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What is a commodity market?

Commodity market is a place where trading in commodities takes place. It is similar to an Equity market, but instead of buying or selling shares one buys or sells commodities.

How old are the commodities market?

The commodities markets are one of the oldest prevailing markets in the human history. In fact derivatives trading started off in commodities with the earliest records being traced back to the 17th century when Rice futures were traded in Japan.

What are commodity exchanges?

Commodity exchanges are institutions, which provide a platform for trading in 'commodity futures' just as how stock markets provide space for trading in equities and their derivatives. They thus play a critical role in robust price discovery where several buyers and sellers interact and determine the most efficient price for the product. Nepal commodity exchanges offer trading in `commodity futures' in a number of commodities.

What are the different types of commodities that are traded in these markets?

World-over one will find that a market exits for almost all the commodities known to us. These commodities can be broadly classified into the following:

1. **Precious Metals**: Gold, Silver, Platinum etc
2. **Other Metals**: Nickel, Aluminum, Copper etc
3. **Agro-Based Commodities**: Wheat, Corn, Cotton, Oils, Oilseeds, etc.
4. **Soft Commodities**: Coffee, Cocoa, Sugar etc
5. **Energy**: Crude Oil, Natural Gas, Gasoline etc

What are the characteristics of the Exchange Traded markets?

The exchange-traded markets are essentially only derivative markets and are similar to equity derivatives in their working. I.e. everything is standardized and a person can purchase a contract by paying only a percentage of the contract value. A person can also go short on these exchanges. Also, even though there is a provision for delivery most of the contracts are squared-off before expiry and are settled in cash. As a result, one can see an active participation by people who are not associated with the commodity.

What is a Derivative contract?

A derivative contract is an enforceable agreement whose value is derived from the value of an underlying asset; the underlying asset can be a commodity, precious metal, currency, bond, stock, or, indices of commodities, stocks etc. Four most common examples of derivative instruments are forwards, futures, options and swaps/spreads.

What is a forward contract?

A forward contract is a legally enforceable agreement for delivery of goods or the underlying asset on a specific date in future at a price agreed on the date of contract.

What are standardized contracts?

Futures contracts are standardized. In other words, the parties to the contracts do not decide the terms of futures contracts; but they merely accept terms of contracts standardized by the Exchange.

What are customized contracts?

Forward contracts (other than futures) are customized. In other words, the terms of forward contracts are individually agreed between two counter-parties.
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What is a futures contract?

Future Contract is a type of forward contract. Futures are exchange - traded contracts to sell or buy standardized financial instruments or physical commodities for delivery on a specified future date at an agreed price. Futures contracts are used generally for protecting against adverse price fluctuation (hedging). As the terms of the contracts are standardized, these are generally not used for merchandizing propose.

What are the commodities suitable for futures trading?

All the commodities are not suitable for FUTURES TRADING and for conducting futures trading. For being suitable for futures trading the market for commodity should be competitive, i.e., there should be large demand for and supply of the commodity ¿ no individual or group of persons acting in concert should be in a position to influence the demand or supply, and consequently the price substantially. There should be fluctuations in price. The market for the commodity should be free from substantial government control. The commodity should have long shelf-life and be capable of standardization and gradation.

Is delivery mandatory in futures contract trading?

Delivery is generally at the option of the sellers. However, provisions vary from Exchange to Exchange. Byelaws of some Associations give both the buyer and seller the right to demand/give delivery.

How are futures prices determined?

Futures prices evolve from the interaction of bids and offers emanating from all over the country - which converge in the trading floor or the trading engine. The bid and offer prices are based on the expectations of prices on the maturity date.

How professionals predict prices in futures?

Two methods generally used for predicting futures prices are fundamental analysis and technical analysis. The fundamental analysis is concerned with basic supply and demand information, such as, weather patterns, carryover supplies, relevant policies of the Government and agricultural reports. Technical analysis includes analysis of movement of prices in the past. Many participants use fundamental analysis to determine the direction of the market, and technical analysis to time their entry and exist.

How is it possible to sell, when one doesn't own commodity?

One doesn't need to have the physical commodity or own a contract for the commodity to enter into a sale contract in futures market. It is simply agreeing to sell the physical commodity at a later date or selling short. It is possible to repurchase the contract before the maturity, thereby dispensing with delivery of goods.

What are long positions?

In simple terms, long position is a net bought position.

What are short positions?

Short position is net sold position.

What is bull spread (futures)?

In most commodities and financial derivatives market, the term refers to buying contracts maturing in nearby month, and selling the deferred month contracts, to profit from the wide spread which is larger than the cost of carry.

What is bear spread (futures)?

In most of commodities and financial derivatives market, the term refers to selling the nearby contract month, and buying the distant contract, to profit from saving in the cost of carry.

What is ‘Contango'?

Contango means a situation, where futures contract prices are higher than the spot price and the futures contracts maturing earlier.

