How to shield yourself from gold investment risks

Gold options contracts, introduced recently by MCX, can help you limit your risks while maximising your gains

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After taking charge of the commodity derivatives market, SEBI strengthened the clearing and settlement framework at the exchanges and gave the go-ahead for the launch of commodity options. This saw MCX launching the first-ever options contract in gold recently. Options contracts are friendlier for those looking to hedge their investment risks because of the lower premium and the limited loss for a buyer in the contract.

They can be used by producers/ farmers as also traders for protection against price volatility.



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What your options are

Options are derivatives instruments that give the buyer the right, but not the obligation, to buy or sell an underlying asset/instrument at a specific price on or before a certain date. The underlying of an option contract can be equity, commodity, foreign exchange, futures contracts, interest rates, real estate or any other asset/ instrument.

For example, a gold futures contract can be the underlying for a gold option contract. Options give the right to the buyer, but places no obligation to buy or sell the underlying. They allow investors to lock in to a future price of an underlying.

This can be explained through an example.

Say you wish to buy 10 grams of gold from a seller after three months, but you worry that prices may go up from ₹3,000 a gram currently to ₹3,200/ 3,500 in the interim period. So you want to lock in at the current price. This can be done by entering into an 'option' agreement with the seller that gives you the right to buy gold at ₹3,000 a gram after three months. This, though, would require you to pay a fee (referred to as 'premium') to execute the contract.

Now, two scenarios can emerge. One, gold prices may go up at the end of three months, say to to ₹3,300. But since you have locked into the price earlier itself, and paid a 'premium' to validate the contract, you pay the seller only ₹3,000 a gram.

Alternatively, gold prices drop in those three months, say, to ₹2,700 a gram. In this case, you can let the contract expire and forego the premium you paid. Since market prices are now much cheaper, you can buy your gold from the market. Your loss is only to the extent of the premium you paid.

'Calls' and 'puts'

Options are of different types. Based on the rights of the holder, an option is classified as a 'call' or a 'put'. You can either buy or sell an option.

A call option gives the buyer the right to buy the underlying at a predetermined price on or before the expiration date. In a put option, the buyer gets the right to sell the underlying at a fixed price on or before the expiration date.

For a buyer of a call/put option, the loss is limited, while there are potentially no limits on the profits. But for a seller (or the writer) of an option, the loss is unlimited, whereas the profit is limited.

SEBI has allowed only European-style options in the commodities derivatives market, which means that the buyer of the option can choose to exercise his option only on the date of expiration of the contract. In an American-style option contract, the buyer of the option can choose to exercise his option at any time between the purchase date and the expiry date of the option contract.

The underlying of a commodity option contracts will be the respective commodity's future contract. On the expiry date, every options contract is converted into a futures contract. If you do not intend to deliver, you can square up your position immediately.

Different from futures

Though both futures and option contracts are derivative instruments, they are different in some ways.

In an options contract, the buyer has a right, but not an obligation, to fulfil the contract. But in a futures contract, both the buyer and the seller are obliged to honour the contract upon expiry. Also, while risks are unlimited to both the parties in a futures contract, in options, only the seller faces unlimited risk.

Further, in the case of futures, the initial margin requirement is high, and it keeps increasing based on market fluctuations. Both the buyer and the seller have to maintain margins. But in case of options, only the option seller needs to maintain a margin.

The one-time fee (premium) collected from the options buyer is relatively a smaller amount compared to the margin in a futures contract.

The importance of hedging

Over the past decade, volatility in commodity prices has increased manifold. This impacts all players in the commodity value chain—either as lower viability of mining projects or decrease in sales revenue for producers or disruption of inventory management, and so on.

For instance, a gold jewellery manufacturer who purchases gold in the form of bars from a dealer pays the rupee equivalent of the international benchmark price. At the time of ordering a consignment, in some cases only an indicative price is mentioned; the full payment is made to the supplier at a later date. So, effectively, the jeweller is exposed to the price risk in the in-between period.

Once the consignment reaches, it doesn't go directly to the factory, but is stored in the vault for some time. Again, the stock is exposed to price risk. Then again, there is a time lag of a few weeks before it is sold to customers at the then prevailing price. If gold prices had fallen during this period—from the time of processing to the time of sale—the jeweller has to bear the loss.

Gold jewellers can use the gold options contract to hedge their risks.

Say, you have a stock of gold jewellery purchased at ₹30,000 per 10 gm and fear that prices will fall in the next month.

To manage this risk, you can buy a gold put option at the strike price of ₹30,000 by paying a premium of ₹300 per 10 gm.

A month later, at the time of expiry of the contract, if gold prices have fallen to ₹29,000 (the market price of the underlying), you will make a profit of ₹1,000 per 10 grams. Net of the premium paid for the option, your profit is ₹700). This profit will negate the loss in the value of your gold stock.

If, however, gold prices rise over that month, you can ignore your open position in the options contract. Your loss will be only to the extent of the premium you paid on the options contract, which is ₹300.