DERIVATIVES

AIMS :

☺ ***To learn about***: future, options and swaps; key vocabulary of derivatives

LET'S TALK A BIT

- **Do you know what the main types of derivatives are?**
- **What are the two main uses of derivatives?**

VOCABULARY: DERIVATIVES

Before reading and hearing about derivatives, match up the half-sentences below which define some basic terms.

1. Derivatives are financial instruments whose prices are dependent upon, or derived from,

2. A future is a contract agreement to buy or sell a security, commodity or financial instrument

3. An option offers the buyer the right, but not the obligation,

4. Commodities are raw materials or primary products such as

5. Hedging means making contracts to buy or sell commodities or financial assets

6. Speculation, on the contrary, means buying assets in the hope of making a capital gain

7. An interest rate swap is an agreement to exchange future interest payments

8. A currency swap is an agreement between two parties who exchange principal and fixed rate interest payments

Match with:

A. at a predetermined price, at a predetermined point in the future.

B. by selling them later at a higher price (or selling them in the hope of buying them back at a lower price).

C. in the future, at a pre-arranged price, as a protection against price changes.

D. metals, cereals, coffee, etc., that are traded on special markets.

E. to buy (call option) or sell (put option) an asset at an agreed-upon price (the strike price), either during a certain period of time, or on a specific date.

F. underlying assets such as stocks, bonds, commodities, currencies, interest rates, and market indices.

G. on a loan in one currency for principal and fixed rate interest payments on an equal loan in another currency.

H. with another company or financial institution, e.g., a floating rate loan for a fixed interest rate loan.

DISCUSSION

What could the following people or companies do, using futures and derivatives?

1. A cocoa grower who thinks the price might drop and a chocolate manufacturer who thinks the price might rise.
2. A company with a lot of fixed interest debt that expects interest rates to fall.
3. An investor who expects the price of a stock to fall in the next few weeks or months.
4. An investor who expects the price of a stock to rise in the next few weeks or months.
5. Are the financial instruments in your answers to 1–4 what people call ‘win-win situations’ or ‘zero-sum games’? Can you explain these terms?

READING: HEDGE FUNDS AND STRUCTURED PRODUCTS

Read the transcript of a discussion about hedge funds and structured products.

THERESA LA THANGUE: Now hedge funds, it's a very, it's a term that covers a number of organized ways of trading. They tend to be things that only firms, or very wealthy organizations, can invest in. In the UK, there is no retail access to hedge funds because we believe that at the moment, hedge funds don’t do enough to ensure that retail investors would be aware of the risks, what they were getting involved with.

Hedge funds used to be, many, many years ago when they first became popular, just a way of hedging your bets, so if you had a derivative you would buy another product, a smaller product, to go against the risk involved with the derivative. But now they are seen as an investment tool in their own right, and they can invest in anything, and they do, they invest in some of them are just straight equity investors, where they invest in the price of a share going up, some of them are short-sellers, some of them are very involved in spread-betting, some involved very much in the derivatives market, some will invest in bonds, so it's basically just a bit of a cover-all term now.

A structured product is pretty much similar to a hedge fund, though I understand that if you are making available to the retail community a structured product, it must have a very consistent risk profile across it, so you don't find that you're investing in a bond, a Triple A bond, but also a very risky derivative at the other end, so you must have a very consistent risk profile so that you, the ... the structured product that you buy is consistent with your understanding of risk.

Questions:

1. Why can't individuals (retail investors) invest in a hedge fund in Britain?
2. In what way have hedge funds changed since they began?
3. What are the 5 forms of investment that La Thangue mentions in relation to hedge funds?
4. Retail investors can buy structured products from banks. What constraint must banks obey when developing this products?

READING

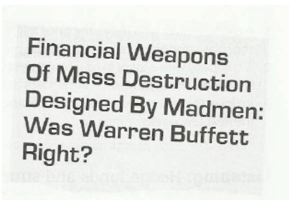
Buffett warns on investment 'time bomb'

The rapidly growing trade in derivatives poses a "mega-catastrophic risk" for the economy and most shares are still "too expensive", legendary investor Warren Buffett has warned. The derivatives market has exploded in recent years, with investment banks selling billions of dollars worth of these investments to clients as a way to off-load or manage market risk. But Mr Buffett argues that such highly complex financial instruments are time bombs and "financial weapons of mass destruction" that could harm not only their buyers and sellers, but the whole economic system.

Contracts devised by 'madmen'

Derivatives are financial instruments that allow investors to speculate on the future price of, for example, commodities or shares - without buying the underlying investment. Derivatives like futures, options and swaps were developed to allow investors hedge risks in financial markets - in effect buy insurance against market movements -, but have quickly become a means of investment in their own right. Outstanding derivatives contracts - excluding those traded on exchanges such as the International Petroleum Exchange - are worth close to $85 trillion, according to the International Swaps and Derivatives Association. Some derivatives contracts, Mr Buffett says, appear to have been devised by "madmen". In his 'Annual Letter to Shareholders', Mr Buffett compares the derivatives business to "hell... easy to enter and almost impossible to exit".

DISCUSSION


Financial Weapons
Of Mass Destruction
Designed By Madmen:
Was Warren Buffett
Right?

Why is it possible to describe derivatives as 'weapons of mass destruction'?

What do you think Buffet means by a 'time bomb'?