What is ‘Backwardation'?

When the prices of spot or contracts maturing earlier are higher than a particular futures contract, it is said to be trading at Backwardation.

What is ‘basis’?

It is normally calculated as cash price minus the futures price. A positive number indicates a futures discount (Backwardation) and a negative number, a futures premium (Contango). Unless otherwise specified, the price of the nearby futures contract month is generally used to calculate the basis.

What is cash settlement?

It is a process for performing a futures contract by payment of money difference rather than by delivering the physical commodity or instrument representing such physical commodity (like, warehouse receipt).

What is offset?

It refers to the liquidation of a futures contract by entering into opposite (purchase or sale, as the case may be) of an identical contract.

What is settlement price?

The settlement price is the price at which all the outstanding trades are settled, i.e. profits or losses, if any, are paid. The method of fixing Settlement price is prescribed in the Byelaws of the exchanges; normally it is a weighted average of prices of transactions both in spot and futures market during specified period.

Can one give delivery against futures contract?

Futures contract are contracts for delivery of goods. But most of the futures contracts, the world over, are performed otherwise than by physical delivery of goods.

Why the proportion of futures contracts resulting in delivery is so low?

The reason is, futures contracts may not be suitable for merchandising purpose, mainly because these are standardized contracts; hence various aspects of the contracts, viz., quality/grade of the goods, packing, place of delivery, etc. may not meet the specific needs of the buyers/sellers.

Why delivery of good is permitted when futures contract by their very nature not suitable for merchandising purposes?

The threat of delivery helps in dissuading the participants from artificially rigging up or depressing the futures prices. For example, if manipulators rig up the prices of a contract, seller may give his intention to make a delivery instead of settling his outstanding contract by entering into purchase contracts at such artificially high price.

Can a buyer demand delivery against futures contract?

The Byelaws of different Exchanges have different provisions relating to delivery. Some Exchanges give the option to seller, i.e., if the seller gives his intention to give delivery, buyers have no choice, but to accept delivery or face selling on account and/or penalty. Some Exchanges, particularly the northern Exchanges trading contracts in “gur”/jaggery provide the option both to buyer and seller. In some Exchanges, if the sellers do not give intention to give delivery, all outstanding short and long position are settled at the “Due Date Rate”.

What is “Due Date Rate”?

Due Date Rate is the weighted average of both spot and futures prices of the specified number of days, as defined in the Byelaws of Association

What is delivery month?

It is the specified month within which a futures contract matures.

What is Warehouse Receipt?

It is a document issued by a warehouse indicating ownership of a stored commodity and specifying details in respect of some particulars, like, quality, quantity and, sometimes, indicating the crop season.

Are futures markets “satta” markets?

Participants in futures market include market intermediaries in the physical market, like, producers, processors, manufacturers, exporters, importers, bulk consumers etc., besides speculators. There is difference between speculation and gambling. Therefore futures markets are not “satta markets”.

Why do we need speculators in futures market?

Participants in physical markets use futures market for price discovery and price risk management. In fact, in the absence of futures market, they would be compelled to speculate on prices. Futures market helps them to avoid speculation by entering into hedge contracts. It is however extremely unlikely for every hedger to find a hedger counter party with matching requirements. The hedgers intend to shift price risk, which they can only if there are participants willing to accept the risk. Speculators are such participants who are willing to take risk of hedgers in the expectation of making profit. Speculators provide liquidity to the market; therefore, it is difficult to imagine a futures market functioning without speculators.

What is the difference between a speculator and gambler?

Speculators are not gamblers, since they do not create risk, but merely accept the risk, which already exists in the market. The speculators are the persons who try to assimilate all the possible price-sensitive information, on the basis of which they can expect to make profit. The speculators therefore contribute in improving the efficiency of price discovery function of the futures market.

How is over-speculation curbed?

In order to curb over-speculation, leading to distortion of price signals, limits are imposed on the open position held by speculators. The positions held by speculators are also subject to certain margins; many Exchanges exempt hedgers from this margins.

How should a futures contract be designed?

The most important principle for designing a futures contract is to take into account the systems and practices being followed in the cash market. The unit of price quotation, unit of trading should be fixed on the basis of prevailing practices. The “basis” – the standard quality/grade – variety should generally be that quality or grade which has maximum production. The delivery centers should be important production or distribution centers. While designing a futures contract care should be taken that the contract designed is fair to both buyers and sellers and there would be adequate supply of the deliverable commodity thus preventing any squeezes of the market.

What are the benefits from Commodity Forward/Futures Trading?

Forward/Futures trading performs two important functions, namely, price discovery and price risk management with reference to the given commodity. It is useful to all segments of the economy. It enables the ‘Consumer' in getting an idea of the price at which the commodity would be available at a future point of time. He can do proper costing and also cover his purchases by making forward contracts. It is very useful to the ‘exporter' as it provides an advance indication of the price likely to prevail and thereby helps him in quoting a realistic price and secure export contract in a competitive market It ensures balance in supply and demand position throughout the year and leads to integrated price structure throughout the country. It also helps in removing risk of price uncertainty, encourages competition and acts as a price barometer to farmers and other functionaries in the economy.

