Indian Institute of Management Kozhikode

Case Study

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Derivative in disguise

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The author thanks Prof. S.S.S. Kumar for helpful comments and suggestions on this case.

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Derivative in disguise[2]

Mark Twain's words, "It is difficult to make predictions, particularly about the future", could not be more true for someone trying to predict oil or gold prices in the current environment. This is even more so for a middle class Indian customer who encounters equal number of bullish predictions and their opposites for the price of every commodity that matters.

Capitalizing on this, a leading jewellery chain has come up with a novel scheme of locking the gold rates for its customers up to two months ahead of their actual purchase date. The final draft of the ad campaign which will begin in a month's time, gives the following information:

You can lock your gold rates for your next purchase right now!

Advance Period	Amount to be paid*
10 days	10%
20 days	20%
30 days	30%
40 days	40%
50 days	50%
60 days	60%

*If the rate at the time of purchase is different from the rate at the time of booking your jewellery, the lesser rate is yours.

The firm believed that the novelty of this scheme can lure many of the customers from its competitors especially during the upcoming marriage season, when sales are typically high. This scheme will address a typical customer who is planning to buy significant amount of gold within a two month window and her concern that gold rates may rise significantly from now to the actual date of purchase. For the firm, increased advance bookings can free up part of their working capital investment in inventory. So the management thought this will be a win-win situation for both the firm and the customers.

Mr.Ashish has recently joined the Finance team of this jewellery at their headquarters in Kochi after completing his MBA from a premier mangement institution. He chanced to look at this ad campaign at a colleague's table and suddenly he was reminded of his Derivatives course that he took during his MBA, since the footnote at the end of the above table resembled a hedging strategy for the customer in a bullish market. When he mentioned this to his boss, she asked him to probe this similarity further and told Ashish that answers to the following questions can help

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[2] This case was motivated by an actual ad that appeared in the daily newspaper by a leading jewelley chain from Kerala.

the management fine tune this scheme before its actual release. She had picked up some derivatives concepts on her own while managing her personal equity investments but she has not gone beyond that. Also she added that this will be a good opportunity for Ashish to apply his learning to immediate practice and an useful addition to his performance appraisal documents for this year.

1) What type of a derivative is the firm selling?
2) What is the premium charged by the firm for these derivatives?
3) Assuming the firm goes ahead with the above scheme, what are the implied forecasts made by the firm about the future gold prices?
4) Derivative traders always look out to grab arbitrage opportunities. Does the above scheme provide any hidden arbitrage opportunities?
5) Should the firm allow early exercise by the customer i.e. if the customer books the jewellery and turns up at the showroom, say 15 days before the actual purchase date, can the firm advance the purchase date of the contract? If it does so, will the firm incur any additional costs?
6) What are the potential risks to the firm once this scheme is launched? If there are any, how should the firm hedge its exposures?

Knowing the answers to the above questions before the launch of the campaign will also make the firm more confident of its offering and avoid any unpleasant surprises.