Speculation, Hedging, Arbitrage and Investment

You might have heard terms like speculation, hedging, arbitrage, investment, trading etc. while reading the business page of your newspaper. For most of us, these are terms not very easy to understand or explain. In this post we attempt explain the concept behind speculation and investment in layman's terms. We have used online sources like encyclopedia.com, investopedia.com etc. along with NOS and CBSE texts for reference. The knowledge on these areas might turn quite handy for those with economics optional. Since UPSC Civil Services Interview also revolve around conceptual knowledge, understanding the fundamentals of economics always helps.

Speculation Transaction vs Investment Transactions

The buyers and sellers at the stock exchange undertake mainly two types of operations, one for ***speculation*** and the other for ***investment***.

Investors: Those who buy securities primarily to earn a regular income from such investment and possibly make some long-term gain on account of price rise in future are called investors. They take delivery of the securities and make full payment of the price. Such transactions are called investment transactions.

Speculators: When the securities are bought with the sole object of selling them in future at higher prices or these are sold now with the intention of buying at a lower price in future, are called speculation transactions. The main objective of such transactions is to take advantage of price differential at different times. The stock exchange also provides for settlement of such transactions even by receiving or paying, as the case may be, just the difference in prices.

For example, Ramu bought 200 shares of Tata Steel Ltd. at Rs. 210 per share and sold them at Rs. 235 per share. He does not take and give delivery of the shares but settles the transactions by receiving the difference in prices amounting to Rs. 5,000 minus brokerage. In another case, Manu bought 200 shares of ONGC Ltd. at Rs. 87 per share and sold them at Rs. 69 per share. He settles these transactions by simply paying the difference amounting to Rs. 3600 plus brokerage. However, now-a days stock exchanges have a system of rolling settlement. Such facility is limited only to transactions of purchase and sale made on the same day, as no carry forward is allowed.

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Speculation : As a matter of basic intention

Though speculation and investment are different in some respects, in practice it is difficult to say who is a genuine investor and who is a pure speculator. Sometimes even a person who has purchased the shares as a long-term investment may suddenly decide to sell to reap the benefit if the price of the share goes up too high or do it to avoid heavy loss if the prices starts declining steeply. But he cannot be called a speculator because his basic intention has been to invest. It is only when a person's basic intention is to take advantage of a change in prices, and not to invest, then the transaction may be termed as speculation.

Speculation = Settlement by paying difference in price without delivery of securities

In strict technical terms, however, the transaction is regarded as speculative only if it is settled by receiving or paying the difference in prices without involving the delivery of securities. It is so because, in practice, it is quite difficult to ascertain the intention. Some people regard speculation as nothing but gambling and consider it as an evil. But it is not true because while speculation is based on foresight and hard calculation, gambling is a kind of blind and reckless activity involving high degree of chance element. No only that, speculation is a legal activity duly recognised as a prerequisite for the success of stock exchange operations while gambling is regarded as an evil and a punishable activity. However, reckless speculation may take the form of gambling and should be avoided.

Participants in the the derivative Market : Hedgers, Speculators and Arbitrageurs

The following three broad categories of participants – hedgers, speculators, and arbitrageurs trade in the derivatives market.

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Arbitrageurs

Arbitrage is the simultaneous purchase and sale of equivalent assets at prices which guarantee a fixed profit at the time of the transactions, although the life of the assets and, hence, the consummation of the profit may be delayed until some future date. The key element in the definition is that the amount of profit be determined with certainty. It specifically excludes transactions which guarantee a minimum rate of return but which also offer an option for increased profits. ***Arbitrageurs*** are in business to take advantage of a discrepancy between prices in two different markets (Eg : NSE and BSE) . If, for example, they see the futures price of an asset getting out of line with the cash price, they will take offsetting positions in the two markets to lock in a profit.

Hedgers

Hedging is the simultaneous purchase and sale of two assets in the expectation of a gain from different subsequent movements in the price of those assets. Usually the two assets are equivalent in all respects except maturity. ***Hedgers*** face risk associated with the price of an asset. They use futures or options markets to reduce or eliminate this risk.

Speculators

Speculation is the purchase or sale of an asset in the expectation of a gain from changes in the price of that asset. ***Speculators*** wish to bet on future movements in the price of an asset. Futures and options contracts can give them an extra leverage; that is, they can increase both the potential gains and potential losses in a speculative venture. Day traders are speculators. NB : While Hedgers look to protect against a price change, speculators look to make profit from a price change. Also, the hedger gives up some opportunity in exchange for reduced risk. The speculator on the other hand acquires opportunity in exchange for taking on risk.

- PS : Speculation involves high risk. Arbitrage involves limited risk. Hedging is done to avoid risk.

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The concept of Short Selling

Short selling is the sale of a security that is not owned by the seller, or that the seller has borrowed. Short selling is motivated by the belief that a security's price will decline, enabling it to be bought back at a lower price to make a profit. Short selling may be prompted by speculation, or by the desire to hedge the downside risk of a long position in the same security or a related one. The risk of loss on a short sale is theoretically infinite.