

Financial Derivatives

Thecasesolution.com

Presented by: Fatimah Alawaji



Overview

- Definition of Derivatives
- History of Derivatives
- Main Purpose of Derivatives
- Players in the Derivatives Market
- Major Categories of Derivatives (Forward, Futures, Options, Swaps)

Definition of Derivatives

- An instrument created by contract between two or more parties whose value depends on - is derived from - the value of some other financial instrument, called the underlying asset.
- The common underlying assets include: bonds, commodities, currencies, interest rates, market indexes and stocks.



Forwards

A forward, or a forward contract, is a private agreement between two parties giving the buyer an obligation to purchase an asset, and the seller an obligation to sell an asset at a set price at a future point in time.

- Forwards are highly customized, and are much less common than the futures.
- The market for forward contracts is huge, since many of the world's biggest corporations use it to hedge currency and interest rate risk.

Players in the Derivatives Market

Who to bet on future movements in the price of an asset. The objective is to gain when prices rise or fall.

Speculator



Use the position when they face risk associated with the price of an asset. Use derivatives to reduce or eliminate this risk.

Arbitrager: in business to take advantage of a discrepancy between prices in two different markets.

Futures

Hedging and Speculating with Futures

- A futures contract is a standardized contract to buy or sell a specific quantity of a commodity or financial instrument at a predetermined future date and price.
- Futures contracts are traded on organized exchanges, such as the Chicago Board of Trade (CBOT) and the New York Mercantile Exchange (NYMEX).
- Futures contracts are highly liquid, meaning they can be bought and sold easily.



Futures

- Futures are financial contracts obligating the buyer to purchase an asset or the seller to sell an asset, such as a physical commodity or a financial instrument, at a predetermined future date and price.
- A future is a forward contract that has been standardized to facilitate trading and sold through an organized exchange "future exchange".
- Some futures contracts may call for physical delivery of the asset, while others are settled in cash.



Options

Like futures, options are agreements between two parties but it gives the buyer of the option the right -not the obligation- to buy or sell a particular asset at a later date at an agreed upon price.

Two types of options:

- Call option
- Put option



Swaps

A derivative contract through which two parties exchange financial instruments, the exchange takes place at a predetermined time. These instruments can be almost anything, but most swaps involve cash flows based on a notional principal amount that both parties agreed on.

- Swaps do not trade on exchange, and retail investors do not generally engage in swaps. Rather, swaps are used by counterparty contracts widely used by institutions, financial institutions, or governments.

References

- The Wall Street Journal
- Investopedia
- The Chicago Board of Trade
- The New York Mercantile Exchange

Thank you for listening



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- History of Derivatives
- Basic Purposes of Derivatives
- Players in the Derivatives Market
- Major Categories of Derivatives (Forwards, Futures, Options, Swaps)

Definition of Derivatives

- An instrument consists of contract between two or more parties whose value depends on the change from the value of some other financial instrument, called the underlying asset.
- The common underlying assets include: Bonds, Commodities, Currencies, Interest Rates, Volatility Indices and Stocks.



Forwards

A forward, or a forward contract, is a private agreement between two parties giving the buyer an obligation to purchase an asset (and the seller an obligation to sell an asset) at a set price at a future point in time.

- Forwards are highly customized, and are much less common than the futures.
- The market for forward contracts is huge, since many of the world's biggest corporations use it to hedge currency and interest rate risk.

Players In the Derivatives Market

seek to bet on future movements in the price of an asset. The objective is to gain when an asset rises or the opposite.



Speculator
Hedger

is in the position where they face risk associated with the price of an asset. Use derivatives to reduce or eliminate this risk.

Arbitrageur is in business to take advantage of a discrepancy between prices in two different markets.

Futures

Hedging and Speculating with Futures

- Hedging: A contract to buy or sell a specific quantity of an asset at a predetermined price at a future date. It is used to reduce the risk of price fluctuations.
- Speculation: A contract to buy or sell a specific quantity of an asset at a predetermined price at a future date. It is used to profit from price fluctuations.
- Arbitrage: A contract to buy or sell a specific quantity of an asset at a predetermined price at a future date. It is used to profit from price discrepancies between different markets.



Futures

- Futures are financial contracts obligating the buyer to purchase an asset or the seller to sell an asset, such as a physical commodity or a financial instrument, at a predetermined future date and price.
- A future is a forward contract that has been standardized to facilitate trading, and sold through an organized exchange "future exchange".
- Some futures contracts may call for physical delivery of the asset, while others are settled in cash.



Options

Like futures, options are agreements between two parties but it gives the buyer of the option the right—not the obligation—to buy or sell a particular asset at a later date at an agreed upon price.

- Two types of options:
- Call option
 - Put option



Swaps

A derivative contract through which two parties exchange financial instruments, the exchange takes place at a pre-determined time. These instruments can be almost anything, but most swaps involve cash flows based on a reference price that both parties agreed on.

Swaps do not trade on exchanges, and retail investors do not generally engage in swaps. Rather, swaps are over the counter contracts widely used by businesses, financial institutions, or governments.

References

- Investopedia
- The Balance
- Investopedia
- Investopedia

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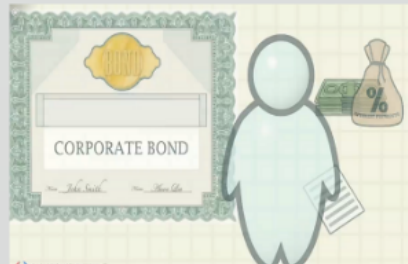




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Definition of Derivatives

- An instrument consists of contract between two or more parties whose value depends on – is derived from – the value of some other financial instrument, called the underlying asset.
- The common underlying assets include: bonds, commodities, currencies, interest rates, market indexes and stocks.



History of Derivatives

- Derivatives markets can be traced back to middle ages.
- Developed to meet the need of farmers and merchants.
- First future exchange was established in Japan in 16th century.
- The Chicago Board of Trade was established in 1848.
- The International Monetary Market was established in 1972 for future trading in foreign currencies.

Basic Purpose of Derivatives

- In derivatives transactions, one party's loss is always another party's gain. So the main purpose of derivatives is to transfer risk from one person or firm to another, that is, to provide insurance and manage the risk.
- **Price Discovery:** Derivatives play a crucial role in discovering the present and future price of any commodity or financial asset. This is an essential part of an efficient economic system.
- **Trading efficiency:** Investing in a derivative can be a more attractive alternative than investing in the underlying instrument. This might be a result of greater liquidity or lower transaction costs in the derivatives market.

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Players in the Derivatives Market

wish to bet on future movements in the price of an asset. The objective is to gain when prices move as per the expectation.



Arbitrageur: is in business to take advantage of a discrepancy between prices in two different markets.

is in the position where they face risk associated with the price of an asset.

Use derivatives to reduce or eliminate this risk.