What is hedging?

Hedging is a mechanism by which the participants in the physical/cash markets can cover their price risk. Theoretically, the relationship between the futures and cash prices is determined by cost of carry. The two prices therefore move in tandem. This enables the participants in the physical/cash markets to cover their price risk by taking opposite position in the futures market.

How does futures market benefit farmers?

World over, farmers do not directly participate in the futures market. They take advantage of the price signals emanating from a futures market. Price-signals given by long-duration new-season futures contract can help farmers to take decision about cropping pattern and the investment intensity of cultivation. Direct participation of farmers in futures market to manage price risk –either as members of an Exchange or as non-member clients of some member - can be cumbersome as it involves meeting various membership criteria and payment of daily margins etc. Options in goods would be relatively more farmer-friendly, as and when they are legally permitted.

Can the loss incurred on the futures market be set off against normal business profit?

Loss incurred in futures market by entering into contracts for hedging purposes can be set off against normal profit. The loss incurred on account of speculative transactions in futures market cannot be set off against normal business profit.

Who can be a member of the Exchange?

The Bye-laws and Articles of the Association prescribed the criteria for being a member of the Exchange. Any person desirous of being a member of the Exchange may approach the contact persons whose names, telephone numbers, fax numbers, email addresses etc. are available on the website of ndex:www.ndex.com.np. They may also refer to the Bye-law and Articles of Association of the concerned Exchange, which contain various criteria for the membership of the Exchange.

Who are the participants in forward/futures markets?

Participants in forward/futures markets are hedgers, speculators, day-traders/scalpers, market makers, and, arbitrageurs.

Who is hedger?

Hedger is a user of the market, who enters into futures contract to manage the risk of adverse price fluctuation in respect of his existing or future asset.

What is arbitrage?

Arbitrage refers to the simultaneous purchase and sale in two markets so that the selling price is higher than the buying price by more than the transaction cost, so that the arbitrageur makes risk-less profit.

Who are day-traders?

Day traders are speculators who take positions in futures or options contracts and liquidate them prior to the close of the same trading day.

Who is floor-trader?

A floor trader is an Exchange member or employee, who executes trade by being personally present in the trading ring or pit floor trader has no place in electronic trading systems.

Who is speculator?

A trader, who trades or takes position without having exposure in the physical market, with the sole intention of earning profit is a speculator.

Who is market maker?

A market maker is a trader, who simultaneously quotes both bid and offer price for a same commodity throughout the trading session.

What is credit risk?

Credit risk on account of default by counter party: This is very low or almost zeros because the Exchange takes on the responsibility for the performance of contracts.

What is liquidity risk?

Liquidity risks is the risk that unwinding of transactions may be difficult, if the market is illiquid

What is Legal risk?

Legal risk is that legal objections might be raised; regulatory framework might disallow some activities.

What is "National" Commodity Exchange?

Government identified the best international systems and practices in respect of trading, clearing, settlement and governance structure and invited applications from associations – existing and potential – to set up National Commodity Exchanges by introducing such systems and practices. The term, "National" used for these Exchanges does not mean that other Exchanges are restricted from having nationwide operations

How do National Commodity Exchanges differ from other Commodity Exchanges?

National Commodity Exchanges would be granted recognition in all permitted commodities; the other exchanges have to approach the Government for grant of recognition for each futures contract separately. Also, National Commodity Exchanges would be putting is place the best international practices in trading, clearing, settlement, and governance.

What is the role of an Exchange in futures trading?

An Exchange designs a contract, which alone would be traded on the Exchange. The contract is not capable of being modified by participants, i.e., it is standardized. The Exchange also provides a trading platform, which converges the bids and offers emanating from geographically dispersed locations. This creates competitive conditions for trading. The Exchange also provides facilities for clearing, settlement, arbitration facilities. The Exchange may also provide financially secure environment by putting in place suitable risk management mechanism (margining system etc.), and guaranteeing performance of contract through the process of novation.

What is initial/ordinary margin?

It is the amount to be deposited by the market participants in his margin account with clearing house before they can place order to buy or sell futures contracts. This must be maintained throughout the time their position is open and is returnable at delivery, exercise, expiry or closing out.

What is Mark-to-Market margin?

Mark-to-market margins (MTM or M2M) are payable based on closing prices at the end of each trading day. These margins will be paid by the buyer if the price declines and by the seller if the price rises. This margin is worked out on difference between the closing/clearing rate and the rate of the contract (if it is entered into on that day) or the previous day's clearing rate. The Exchange collects these margins from buyers if the prices decline and pays to the sellers and vice versa.

Why is Mark-to-Market margin collected daily in commodity market?

