Hedging Strategies in a Volatile Market with Options

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Abstract

In today's financial markets, characterized by their inherent volatility and uncertainty, the need for effective risk management strategies has never been more pronounced. This study delves into the realm of hedging strategies, focusing particularly on the utilization of call options as a means to mitigate risk in volatile market conditions. The study provides a comprehensive overview of the impact of volatility on option pricing and the performance of hedging strategies, highlighting the importance of accurately assessing and forecasting market volatility, discussing its drivers, manifestations, and implications for investors. It explores the challenges posed by volatile markets, including heightened price fluctuations, increased risk exposure, and uncertainty surrounding future market movements. Various options strategies are analyzed, including protective puts, covered calls, and collars, each offering unique advantages and trade-offs in mitigating risk.

The study explores how options trading activity, market sentiment, and macroeconomic factors influence volatility dynamics, providing insights into market behavior and trends through quantitative analysis mainly conducted to evaluate the effectiveness of various hedging strategies in volatile market environments by using Binomial Option Pricing Model (BOPM).

Keywords: BOPM; Hedging Strategies; Macro Factors; Risk Management; Risk Exposure.

1. Introduction

In the dynamic landscape of financial markets, volatility often reigns supreme, presenting both opportunities and challenges for investors. Amidst this uncertainty, the concept of hedging emerges as a crucial risk management tool, offering investors a means to mitigate potential losses while navigating turbulent market conditions. Within the realm of hedging, options play a pivotal role, providing a flexible framework for strategic risk management [1]. The aim of this study is to explore the intricate interplay between market volatility and hedging strategies, with a specific focus on the utilization of options. By delving into this domain, we seek to unravel the complexities of volatile markets and equip investors with the knowledge and tools necessary to safeguard their portfolios against adverse movements [2].

Hedging strategies: Hedging strategies involving call options are techniques used to mitigate or offset potential losses from adverse price movements in an underlying asset [3]. Call options give the holder the right, but not the obligation, to buy the underlying asset at a specified price (strike price) within a predetermined period (until expiration) [4].

1.1. Purpose

In such volatile environments, traditional investment strategies may prove insufficient protecting portfolios from significant losses. Hence, there is a pressing need to explore and develop effective risk management techniques that can help investors navigate volatile market conditions. Hedging strategies, particularly those involving options, offer a promising avenue for mitigating risk and preserving capital in the face of market uncertainty [5]. However, the complex nature of options trading and the dynamic nature of market volatility necessitate a deeper understanding and analysis.

1.2. Objectives

- To know the significance of hedging strategies in volatile markets, with a specific focus on options [6].
To assess the impact of volatility on investment decisions [7].
To evaluate the historical market data to assess the effectiveness of hedging strategies.
To recommend some guidelines for investors and portfolio managers [8].

2. Method
The study is based on empirical evidence and the source of data is secondary data. The present study is based on secondary data source company websites, search engines and published data [9]. The statistical tool used is binomial option pricing model in Table 1 & 2.

### Table 1 Cipla Ltd

<table>
<thead>
<tr>
<th>Instrument type</th>
<th>stock options</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expiry date</td>
<td>25 April 2024</td>
</tr>
<tr>
<td>Option type</td>
<td>call option</td>
</tr>
<tr>
<td>Strike price</td>
<td>1460</td>
</tr>
<tr>
<td>Percentage change</td>
<td>Assuming up 10% &amp; down 5%</td>
</tr>
<tr>
<td>Probability of premium</td>
<td>Assuming it to be 40%</td>
</tr>
</tbody>
</table>

**ANALYSIS:**
Strike price: 1460
Percentage change: Assuming up 10% & down 5%

**Calculation of profit:**
Profit = 1766.6 – 1460 = 306.6

**Calculation of option price:**

**year 1:**
option price = profit*probability + 0*probability
option price = 306.6*0.4 + 0*0.6
option price = 122.64

**year 2:**
option price = profit*probability + 0*probability
option price = 122.64*0.4 + 0*0.6
option price = 49.056

**year 3:**
option price = profit*probability + 0*probability
option price = 49.056*0.4 + 0*0.6
option price = 19.6224

**Figure 1 Binomial Tree**

**Figure 2 Cipla Ltd**

**Interpretation:** From the above analysis of call option which is calculated through binomial option pricing model, there is a decrease trend in the call option prices across the years which indicates that the investors can buy at a cost less than premium in Figure 1&2.

