Derivatives Demystified

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

Andrew M. Chisholm

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This book is based on a series of seminars delivered over a period of many years to people working in the global financial markets. The material has expanded and evolved over that time. Participation on the seminars has covered the widest possible spectrum in terms of age, background and seniority, ranging all the way from new graduate entrants to the financial services industry up to very senior managing directors. What all these many and varied individuals had in common was a strong desire to understand how derivative products are used in practice, without becoming too involved in the more complex mathematics of the subject.

The seminars (and this book) originated from the conviction that bankers, fund managers and other professionals in the modern financial markets must have a grasp of derivative products. In fact the target audience broadened out over the years to include technology specialists, operations experts, finance professionals working in the corporate environment and their business advisers. It is estimated that over 90% of the world’s largest 500 companies now use derivatives to help to manage their exposures to the risks arising from factors such as currency fluctuations, interest rate changes and unstable commodity prices.

Derivatives are everywhere in the modern world, but sometimes are not easily detected except by those in the know. If you have the option to extend a loan or redeem a mortgage early, then you have a derivative product. If a company has the opportunity to increase its production facilities or exploit some new technology, then it has what is known in the world of derivatives as a real option. This has a value, and given certain assumptions its value can be measured.

It is my view that with a little application anyone can achieve a working knowledge of the key derivative products. It is not widely appreciated that many people in the financial markets who handle derivatives regularly are not specialists in higher mathematics. Nor is it important for them to be so, but they do need to understand how the products can be used in practice to create risk management, investment and trading solutions that are appropriate for particular organizations in certain market circumstances. The real strength of derivatives is that they offer a new set of tools with which to solve real-world problems. They are not a substitute for thought or creativity; quite the reverse. Human beings have to analyse the problems and learn how to use the appropriate tools to design the best possible solutions.

A number of excellent textbooks are available that take a quantitative approach to this subject and explain in detail the pricing models used to value derivative products. At the end of this book there is a list of further reading for those who wish to delve more deeply into this subject.