

B16. DERIVATIVES



- HEDGING AND THE WHY OF DERIVATIVES
- TYPES AND PAYOFFS
- INVESTMENTS STRATEGIES

HEDGING AND DERIVATIVES

- Hedging: protection through a **transaction offsetting another**
- **micro-hedging:**
 - One exposure protected by taking another symmetrical one
 - *F.i. an ITA firm has to pay \$ in 30dd and buys a deposit in \$ now*
- **macro-hedging:**
 - One group of similar exposures protected by taking one that is symmetrical
 - *F.i. an Italian bank holds a portfolio of fixed-interest loans and borrows through a fixed-interest bond*
- **partial hedging:**
 - One exposure protected through another for a component/portion of the whole risk
 - *F.i. an Italian firm that will buy oil gets a deposit in \$ to hedge the currency risk only*
- **cross-hedging:**
 - One exposure protected through another that is highly correlated but not symmetrical
 - *F.i. exposure to fuel costs of a delivery company is protected through an exposure to Brent oil*



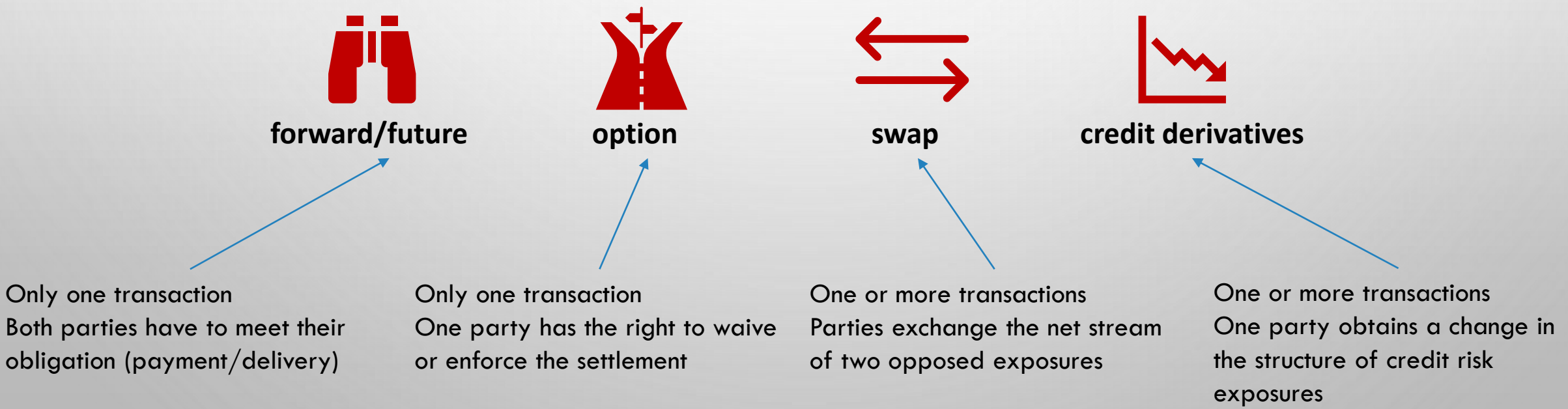
PROBLEM: offsetting exposures are costly, exact coverage hard to find, additional risks arise

HEDGING AND DERIVATIVES

How to make hedging more effective and simpler?

By designing an instrument that:

- Requires **little o no initial investment** (compared to the exposure effect obtained)
- **Settled at a future date**
- Referenced to one or more **external variables**
- Main instruments (mostly **OTC**, but also **exchange-traded**):

