Fundamental Understanding of Derivatives

Derivatives provide platform to investor to make huge profit by leveraging their position. However it is double edge sword if not handled properly may result in huge losses too. So as a prudent and smart investor one must look at the signal that markets continuously provide to make a right decision by taking calculative risk.

The most important parameter to judge the performance of stock in Future and Option market is OPEN INTEREST

OPEN INTEREST:
Open interest and volumes are very close to each other. However Volumes considered total trade carried out whereas open interest is number of outstanding contracts at a particular time. It is more relevant as it considers number of contract which are outstanding and not squared off by the investor.
Further Open interest increases only when new contract is traded i.e when existing parties (Buyer or seller) enters in fresh position and not square of or when new parties enter into a contract whereas
Open interest decreases when existing parties i.e. Buyer as well as seller square off their position.

Buyer of the contract sells it
Seller of the contract buys it

Example:
Suppose trade is taking place in Infy Futures on 1st July 2005

Time	Trader	Trade	Change	Net open Interest
10.55 A.M.s	Mr. Subhash Mr. Ankit	Buy 2 Futures Sells 2 Future		2
12.00 Noon	Mr. Ankit Ms. Seema	Buy 2 Futures Sells 2 Futures	=	2
2:30 P.M.	Ms. Dhiraj Mr. Sunil	Sells 4 Futures Buys 4 Futures	↑	6
3:25 P.M	4	Sells 2 Futures Buys 2 Futures	↓	

Open Interest along with Price movement is consider a good indicator of market trend

OPEN INTEREST	PRICE	OUTLOOK
↑	↑	POSITIVE
↑	↓	NEGATIVE
↓	↑	POSITIVE
↓	↓	NEGATIVE

PUT-CALL RATIO:

While most options traders are familiar with the leverage and flexibility that options offer, not everybody is aware of their value as predictive tools. Yet one of the most reliable indicators of future market direction is a contrarian sentiment measure known as the Put/Call options volume ratio.

Put option gives the right to sell the option at a predetermined price whereas call option gives right to sell. While too many put buyer usually signals that market bottom is nearby while too many call buyer indicates market top is making.

Put call ratio is simply number of put contracts divided by number of call contracts traded during the particular day. Higher put call ratio signifies market player are bearish and feel stock may fall whereas lower put call ratio tells the opposite story.
However, signals thrown by market player contradict the real outcome. Higher PCR portrays that the stock is oversold and reversal is on the way (it's right time to get in), whereas Lower PCR portrays that the stock is overbought and downward trend is soon expected.

The Put/call ratio is yet another solid weapon within a speculator's arsenal to trade and give clear picture many time that when to exit or when to enter the market but then also one cannot rely only on Put/call ratio to survive in the market and earn money. This fact also cannot be ignored that it is a very powerful tool, which help speculator up to a great extent to prejudge the market movement and invest accordingly.