Collecting mark-to-market margin on a daily basis reduces the possibility of accumulation of loss, particularly when futures price moves only in one direction. Hence the risk of default is reduced. Also, the participants are required to pay less upfront margin – which is normally collected to cover the maximum, say, 99.9%, of the potential risk during the period of mark-to-market, for a given limit on open position. Alternatively, for the given upfront margin the limit on open position would have to be reduced, which has the effect of restraining the trade and liquidity.

What is Volatility?

It is a measurement of the variability rate (but not the direction) of the change in price over a given time period. It is often expressed as a percentage and computed as the annualized standard deviation of percentage change in daily price.

What is a Client Account?

Client Account is an account maintained for any individual or entity being serviced by an agent (broker, members), for a commission. A customer's business must be segregated from the broker's/member's/principal's own business and clients' money should be kept in segregated accounts.

What is a client agreement?

It is a legal document entered into between the broker and the client setting out the conditions of their relationship and meeting the requirements of the relevant self-regulatory organization and the Regulator.

What is the role of Clearing House?

Clearing House performs post trading functions like confirming trades, working out gains or losses made by the participants during the course of the clearing period – usually a day-collecting the losses from the members and paying out to other who have made gains.

Can a member enter into the options in goods?

No exchange or no person – whether he is a member of any recognized association or not - can organize or enter into or make or perform options in goods; it constitutes cognizable offence, which is punishable.

What is the need for regulating futures market?

The need for regulation arises on account of the fact that the benefits of futures markets accrue in competitive conditions. The regulation is needed to create competitive conditions. In the absence of regulation, unscrupulous participants could use these leveraged contracts for manipulating prices. This could have undesirable influence on the spot prices, thereby affecting interests of society at large. Regulation is also needed to ensure that the market has appropriate risk management system. In the absence of such a system, a major default could create a chain reaction. The resultant financial crisis in a futures market could create systematic risk. Regulation is also needed to ensure fairness and transparency in trading, clearing, settlement and management of the exchange so as to protect and promote the interest of various stakeholders, particularly non-member users of the market.

What is bucketing?

Broker is said to be indulging in bucketing, when he takes directly or indirectly, the opposite side of a customer's order either on his own account or into on account in which he or she has an interest, without executing the order on an Exchange. Appropriation of clients' trade without written consent constitutes contravention and is punishable.

Equity FAQ

- What is Investment?
- What is Inflation?
- What is Equity?
- What is a Share?
- What is a Derivative?
- What is an Index?
- What is a Depository?
- What is Dematerialization?
- What is the function of Securities Market?
- Why do Securities Markets need Regulators?
- Who regulates the Securities Market?
- What is SEBI and what is its role?
- Who are the participants in the Stock Exchanges?
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- What is meant by Face Value of a share?
- What is an Initial Public Offer (IPO)?
- What is meant by Secondary market?
- What is the role of a Stock Exchange in buying and selling shares?
- What is Dividend?
- What are the advantages of depository services?
- What is the process of opening a demat account?
- What is the procedure to dematerialize your share certificates?
- What makes investment different from savings?
- What is the safest investment?
- Should everyone consider Stock Market/Direct Equity as investment option?

What is Investment?

Money is a need in today's environment and everybody has a varied income level. Whatever is earned is partly spent and partly saved for meeting future expenses. Instead of keeping the savings idle an individual uses the savings in order to get return on it in the future and mitigate inflation to some extent. This is called Investment.

What is Inflation?

The rate at which the cost of living increases is termed as inflation. It is simply the costs to buy the goods and services you need to live. Inflation causes money to lose value as the same amount of money will not buy the same amount of a good or a service in the future as it does now or did in the past. For example, if the average inflation rate is 7% for the next 20 years, goods or serviced that are priced at Rs. 1000 today would cost Rs. 3617 in 20 years. This makes it all the more important to consider inflation as a factor in any long-term investment strategy. One should look at an investment's 'actual' rate of return, which is the return after inflation. One should aim to invest to get a return above the inflation rate ensuring that the investment does not decrease in value.

What is Equity?

Equity investments are basically investments in shares of companies which are listed/being listed on TRADING EXCHANGES. Stocks can be bought/sold from the exchanges (secondary market) or via IPOs – Initial Public Offerings (primary market). Stocks can be termed as one of the best long-term investment options as the market volatility and the resultant risk of losses are mitigated by the general upward momentum of the economy in the long run.

What is a Share?

Shares define the portion of investment an investor has made in a particular company at a given price. The total equity capital of a company is divided into equal units of small denominations, each called a share. The holders of such shares are members of the company and have voting rights.

What is a Derivative?

It is a product whose value is derived from the value of one or more basic variables, which is called underlying. The underlying asset can be equity, commodity or any other asset. These products had initially emerged as hedging devices to safe guard an individual/ organization from the volatility of commodity prices over a period of time. Financial derivatives gained momentum post-1970 period due to growing instability in the financial markets. However, since their emergence, these products have become very popular.

