WILEY FINANCE

Derivatives demystified

A Step-by-Step Guide to Forwards, Futures, Swaps and Options

SECOND EDITION

ANDREW M. CHISHOLM

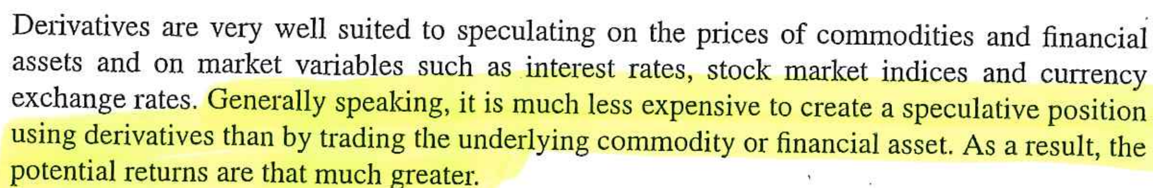
Derivatives demystified

SECOND EDITION

receive a predetermined quantity of domestic currency. Or it purchases an option which gives it the right but not the obligation to sell the foreign currency at a set rate.

Speculators

Derivatives are very well suited to speculating on the prices of commodities and financial assets and on market variables such as interest rates, stock market indices and currency exchange rates. Generally speaking, it is much less expensive to create a speculative position using derivatives than by trading the underlying commodity or financial asset. As a result, the potential returns are that much greater.



A classic case is the trader who believes that increasing demand or reduced supply is likely to boost the market price of oil. Since it would be too expensive to buy and store the physical commodity, the trader buys exchange-traded futures contracts agreeing to take delivery of oil on a future delivery date at a fixed price. If the oil price rises in the spot market, the value of the futures contracts will also rise and they can be sold back into the market at a profit.

In fact if the trader buys and then sells the futures contracts before they reach the delivery point the trader never has to take delivery of any actual oil. The profit from the trades is realized in cash.

Arbitrageurs

An arbitrage is a deal that produces risk-free profits by exploiting a mispricing in the market. A simple example occurs when a trader can buy an asset cheaply in one location and simultaneously arrange to sell it in another for a higher price. Such opportunities are unlikely to persist for very long, since arbitrageurs would rush in to buy the asset in the 'cheap' location, thus closing the pricing gap.

In the derivatives business arbitrage opportunities typically arise because a product can be assembled in different ways out of different building blocks. If it is possible to sell a product for more than it costs to buy the constituent parts, then a risk-free profit can be generated. In practice the presence of transaction costs often means that only the large market players can profit from such opportunities.

In fact many so-called arbitrage deals constructed in the financial markets are not entirely risk-free. They are designed to exploit differences in the market prices of products which are very similar, but not completely identical. For this reason they are sometimes (and more accurately) called **relative value** trades.

SUPPORTING ORGANIZATIONS

There are, in addition, many individuals and organizations supporting the derivatives market and helping to ensure orderly and efficient dealings. For example, those who are not members of a futures and options exchange have to employ a broker to transact or 'fill' their orders on the market. A broker acts as an agent and takes an agreed fee or commission. The smaller brokers operate through larger banks and securities houses.

Trading in derivatives generally is overseen and monitored by government-appointed regulatory organizations. For example, the US Commodity and Futures Trading Commission (CFTC) was created by Congress in 1974 as an independent agency to regulate commodity futures and options markets in the United States.