FN 201 : Lecture Note 10

Derivatives and Introduction to Risk Management

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Outline

1. Risk Management and Analysis
2. Derivatives

Risk Management and Analysis

1. Identify the risks faced by the company.
2. Gauge the potential impact of each risk.
3. Decide how each relevant risk should be handled. Risk exposure can be reduced by buying an insurance policy and/or by hedging by means of derivatives such as futures and options.

3. Options

= a contract to give the investor the right – but *not an obligation* – to buy or sell something

1. A specified number of shares of stock
2. At a fixed price per share, called **strike or exercise price**
3. For a limited length of time.

Call options = the right to **PURCHASE** stock at a fixed price

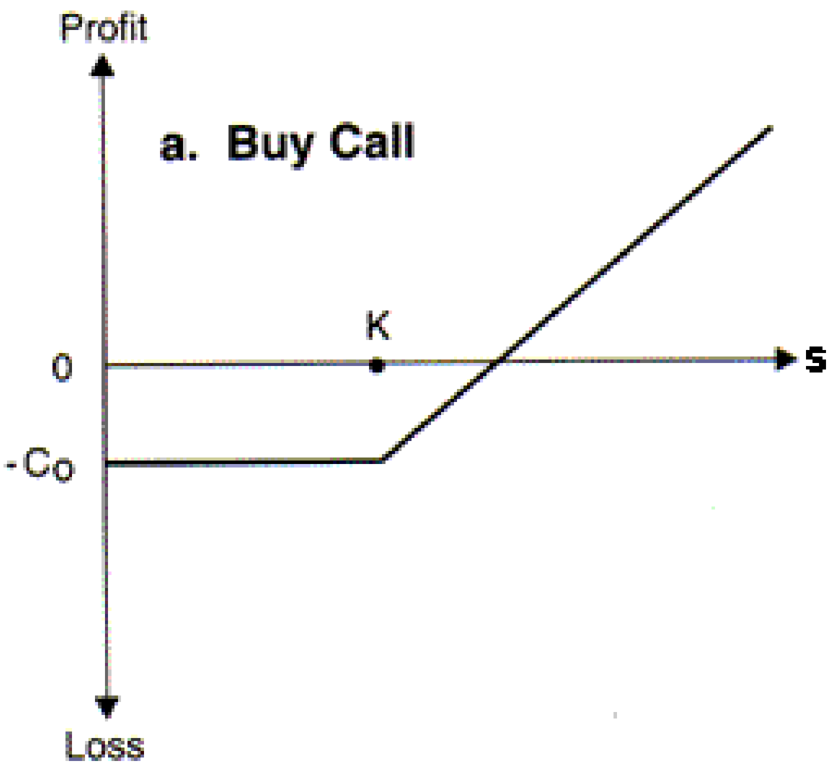
Put options = the right to **SELL** stock at a fixed price

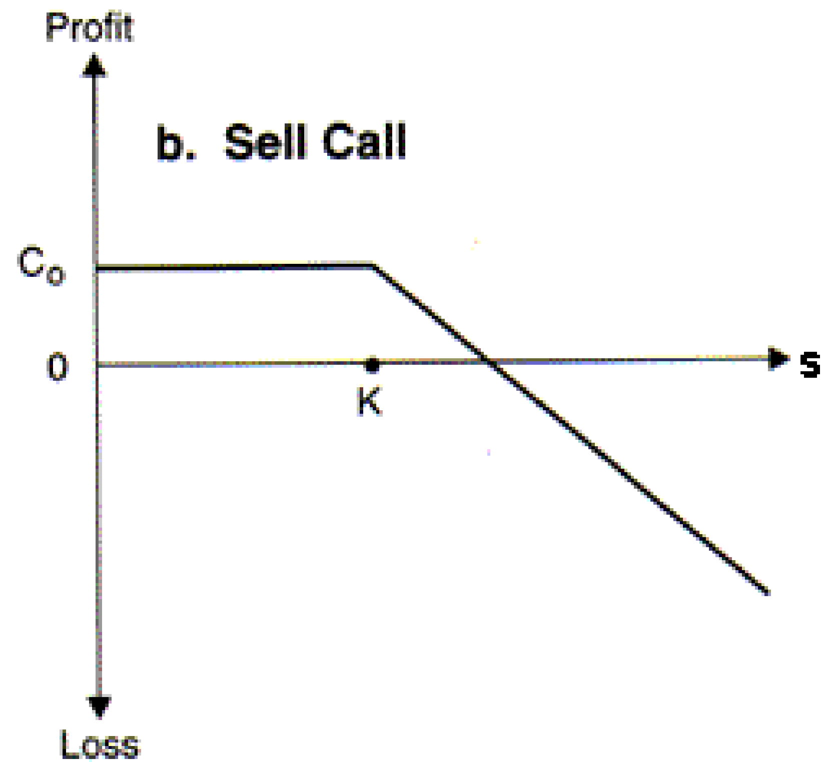
3. Options

In-the-Money and Out-of-the-Money

Comp Inc. Puts and Calls at 50 Strike Price		
	Stock Price	
	<u>Calls</u>	<u>Puts</u>
In-the-money	Over 50	Under 50
At-the-money	50	50
Out-of-the-money	Under 50	Over 50

3. Options





4. Futures and Forward Contracts

Futures

= a contract to purchase or sell a given amount of an item for a given price by a certain date (in the future – thus the name ‘‘futures market’’)

Forwards

= similar to *futures* but are not uniform or standardized. They are not traded on exchange

4. Futures vs. Forward Contracts

Futures Contracts	Forward Contracts
1. Standardized contracts in terms of size and delivery dates.	1. Customized contracts in terms of size and delivery dates.
2. Standardized contract between a customer and a clearinghouse.	2. Private contracts between two parties.
3. Impossible to reverse a contract.	3. Contract may be freely traded on the market.
4. All contracts are marked to market; profits and losses are realized immediately.	4. Profit or loss on a position is realized only on the delivery date.
5. Margins must be maintained to reflect price movements.	5. Margins are set once, on the day of the initial transaction.

Question?