What is an Index?

An Index is a basket of securities and the average price movement of the basket of securities indicates the index movement, whether upwards or downwards The leading Indices in the nepal markets are based on NEPSE. This indices are a reflection of the overall price movement in the market.

What is a Depository?

A depository is like a bank wherein the deposits are securities (viz. shares, debentures, bonds, government securities, units etc.) in electronic form..

What is Dematerialization?

Prior to the concept of electronic exchanges shares were issued to investors in physical form. Dematerialization is the process by which physical certificates of an investor are converted to an equivalent number of securities in electronic form and credited to the investor’s account with his Depository Participant (DP).

What is the function of Securities Market?

Securities Markets, in Nepal are NEPSE, is a place where buyers and sellers of securities can enter into transactions to purchase and sell shares, bonds, debentures etc. This exchange also perform an important role of enabling corporates, entrepreneurs to raise resources for their companies and business ventures through public issues. It efficiently facilitates transfer of resources from investors to others who have a need for those (corporates). It links savings to investments by a variety of intermediaries, through a range of financial products, called ‘Securities’.

Why do Securities Markets need Regulators?

Due to the changing economy and ratio between supply and demand resulting in the absence of conditions of perfect competition in the securities market, the role of the Regulator is extremely important. The regulator ensures that the market participants behave in a desired manner so that securities market continues to be a major source of liquidity for corporate and government and the interest of investors are protected.

What is SEBON and what is its role?

The Securities and Exchange Board of Nepal (SEBON) is the regulatory authority in NEPAL. It provides SEBON with statutory powers for protecting the interests of investors in securities, promoting the development of the securities market and regulating the securities market. Its regulatory jurisdiction extends over organizations in the issuance of capital and transfer of securities, in addition to all intermediaries and persons associated with securities market. It has been obligated to perform the aforesaid functions by such measures as it thinks fit. To be specific, it has powers as below :

- To regulate the business in stock exchanges and any other securities markets
- To Register and regulate the working of STOCK BROKERS, sub–brokers etc.
- Promoting and regulating self-regulatory organizations
- Prohibiting fraudulent and unfair trade practices
- Taking information by undertaking inspection, conducting inquiries and audits of the stock exchanges, intermediaries, self– regulatory organizations, mutual funds and other persons associated with the securities market.

Who are the participants in the Stock Exchanges?

The Stock Exchanges essentially has three categories of participants, which are, the issuers of securities, investors in securities and the intermediaries which bring in the issuers and the investors together, such as merchant bankers, brokers etc.

Is it necessary to transact through an intermediary?

It is advisable to conduct transactions through an intermediary as you need a trading member of a stock exchange if you intend to buy or sell any security on stock exchanges, maintain an account with a depository if you intend to hold securities in demat form, need to deposit money with a banker to an issue if you are subscribing to public issues. One also gets guidance while transacting through an intermediary. We should choose a SEBON registered intermediary, as he is accountable for its activities.

What are the major segments of a Stock Exchange?

The Stock Exchanges has two interdependent segments: the primary (new issues) market and the secondary market. The primary market provides the channel for sale of new securities while the secondary market deals in securities previously issued.

What is meant by Face Value of a share?

The nominal or stated amount (in Rs.) assigned to a security by the issuer. For shares, it is the original cost of the stock shown on the certificate. For an equity share, the face value is usually a very small amount (Rs. 5, Rs. 10) and is a small contributor on the price of the share, which may quote higher in the market, at Rs. 100 or Rs. 1000 or any other price.

What is an Initial Public Offer (IPO)?

An Initial Public Offer (IPO) is the selling of securities to the public in the primary market. This is when an unlisted company makes either a fresh issue of securities or an offer for sale of its existing securities or both for the first time to the public. This paves way for listing and trading of the issuer's securities. The sale of securities is generally through book building or through normal public issue.

What is meant by Secondary market?

It refers to a market where securities are traded after they have initially offered to the public in the primary market and/or listed on the Stock Exchange. Majority of the trading is done in the secondary market.

What is Dividend?

Periodic payments to shareholders made out of the company's profits are termed as dividends. The company decides the amount in a board meeting based on the company's performance and surplus.

What are the advantages of depository services?

By trading in demat segment the risk of bad deliveries is completely eliminated. One can also save on 0.5% in stamp duty in case of transfer of electronic shares. It also avoids the cost of courier; follow up with broker and loss of share certificates in transit. One can also take a loan against shares held in demat form by pledging the same with various lending institutions if required.

What makes investment different from savings?

Saving is a stage on the way to investing. You cannot be an investor without being a saver but you can be a saver without being an investor. Savings are effectively cash or cash instruments, such as deposit account, term bonds etc. Investing is what you do with the savings you have created if you are looking to generate a return on your money that is greater than what is already available to you through your savings instruments

What is the safest investment?

