TRADING GROUP UBC

Weekly Educational Topics

Introduction to Derivative Contracts

Derivative contracts are financial instruments whose prices are determined by the value of other (underlying) asset such as commodities, precious metals, or currencies. The most common examples of derivatives are swaps, forwards, futures, and options. Derivatives allow investors to hedge exposure to fluctuations of the primary asset, and thus are useful for mitigating risk.

- Swaps - Contracts through which two parties swap cash flows of one asset with that of another asset.
  - Interest rate swaps, for example, usually involve the swapping of a fixed rate to a variable rate.
- Forwards - Contracts which require a buyer to purchase or sell an asset for a set price at some point in the future.
- Futures - Contracts which require the buyer to purchase or sell an asset at a set price and date in the future.
- Options - Contracts which give the buyer an opportunity to purchase (call options) or sell (put options) an underlying asset.

The derivatives market is much larger than the primary assets market, and can be divided into two components; Over-the-counter (OTC) Derivatives and Exchange-Traded Derivatives.

Exchange-Traded Derivatives are known to be more approachable to retail investors for a multitude of reasons. Since ETD's are traded on regulated exchanges, transactions are standardized, which is to say that regulatory bodies or clearing houses act a guarantor, guarding against default for all transactions. Additionally, investors trading them tend to benefit from relatively higher liquidity, due to a relatively more active secondary market being facilitated by the exchange.

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In contrast, OTC derivatives are traded in the private and decentralized market in which many institutions and brokers are offering similar derivative products. Although lack of transparency in this market brings with it considerable risk, for well informed institutional players, this is compensated for in the form of generally lower transaction costs.

Further Readings:

CISI Exchange Traded Derivatives
http://www.cisi.org/bookmark/bitmark/Uploads/Publications/86743898/Exchange-Traded%20Derivatives%20Ed19.pdf

Examples of Exchange Traded Derivatives
https://www.investopedia.com/articles/active-trading/032515/examples-exchangetraded-derivatives.asp

Applications of Financial Derivatives
http://www.marciniak.waw.pl/NEW/231231/DE1.pdf

Types of Options
https://www.optionstrading.org/basics/option-types/