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Gold Options: A Risk Management Tool for All



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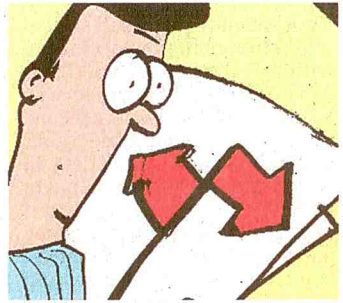
India's jewellery industry is at yet another transformational stage. Traditional and largely unorganised jewellery businesses are slowly making way for corporate players. Policy reforms such as demonetisation and GST and related compliances have only accentuated this shift. Smaller jewellers are feeling most threatened with the transformation as they are devoid of better margins and connectivity to the larger world of financing. It would be worthwhile to examine the significance of gold options that are set to be launched on MCX for the healthy transformation of the industry.

Volatility in raw material prices not only keeps product margins at a bay but also puts the entire business planning process in crumbles. Gold prices have consistently displayed significant levels of volatility. During FY 2016-17, annualised price volatility in gold had been over 13%. What this means to jewellery firm with an annual turnover of ₹100 crore is that it is exposed to a price risk of ₹13 crore. The jeweller has two options: either to pass on this risk to customers or take a hit on profitability. While the first choice would have made him uncompetitive, the second choice would be bad economics to continue a low-margin business, given various other charges associated with the making of a jewellery piece. Thus, high volatility in gold prices necessitates need for price risk management by stakeholders in the jewellery industry. With the introduction of trading in gold options, risk-averse stakeholders like small jewellers will find an avenue for gold price risk management.

In this context, it is pertinent for me to summarise the roils of Manilal, a recent fellow walker in our group. For the last few days, Manilal, a jeweller, seemed quite engrossed with himself. On being prodded, he said "Business tensions bhai; business tensions". Manilal then stated various problems such as low business, increasing compliances – paper work and high gold price volatility. I was quick to ask him if he would be willing to try MCX gold options to cater to his problem of gold price volatility.

Manilal looked clueless but said he once tried futures and he is not comfortable with daily margin calls and that hits his cash flow sometimes. I told him that the structural design of options contract such as gold options is suited to the needs of small and risk-averse stakeholders. For example,



RISK MANAGEMENT

High volatility in gold prices necessitates need for risk management by stakeholders

OPEN FOR ALL

With gold options, even small jewellers will find an avenue for gold price risk management

there are no margin calls for option buyers. Option buyer must only pay a one-time fee/premium upfront to have the option of buying gold, which is called 'call option'. On the other hand, option buyer can have the option of selling gold, which is called as 'put option' by paying a one-time fee/premium upfront. While options enable the hedger to hedge against adverse price movement by locking in at a price, options offer the flexibility to take advantage of any favourable price movement. The maximum loss for him as an option buyer is just the premium.

Manilal just quipped "That all sounds good, but please explain me in terms of money flow involved with options contract... after all money matters."

This is how I explained: "Suppose you have a stock of 1 kg of gold jewellery and fear a price fall from current gold price of ₹30,000/10 gm within the next one month, thereby bringing down the potential sale price. To manage this risk of price fall, you must buy a MCX gold put option on futures say at a strike price of ₹30,000, for a premium that may prevail at an estimated ₹300 per 10 gm. Now suppose in the next one month, gold prices fell below ₹30,000. With the fall in gold prices, premium for gold put option will rise above ₹300 per 10 gm. Thus, the gain in gold put option will help you negate the loss in valuation of your gold jewellery stock."

"In case gold prices rises, you can just ignore your options position and sell your gold jewellery at increased prices. The maximum loss that you would take be ₹300 per 10 gm i.e. premium paid for buying gold put option. Hence like other insurances, by buying gold put option for about ₹300 i.e. option premium, you are safeguarding yourself against a potential fall in gold prices; at the same time, still able to benefit from any potential rise in gold prices." Options prices quoted herein are indicative and may vary based on future market conditions. I advised Manilal to consult his broker to better design a hedging strategy using MCX gold options that suits his needs.