There is really no such thing as 100% safe saving scheme or investment scheme. If anybody tells you different, don't believe them! Not even government-backed bonds are 100% safe. For that matter, ask anybody who had money invested in various Latin America debt instruments in the 1970s and 1980s. Even governments can go out of business!

Should everyone consider Stock Market/Direct Equity as investment option?

The answer to this question is a definite yes. It has been seen that over the years there has been no financial instrument which has given returns as high as the stock markets. The only important factor to be kept in mind is that investment should always be made with an objective in mind and we should not be too greedy while investing. On the other hand, as inflation has fallen over the last couple of decades so have the returns available from basic savings accounts. In fact, many instant access accounts no longer keep pace with inflation at all. Leaving your money in such an account now actually means it is falling in value!

IPO FAQ

- **What is an IPO?**
- **What are the different types of IPOs?**
- **What is meant by Primary Market and Secondary Market?**
- **When is the payment for the shares made?**
- **What is the procedure for applying for an IPO?**
- **What are the necessary details to be mentioned in the IPO Application?**

What is an IPO?

An Initial Public Offer or IPO is the first sale of a company's shares to investors on a public stock exchange. While IPOs are effective at raising capital, being listed on a stock exchange Imposes Regulatory compliance and reporting requirements.

When a shareholder sells shares it is called a "secondary offering" and the shareholder, not the company who originally issued the shares, retains the proceeds of the offering. To avoid confusion, it is important to remember that only a company which issues shares can make a "primary offering". Secondary offerings occur on the "secondary market", where shareholders (not the issuing company) buy and sell shares to each other.

What are the different types of IPOs?

There are two types of IPOs. These are listed below :

1. Fixed Price Issue – In this case, the issue price is pre ascertained by the issuer.
2. Book Building – In this case, an indicative price range is declared by the company for a public offer of its equity shares. Interested investors place bids within this price range for the quantum of securities they want to subscribe to. Prospective investors can revise their bids at anytime during the bid period, that is, the quantity of shares or the bid price or any of the bid options. Usually, the bid must be for a minimum of 500 equity shares and in multiples of 100 equity shares thereafter. By recording the bids (quantum of shares ordered and the respective prices offered) received in a "book", the issuer makes an assessment of the demand for the securities proposed to be issued. After the bid closing date, the book runner and the company fix the issue price and decide the allocation to each syndicate member. Thus, book building method helps in optimum price discovery for the security.

What is meant by Primary Market and Secondary Market?

Primary Market refers to a market which provides the channel for creation and sale of securities. Primary market provides an opportunity to investors to apply & own stocks issued by the corporate (as well as the government) through an IPO (Initial Public Offer). A corporate raises capital from the public to meet its expansion plans or discharge financial obligations.

The resources in this kind of market are mobilized either through the public issue in which anyone can subscribe for it, or through the private placement route in which the issue is made available only to a selected group of subscribers such as banks, FIs, MFs and high net worth individuals. In private placement, the stringent public disclosure regulations and registration requirements are relaxed since these securities are allotted to a few sophisticated and experienced investors.

Secondary Market refers to a market where shares are traded after being initially offered to the public in the primary market. It is a market in which an investor purchases shares from another investor through stock exchange. Majority of the STOCK TRADING is done in the secondary market. The secondary market enables participants who hold securities to adjust their holdings in response to changes in their assessment of risk and return. They also sell securities for cash to meet their liquidity needs.

When is the payment for the shares made?

The bidder has to pay the maximum bid price at the time of bidding based on the highest bidding option of the bidder. The bidder has the option to make different bids like quoting a lower price for higher number of shares or a higher price for lower number of shares. The syndicate member may waive the payment of bid price at the time of bidding. In such cases, the issue price may be paid later to the syndicate member within four days of confirmation of allocation. Where a bidder has been allocated lesser number of shares than he or she had bid for, the excess amount paid on bidding, if any will be refunded to such bidder.

Derivatives FAQ

What are derivatives?

Derivatives are financial contracts, which derive their value off a spot price time-series, which is called "the underlying". The underlying asset can be equity, index, commodity or any other asset. Some common examples of derivatives are Forwards, Futures, Options and Swaps.

Derivatives help to improve market efficiencies because risks can be isolated and sold to those who are willing to accept them at the least cost. Using derivatives breaks risk into pieces that can be managed independently. From a market-oriented perspective, derivatives offer the free trading of financial risks.

What is the importance of derivatives?

There are several risks inherent in financial transactions. Derivatives are used to separate risks from traditional instruments and transfer these risks to parties willing to bear these risks.

Who are the operators in the derivatives market?

Hedgers - Operators, who want to transfer a risk component of their portfolio.
Speculators - Operators, who intentionally take the risk from hedgers in pursuit of profit.
Arbitrageurs - Operators who operate in the different markets simultaneously, in pursuit of profit and eliminate mis-pricing.

What are Forward contracts?

