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A STUDY ON OPTION TRADERS PERCEPTION OF OPTION TRADING STRATEGIES

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Abstract:

The National stock exchange Limited (NSE) commenced trading in derivatives in 2000. The future contracts were based on Nifty 50 index. It was also the first exchange in India to introduce trading in options on individual securities from July2, 2001. With the technology pushing trading to online platform, it became easier for individuals to trade in options. It became an opportunity even for small investors to make profits or earn a passive income without huge investments. However, even now options are considered highly risky and many option traders have incurred irreparable losses, however it appears this is because of their lack of understanding on option trading strategies. With a view to find out how after about 2 decades of the introduction of this derivative in NSE, how traders perceive the some of the popular strategies to improve their performance and reduce their losses.

Key Words: Options, Option Traders, Option Trading Strategies

1. Introduction:

An option as a derivative instrument has gained importance in recent years and is continuing to grow. It is a common understanding that Options is a relatively new financial instrument, but this form of a contract dates back to ancient Greece, where it was used in the trading of Olives. In the 17th century, The Tulip Mania was a fad and big business, option contracts were used here as well. However, formal standardized option contracts were originally introduced in 1973 and were listed by the Chicago board of options exchange (CBOE), with a view to build a trusted, inclusive global marketplace that enables people to pursue a sustainable financial future. Option traders use it as a Hedging tool and at the same time make profits on premium differentials. It can be used by option traders to make unlimited profits and at the same time losses can be limited. The option buyer or holder has the right to buy or sell the respective underlying asset, but not the obligation to do so, hence he can exercise his right when it is profitable, or else he can restrict his losses to the option premiums paid. Option traders use different strategies to maximise their profits and reduce their losses. Quite a few do not use strategies and end up losing in the options markets. Therefore, it is imperative to find out how option traders perceive strategies to tide over the complexities of this trade and have these strategies really helped them towards better decision making to maximise profits and minimise losses.

2. Objectives:

This research is carried out with a view to exploring the perception of the NSE option traders in Chennai. Many of the small and new option traders do not use strategies and often end up burning their fingers and move out of this derivatives markets. They lose and term this trade risky based on hearsay, availability of unauthentic information, overconfidence and irrational decisions.

How different strategies are perceived by the option trader

- Strategies that help in risk aversion
- Strategies are best in maximising the profits
- Strategies are safe during periods of high volatility and effective as a hedging tool.
- Impact of the market factors on the strategies

The insight provided will be useful to the existing and new traders in their future trades by better decisions to maximise profit and reduce risk given the Indian social and political environment and other market conditions.

3. Literature Review:

There is descriptive literature on Option trading strategies and Lawerence G McMillan has simplified this in Options as a strategic investment by Lawrence G McMillan (2012), Option volatility and pricing, Advanced trading strategies and Techniques, Sheldon Natenberg (2014) discusses the trading strategies and risk management techniques that are essential to succeed in Options trading.Fundamentals of futures and options markets, John Hull (2018) uses mathematics and binomial trees to make informed decisions in the derivatives markets. Detailed readings and information were also accessed from the following websites viz., www.optionstrading.org, www.cboe.com, www.nseindia.com to have a detailed understanding on Options trading.

4. Research Methodology:

The groundwork for conducting research is established through a research design, serving as the blueprint that shapes the research inquiries and controls variability (Kerlinger, 1986). Researchers typically orient themselves in two ways: quantitative and qualitative (Bryman, 2006).

Based on the research objectives the following hypotheses are made;-

H1: Option trading strategies has a significant and positive impact on the performance of the options.
H2: Option trading strategies has a significant and positive impact on reducing the risk

A well-defined questionnaire was used for data collection from individual option traders in the city of Chennai. The variables were measured on a five point Likert scale ranging from Strongly disagree (1) to strongly agree (5).

The sample is collected from Option traders who use strategies to help them in their options trading in the city of Chennai. As per the popularly used formula, the sample size was determined at 390, and the actual completed and valid samples collected were 400.

The Reliability was tested using Cronbach's alpha value and the variables gave good to excellent reliability by exceeding the value of 0.7. Normality of the data was also established by the bell shaped curve typically indicating normal distribution pattern.

CFA, t-tests, one way Anova and regression analysis were employed using statistical software.

5. Options Trading Strategies:

The strategies can be broadly classified as Bullish, Bearish and Neutral strategies, out of which few popular and commonly used strategies have been identified for this study.

Under Bullish strategies, Bull call spread and Bull put spread have been taken and in Bearish strategies Bear call spread and Bear put spread and long strangles and short straddles being Neutral are considered for finding the perception of the option traders.

6. Findings and Conclusion:

The reliability of the variables using Cronbach's Alpha were ranging from 0.612 to 0.801, though a 0.7 is the generally accepted value for reliability, if the C R value is above 0.5 is considered satisfactory.

Variable	Cronback's Alpha	AVE	Composite Reliability (CR)
Bull Put Spread	0.712	0.628	0.612
Bull Call Spread	0.692	0.651	0.659
Bear Put Spread	0.688	0.669	0.683
Bear Call Spread	0.756	0.602	0.674
Long Strangles	0.801	0.710	0.622
Short Straddles	0.741	0.704	0.712
Risk Aversion	0.799	0.697	0.703
Option Performance	0.701	0.623	0.688

The values exhibit good reliability of the variables of the study.

- To validate the measurement models and analysing the relationship of the variables in study, confirmatory factor analysis is a useful tool
- The model fit for the variables were established using CFA and CMIN/df was less than 5 and the model fit indices namely GFI, AGFI, CFI and NFI are above the cut off value of 0.9
- The Histogram from the Normality study established a bell shaped curve, showing a normal distribution around the central tendency.
- One way ANOVA showed significant differences between the groups and demographic factors like education, for instance traders with post-graduation degrees used the strategies better for risk aversion.
- The implications and findings from the various statistical tools used above indicate that Option trading strategies significantly and positively impact the performance of the option traders and in reducing the risk associated with the implied volatility. Higher risk reduction was seen amongst the more educated traders. A more thorough understanding and knowledge of the strategies will go a long way in improving the performance and to make better decision during volatile conditions.

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