The ABCs of Derivatives

An Introduction to Financial Contracts

What is a Derivative

A derivative is a financial instrument that derives its value from the underlying asset or security.

The underlying asset could be Stocks, Bonds, Commodities or Currencies, etc.

The contract involve two parties:

1. Buyer (Long)
2. Seller or Writer (Short)

Example:

Let's say a farmer wants to sell his crop of corn, but he's worried that the price of corn might go down in the future.

To hedge this risk he enters into a contract with the wholesaler who agrees to buy the corn in the future at the price decided today.

This contract is a type of derivative called a forward contract where the underlying asset is the corn, and the contract derives its value from the price of corn.

Types of Derivatives Contract

- Forward Contract
- Futures Contract
- Swaps Contract

→ Forward Commitments

- Options Contract → Contingent Claim

Forward Contract

A forward contract is a private agreement between two parties to buy or sell an asset at a specific price, date, and quantity in the future.

They are customizable contracts and traded in largely unregulated markets thus possess the high credit risk.

These contracts are privately negotiated between buyers and sellers and not traded on a centralized exchange.

Futures Contract

Future contracts are the same as Forwards but they are traded on Exchanges.

They are more standardized with terms and conditions set by the exchange on which it is traded..

Since they are traded on Exchanges, the credit risk is very low and liquidity is high.

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Swaps

Swaps are a type of derivative contract in which two parties agree to exchange one stream of cash flows with another.

Swaps can be used to hedge against or speculate on changes in interest rates, currencies, or other financial variables.

Ex: Basic Interest Rate Swap in which one party agrees to pay a fixed interest rate in exchange for a Floating interest rate

Options Contract

Options are a type of financial contract that gives the buyer the right, but not the obligation, to buy or sell an underlying asset at a specified price.

In exchange for this right, the buyer pays the seller a premium.

Types of Options Contracts:

1. Call Option
2. Put Option

Call Option

A call option gives the buyer the right, but not the obligation, to buy an underlying asset at a specified price

A call option is typically used when the buyer expects the price of the underlying asset to rise in the future.

In exchange for this right, the buyer pays the seller a premium.

Put Option

A put option is a type of financial contract that gives the buyer the right, but not the obligation, to sell an underlying asset at a specified price.

A put option is typically used when the buyer expects the price of the underlying asset to fall in the future.

In exchange for this right, the buyer pays the seller a premium.

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