A forward contract is a customized contract between two parties, where settlement takes place on a specific date in future at a price agreed today.

What are Futures?

Futures are exchange traded contracts to sell or buy financial instruments or physical commodities for Future delivery at an agreed price. There is an agreement to buy or sell a specified quantity of financial instrument/ commodity in a designated Future month at a price agreed upon by the buyer and seller. The contracts have certain standardized specifications.

What do you mean by Closing out contracts?

A long position in futures can be closed out by selling futures while a short position in futures can be closed out by buying futures on the exchange. Once position is closed out, only the net difference needs to be settled in cash, without any delivery of underlying. Most contracts are not held to expiry but closed out before that. If held until expiry, some are settled for cash and others for physical delivery.

What is the concept of Basis?

The difference between spot price and Futures price is known as basis. Although the spot price and Futures prices generally move in line with each other, the basis is not constant. Generally basis will decrease with time. And on expiry, the basis is zero and Futures price equals spot price.

What is the difference between Commodity and Financial Futures?

The basic difference between commodity and financial Futures is the nature of the underlying instrument. In a commodity Futures, the underlying is a commodity which may be Wheat, Cotton, Pepper, Turmeric, corn, oats, soybeans, orange juice, crude oil, natural gas, gold, silver, pork-bellies etc. In a financial instrument, the underlying can be Treasuries, Bonds, Stocks, Stock-Index, Foreign Exchange, Euro-dollar deposits etc. As is evident, a financial Future is fairly standard and there are no quality issues while a commodity instrument, quality of the underlying matters.

Mutual Fund FAQ

Worldwide, the Mutual Fund, or Unit Trust as it is called in some parts of the world, has a long and successful history. The popularity of the Mutual Fund has increased manifold. In developed financial markets, like the United States, Mutual Funds have almost overtaken bank deposits and total assets of insurance funds. As of date, in the US alone there are over 5,000 Mutual Funds with total assets of over US $ 3 trillion (Rs. 100 lakh crores).

- **What is a mutual fund?**
- **What are the types of mutual fund?**
- **Why should you invest in mutual funds?**
- **How do you understand and manage risk?**
- **How to invest in mutual funds?**
- **Regulation related mutual fund in Nepal?**
- **Can NRNs invest in mutual fund?**

What Is a Mutual Fund?

A Mutual Fund is a trust that pools the savings of a number of investors who share a common financial goal. Anybody with an investable surplus of as little as a few thousand rupees can invest in Mutual Funds. These investors buy units of a particular Mutual Fund scheme that has a defined investment objective and strategy the money thus collected is then invested by the fund manager in different types of securities. These could range from shares to debentures to money market instruments, depending upon the scheme's stated objectives. The income earned through these investments and the capital appreciations realized by the scheme are shared by its unit holders in proportion to the number of units owned by them. Thus a Mutual Fund is the most suitable investment for the common man as it offers an opportunity to invest in a diversified, professionally managed basket of securities at a relatively low cost.

What Are The Types of Mutual Fund?

- **Closed-End Funds:**

A closed-end fund has a fixed number of shares outstanding and operates for a fixed duration (generally ranging from 3 to 15 years). Close-end funds raise a fixed amount of capital through an initial public offering (IPO). After the funds are raised, the closed-end funds are listed on a stock exchange so its units are traded just like any other stock on an exchange. After the fixed-duration expires, the closed-end mutual fund scheme terminates and investors can redeem their units.

- **Open-End Funds:**

An open-end fund is one that is available for subscription all through the year and is not listed on the stock exchanges. Investors have the flexibility to buy or sell any part of their investment at any time at a price linked to the fund's Net Asset Value (NAV). Open-end funds do not have restrictions on the amount of shares the fund will issue. If demand is high enough, the fund will continue to issue shares no matter how many investors there are. Open-end funds also buy back shares when investors wish to sell.

Why Should You Invest In Mutual Fund?

The advantages of investing in a Mutual Fund are:

1. **Professional Management.** You avail of the services of experienced and skilled professionals who are backed by a dedicated investment research team which analyses the performance and prospects of companies and selects suitable investments to achieve the objectives of the scheme.
2. **Diversification.** Mutual Funds invest in a number of companies across a broad cross-section of industries and sectors. This diversification reduces the risk because seldom do all stocks declare at the same time and in the same proportion. You achieve this diversification through a Mutual Fund with far less money than you can do on your own.
3. **Convenient Administration.** Investing in a Mutual Fund reduces paperwork and helps you avoid many problems such as bad deliveries, delayed payments

and unnecessary follow up with brokers and companies. Mutual Funds save your time and make investing easy and convenient.