### Table 2 Kotak Bank

<table>
<thead>
<tr>
<th>Instrument type</th>
<th>stock options</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expiry date</td>
<td>25 April 2024</td>
</tr>
<tr>
<td>Option type</td>
<td>call option</td>
</tr>
<tr>
<td>Strike price</td>
<td>1800</td>
</tr>
<tr>
<td>Percentage change</td>
<td>Assuming up 10% &amp; down 5%</td>
</tr>
<tr>
<td>Probability of premium</td>
<td>Assuming it to be 80%</td>
</tr>
</tbody>
</table>
ANALYSIS
Strike price: 1800
Percentage change: Assuming up 10% & down 5%

**BINOMIAL TREE**

**Calculation of profit:**
Profit = 2178 - 1800  
= 378

**Calculation of option price:**

- **year 1:**
option price = profit*probability + 0*probability  
option price = 378*0.8+ 0*0.2  
option price = 302.4

- **year 2:**
option price = profit*probability + 0*probability  
option price = 302.4*0.8 + 0*0.2  
option price = 241.92

- **year 3:**
option price = profit*probability + 0*probability  
option price = 241.92*0.8+ 0*0.2  
option price = 193.536

**Figure 3 Binomial Tree**

**Interpretation:** From the above analysis of call option which is calculated through binomial option pricing model, there is a slight decrease in the call option prices of kotak Mahindra bank across 3 years i.e from 302.4 to 19.536 which indicates that the investors can earn an average profit in Figure 3&4.

3. **Results and Discussions**

3.1. **Results**

- From the above study the call option prices of Cipla ltd have decreased drastically which indicates that the investors can buy at cost less than premium.
- From the above analysis the call option prices of Kotak bank have decreased slightly which indicates that the investors can earn average profits.
- Kotak bank is perceived to have a higher risk according to the BOPM model. This implies that the market views Kotak bank as having a higher likelihood of experiencing an adverse outcome or facing greater uncertainty compared to Cipla.
- The BOPM facilitates the identification of optimal strike prices for call options, considering the prevailing market volatility.

3.2. **Discussions**

- Investors can tailor their hedging strategies to mitigate specific risks effectively, by analyzing different strike prices in conjunction with market conditions.
- Investors can use BOPM model to determine the optimal hedge ratio under different market conditions.
- Implementing hedging strategies using call options incurs costs such as the premium paid for the options and transaction costs. These costs need to be factored into the analysis to assess the overall effectiveness of the hedge.
- If an investor wants to hedge with portfolios, it must consist of scripts from different industries, since they are convenient and represent true nature of the securities market as a whole.
Conclusion

In conclusion, employing hedging strategies utilizing call options in a volatile market, analyzed through the Binomial Option Pricing Model (BOPM), offers investors a robust framework to navigate uncertainty and manage risk effectively. Delta hedging emerges as a cornerstone, allowing for dynamic adjustments to offset fluctuations in the underlying asset's price. By continuously monitoring and adapting the hedge based on changes in delta, investors can mitigate the impact of market volatility on option values. Additionally, strategies such as gamma scalping, vega hedging, calendar spreads, ratio spreads, and collar strategies provide further avenues for risk management and optimization. Through scenario analysis using the BOPM, investors can evaluate the performance of these strategies under different market conditions, enhancing decision-making and portfolio resilience. Ultimately, integrating these hedging techniques offers a comprehensive approach to safeguarding against volatility while maximizing opportunities for returns in unpredictable market environments.

References

[1]. https://www.jstor.org/stable/1831029