INDIAN INSTITUTE OF MANAGEMENT KOZHIKODE

Case Study

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Managing market risk with equity derivatives

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Extended Abstract:

The central character in the case just began his career is also a novice investor who seems to be conservative with his investments. He is in the process of building a long-term portfolio of stocks. As part of the portfolio he comes across an opportunity to invest in an initial public offer (IPO) in the month of March 2020. This is a much-awaited IPO even by the market as it is by a business, which is unique, and no other company in that line of business had their shares listed in the market. Due to the perceived benefits from diversification there is considerable euphoria about the IPO.

The protagonist was following the business of this IPO from a reasonable period of time and is convinced about its business prospects over the long term. Further, he is also tracking the grey market premium for this IPO stock. All such, indicators and stable equity market conditions forebode that the IPO is going to do well upon listing. He also notes that even some of his friends are also bullish about this IPO. Due to the perceived oversubscription ratio and to brighten the possibility of getting allocation some of his friends are investing huge amounts by borrowing. As he came across such incidents, fuelled by greed he too turns in to making a leveraged bet on the IPO by taking a personal loan. Immediately after the closure of the IPO the over all market declined sharply due to heightened uncertainty arising from the sudden onset of a world wide pandemic. In order to protect from the possibility of losses from the IPO shares he wants to make use of equity derivatives that trade on the NSE.

The objective of the case participants will be to design a hedging strategy and evaluate the outcome the hedging strategy up on listing of the IPO shares. As part of developing the hedging strategy the participants have to estimate the size of the exposure, the appropriate choice of the hedge instrument its expiry date, and position to be adopted while placing the hedge. Afterwards the participants also have to examine the performance of the hedging decision.

This case can be used as part of courses like Financial Derivatives, Risk Management and Investments. It is most suitable after teaching introductory chapters on derivatives like stock index futures. It is most appropriate to discuss the concept of hedging with index futures. It is advised that students collect the specifications of the contracts that are traded on the NSE. Especially students ought to understand concepts like contract multiplier/lot size and expiry cycle. For a focused discussion the case also gives a set assignment questions. Apart from the assignment questions, the instructor can direct the students to understand additional aspects related to investment banking like the concept of book building, IPO share allocation process in case of oversubscription, IPO funding and fundamental analysis.

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