4. **Return Potential.** Over a medium to long-term, Mutual Funds have the potential to provide a higher return as they invest in a diversified basket of selected securities
5. **Low Costs.** Mutual Funds are a relatively less expensive way to invest compared to directly investing in the capital markets because the benefits of scale in brokerage, custodial and other fees translate into lower costs for investors.
6. **Liquidity.** In open-ended schemes, you can get your money back promptly at net asset value related prices from the Mutual Fund itself. With close-ended schemes, you can sell your units on a stock exchange at the prevailing market price or avail of the facility of direct repurchase at NAV related prices which some close-ended and interval schemes offer you periodically.
7. **Transparency.** You get regular information on the value of your investment in addition to disclosure on the specific investments made by your scheme, the proportion invested in each class of assets and the fund manager's investment strategy and outlook.
8. **Flexibility.** Through features such as regular investment plans, regular withdrawal plans and dividend reinvestment plans, you can systematically invest or withdraw funds according to your needs and convenience.
9. **Choice of Schemes.** Mutual Funds offer a family of schemes to suit your varying needs over a lifetime.

How Do You Understand And Manage Risk?

All investments whether in shares, debentures or deposits involve risk: share value may go down depending upon the performance of the company, the industry, state of capital markets and the economy; generally, however, longer the term, lesser the risk; companies may default in payment of interest/ principal on their debentures/bonds/deposits; the rate of interest on an investment may fall short of the rate of inflation reducing the purchasing power. While risk cannot be eliminated, skillful management can minimize risk. Mutual Funds help to reduce risk through diversification and professional management. The experience and expertise of Mutual Fund managers in selecting fundamentally sound securities and timing their purchases and sales, help them to build a diversified portfolio that Minimizes risk and maximizes returns.

Top

How To Invest In Mutual Funds?

Step One - Identify your investment needs.

Your financial goals will vary, based on your age, lifestyle, financial independence, family commitments, level of income and expenses among many other factors. Therefore, the first step is to assess your needs. Begin by asking yourself these questions:

a. What are my investment objectives and needs? Probable Answers: I need regular income or need to buy a home or finance a wedding or educate my children or a combination of all these needs.
b. How much risk am I willing to take? Probable Answers: I can only take a minimum amount of risk or I am willing to accept the fact that my investment value may fluctuate or that there may be a short-term loss in order to achieve a long-term potential gain.
c. What are my cash flow requirements? Probable Answers: I need a regular cash flow or I need a lump sum amount to meet a specific need after a certain period or I don't require a current cash flow but I want to build my assets for the future. By going through such an exercise, you will know what you want out of your investment and can set the foundation for a sound Mutual Fund investment strategy.

Step Two - Choose the right Mutual Fund.

Once you have a clear strategy in mind, you now have to choose which Mutual Fund and scheme you want to invest in. The offer document of the scheme tells you its objectives and provides supplementary details like the track record of other schemes managed by the same Fund Manager. Some factors to evaluate before choosing a particular Mutual Fund are:

- the track record of performance over the last few years in relation to the appropriate yardstick and similar funds in the same category.
- how well the Mutual Fund is organized to provide efficient, prompt and personalized service.
- degree of transparency as reflected in frequency and quality of their communications.

Step Three - Select the ideal mix of Schemes

Investing in just one Mutual Fund scheme may not meet all your investment needs. You may consider investing in a combination of schemes to achieve your specific goals. The charts could prove useful in selecting a combination of schemes that satisfy your needs

Step four - Invest regularly

For most of us, the approach that works best is to invest a fixed amount at specific intervals, say every month. By investing a fixed sum each month, you buy fewer units when the price is higher and more units when the price is low, thus bringing down your average cost per unit. This is called rupee cost averaging and is a disciplined investment strategy followed by investors all over the world. With many open-ended schemes offering systematic investment plans, this regular investing habit is made easy for you.

Step Five - Keep your taxes in mind

If you are in a high tax bracket and have utilized fully the exemptions under Section 80L of the Income Tax Act, investing in growth funds that do not pay dividends might be more tax efficient and improve your post-tax return. If you are in a low tax bracket and have not utilized fully the exemption available under Section 80L, selecting funds paying regular income could be more tax efficient. Further, there are other benefits available for investment in Mutual Funds under the provisions of the prevailing tax laws. You may therefore consult your tax advisor or Chartered Accountant for specific advice.

Step Six - Start early

It is desirable to start investing early and stick to a regular investment plan. If you start now, you will make more than if you wait and invest later. The power of compounding lets you earn income on income and your money multiplies at a compounded rate of return.

Step Seven - The final step

All you need to do now is to get in touch with a Mutual Fund or your agent/broker and start investing. Reap the rewards in the years to come. Mutual Funds are suitable for every kind of investor-whether starting a career or retiring, conservative or risk taking, growth oriented or income seeking.

Regulation related mutual fund in Nepal?

In Nepal, Mutual Funds are governed by:

- The Mutual Fund Regulations, 2067 (2010 A.D.)
- The Mutual Fund Directive, 2069 (2012 A.D.).

Can NRNs Invest in Mutual Funds?

Yes, NRNs can also invest in mutual funds through portfolio managers.