Mauritius needs an options market

By Yvan Byeajee

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Over the past decade, derivative markets in emerging market economies (EMEs) have grown at a rapid pace. In layman terms, a derivative is a contract that derives its value from the performance of an underlying security. The underlying security can be a commodity, an asset, a currency, an index, an interest rate, etc.

Yvan Byeajee

Derivative such as Futures contracts have been traded in Mauritius for quite some time now and its introduction originated, in many respects, as a way to hedge commodity prices. While that is still a key function, in recent years the Financial Services Commission (FSC) has authorized the trading and clearing of Index Futures, giving retail Futures traders the opportunity to instigate speculative practices on the price movements of an array of assets. With the advance of technology, we are also witnessing the democratization of commodity and currency Futures trading via entities like Africa Bourse (formerly known as GBOT). But what about other derivatives such as Options contracts?

In other parts of the world, traders use Options to speculate, which can be a relatively risky practice, while hedgers use options to reduce the risk of holding an asset. In its essence, an Option contract gives the buyer the right, but generally not the obligation, to buy or sell an underlying asset at a specific price on or before a certain date. In other words, just like the Futures contract, it can be used to mitigate risks - it is an insurance contract.

Calls and Puts

There two types of Options - Calls and Puts:

A Call gives the holder the right to buy an asset at a certain price within a specific period of time. Calls are similar to having a long position on a stock. Buyers of Calls hope that the stock will increase substantially before the option expires.

A Put gives the holder the right to sell an asset at a certain price within a specific period of time. Puts are very similar to having a short position on a stock. Buyers of Puts hope that the price of the stock will fall before the Option expires.

Options contracts are similar to Futures in the sense that they are both standardized binding agreements that are traded on an exchange; however, they also differ in many respects. For instance:

1. Options give you the right to buy or sell an underlying security or asset without being obligated to do so, as long as you follow the rules of the options contract. On the other hand, Futures don't give you that right.

2. Options are cheaper to trade than Futures but they offer very similar - if not better - potential for leverage. This efficiency makes them very attractive to a wider public.

3. They offer strategic deployment of capital in unparalleled ways. Options are extremely versatile securities. In some specific instances, if used by well-versed hands they can even "void" any potential risks.

4. Although more complex, Options are inherently less risky than Futures or even holding the actual underlying it tracks. This is because, when you buy an Option, your risk is defined. When you sell (or write) an Option, theoretically your risk is unlimited. But, realistically there is almost always an array of strategies than you can implement to cap your losses.

If Mauritius' goal is to assert itself as a true financial hub, it needs to continue developing its financial markets. It needs to offer more sophisticated financial instruments, and instigate further incentives to attract potential savvy investors and businesses. In time, this would undoubtedly help the country establish further its reputation as one of the leaders of progress in the African region.

ABOUT THE AUTHOR

Yvan Byeajee ia a full-time trader and the author of an acclaimed book on trading psychology, *Paradigm Shift* and Amazon best-seller, *Zero to Hero*. When he is not trading, he blogs at [[www.tradingcomposure.com]].