaire is used to select a sufficient and trustworthy sample size in order to produce valid results. Primary data were gathered by self-completion questionnaires sent via Google forms from a sample of 300 equities derivative dealers in Kerala. The replies were automatically saved in Google Forms as an Excel (CSV) file, which could then be exported to SPSS Version 22 for additional coding. In addition to the basic respondent profile, descriptive statistics such as frequencies, means, and standard deviation are utilized to discover response patterns. ANOVA, t-test, and other parametric tests were utilized for data analysis because the distributions were found to be normal.

4. Results and Discussions

Investors have different objectives for trading in the derivative market such as hedging a stock portfolio, earning a speculative profit, earning arbitrage profit, getting an additional return on an existing portfolio etc. This study reveals the trading objectives of equity derivative traders in Kerala which is described in the following table.

Table 1 Trading Objectives of equity derivative traders

Sl. No.	*Response*	*Frequency*	*Percent*
1	*For Hedging a stock portfolio*	*16*	*5.3*
2	*For earning speculative profit*	*133*	*44.3*
3	*Both hedging and speculation*	*75*	*25.0*
4	*For earning arbitrage profit*	*11*	*3.7*
5	*For getting additional return on existing portfolio*	*65*	*21.7*
Total		***300***	***100.0***

Source: Primary data

Table 1 presents the objectives of sample equity derivative traders in Kerala. It shows that earning speculative profit (44.3%) is the most preferred trading objective of traders in the derivative market. Out of 300 respondents 16 (5.3%) trade derivatives for hedging, 133 (44.3%) for speculation, 75 (25%) respondents use derivatives for both hedging and speculation, only 3.7% (11) are trading derivatives for earning arbitrage gain, and remaining 65 (21.7%) are trading derivative for getting an additional return on existing equity portfolio. Derivatives emerged as hedging tools, but most investors are reluctant to use them for hedging equity portfolios because of higher cost as compared to the benefit received from hedging. Therefore, many high-profile investors in the equity market now trading in the derivative market using capital by way of pledging their equity holding and earning a reasonably good percentage of additional return on equity portfolio.

The choice to make trading in a derivative market is a complex decision. Once you decide to start derivative trading, the next question is which instrument is suitable for you- Futures or Options? Both futures and option contracts have their own benefits and risks. It may seem that options are a better choice since your losses can be restricted to the premium paid (in the case of the options buyer). However, in the case of short-selling of options, the potential for losses can be unlimited if the movement gets adverse. One more risk in options trading is the time value. One should be sure about the timing before entering an options contract (buy-side), as most option contracts expire worthless due to time decay. So compared with futures contracts, the chances of making a profit are much higher in options. After deciding the type of product, the next question is about the underlying asset. Index-based product or stock-based product, which is good for trading? Again, the trader is having a choice between different types of trade like intra-day or overnight, weekly contract or monthly contract? Which is the appropriate strike price? Which type of trading strategy is good, etc., is the choice concern of a derivative trader. The following table shows the trading choice of derivative traders in Kerala.

Table 2. Preferences of Equity Derivative traders
(n=300)

Variable		***Frequency***	***Percent***
Most Preferred Market	*Options Market*	*164*	*54.7*
	Futures Market	*29*	*9.7*
	Spot Market	*40*	*13.3*
	Both futures and options market	*37*	*12.3*
	All three	*30*	*10.0*
Most Preferred Contract	*Index Futures*	*36*	*12.0*
	Stock Futures	*20*	*6.7*
	Index Options	*156*	*52.0*
	Stock Options	*23*	*7.7*
	Any of the above	*65*	*21.7*
Most Preferred type of Trade	*Intra-day Trade*	*120*	*40.0*
	Overnight Trade	*29*	*9.7*
	Swing Trade	*74*	*24.7*
	Roll-over Trade	*17*	*5.7*
	Any of the above	*60*	*20.0*
Most Preferred Maturity of contract	*Weekly contract*	*152*	*50.7*
	Monthly contract	*74*	*24.6*
	Annual contract	*2*	*0.7*
	Any of the above	*72*	*24.0*

Variable		*Frequency*	*Percent*
Most Preferred Option strike	*DITM*	*4*	*1.4*
	ITM	*48*	*16.0*
	ATM	*89*	*29.8*
	OTM	*59*	*19.8*
	DOTM	*7*	*2.3*
	Any of the above	*63*	*21*
	Not applicable	*29*	*9.7*
Most Preferred Option Strategy	*Basic Strategy*	*95*	*31.7*
	Income strategy	*8*	*2.7*
	Vertical spread strategy	*9*	*3.0*
	Volatility strategy	*6*	*2.0*
	Sideways strategy	*13*	*4.3*
	Leverage strategy	*1*	*0.3*
	Synthetic strategy	*3*	*1.0*
	Any of the above	*165*	*55.0*

Source: Primary data

From the above data, it can be concluded that the options market is the most preferred market for derivative traders, as more than 50 % of the traders prefer the options market for trade. Table 2 shows that out of 300 respondents 54.7% traders gave more preference to the options market, 9.7% prefers the futures market, 13.3% gave preference to the spot market whereas 34 12.3% are preferring both futures and options market for trading and remaining 10% prefer all the three markets for trade. With regard to the most preferred contract for derivative traders as more than 50 % of the traders prefer index options for trade. Out of 300 respondents 12% give preference to Index futures, 6.7% prefer stock future, 52% give preference to Index options, 7.7% are preferring stock options and remaining 21.7% prefer all types of equity derivatives for trade.

With regard to Preferred type of Trade 40% traders gave preference to intra-day trade, 9.7% prefer overnight trade, 24.7% gave preference to swing trade, only 5.7% are preferring roll over trade and 20% prefer all types of trade. From the above data it can be clear intra-day trade is the most popular type of trade among derivative traders as 40 % of the traders prefer intra-day trade. Weekly maturing contracts is found as the most preferred contract. Out of total respondents 50.7% traders give preference to weekly maturing contracts for trade, 24.7% prefer monthly contract, only 0.7% give preference to annual contract and 24% are using all type of expiry contract for trade.

Five types of option strike prices are available for option traders. This study tries to explore the most demanding option strike price and found that ATM is the most demanding strike price for option traders. 1.4% prefer DITM strike, 16% prefer ITM strike, 89 29.8% give preference to ATM strike, 19.8% prefer OTM strike and only 2.3% prefer DOTM strike for trade. 21% of traders use all types of strike prices for trade.

Hundreds of option strategies suitable for different market conditions are available for option traders. This study tries to find out the most popular option trading strategy and for that purpose option strategies are divided into seven broad categories based on the Bible of Option strategy *(Cohen, 2005)*. It is found that out of 300 sample option traders included in the study 31.7% prefer basic option strategy, 2.7% prefer income strategy, 3% prefer vertical spread strategy, 2% prefer volatility strategy, 4.3% prefer to use sideways strategy, only 0.3% prefer leveraged strategy, 1% prefer synthetic strategy and 55% prefer all of these strategies based on market outlook. From the above data it can be inferred that majority of option traders are using different types of option strategies depending on market trends.

5. Conclusion

This study examines the trading preferences of equity derivative traders in Kerala. The analysis of the goals and preferences of equity derivative traders reveals that the most popular trading goal for these traders is to make speculative profits. The most popular markets, instruments, and trades for these traders are the intra-day trade, index options, and options market. When trading in the options market, the majority of traders are showing interest in weekly expiration contracts, ATM options, and various market-based strategies. Of the 300 traders surveyed, over one-third square off their position without waiting for a stop-loss when the market swings negatively. The remaining traders said they adjust their strategies when the market moves adversely.

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