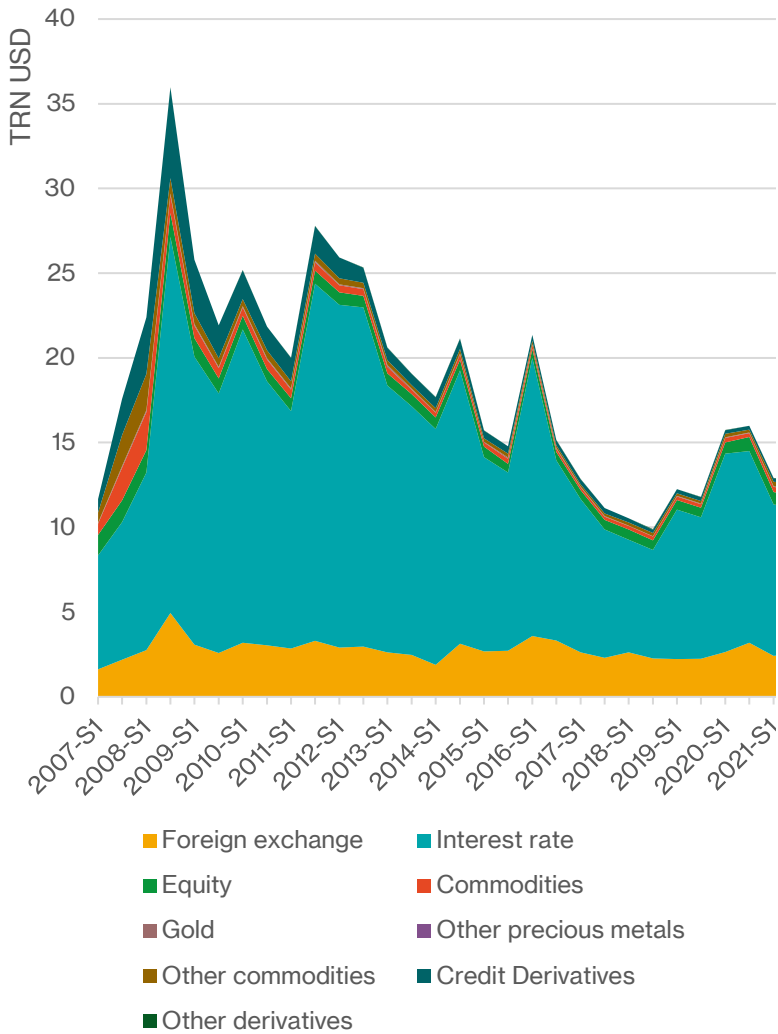


SOME USEFUL TERMINOLOGY...

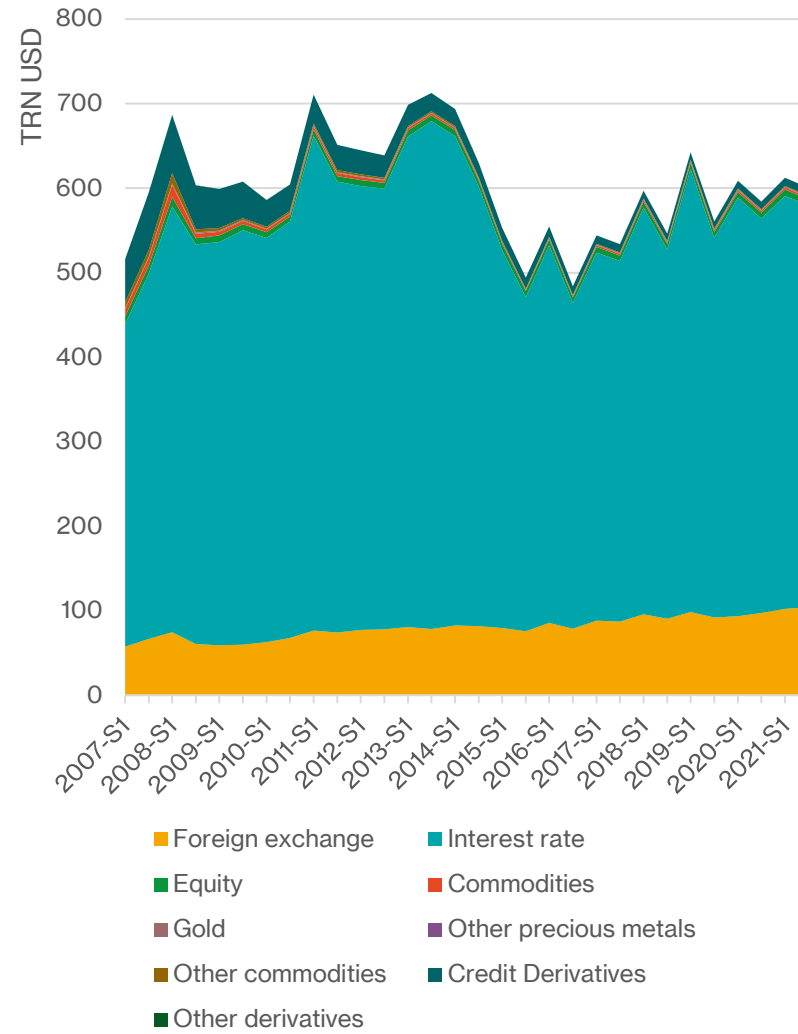
- **Strike price:** the reference amount required to settle a contract
- **Underlying:** asset, index, rate, commodity, ... from which the contract derives its value and targets its settlement
- **Settlement date:** date at which obligations are met
- **Notional:** amount of underlying on which the contract is built
- **Market price:** current transfer/settlement price
- **Long VS short leg:** right to receive, or obligation to deliver (underlying or cash)
- **Open interest:** total number of contracts outstanding not settled yet (long or short, since for each buyer there is a seller...)
- **Trading volume:** number of transactions in a given instrument in a specific period of time (if I sell my contracts to a third party, open interest does not change, but volumes do)



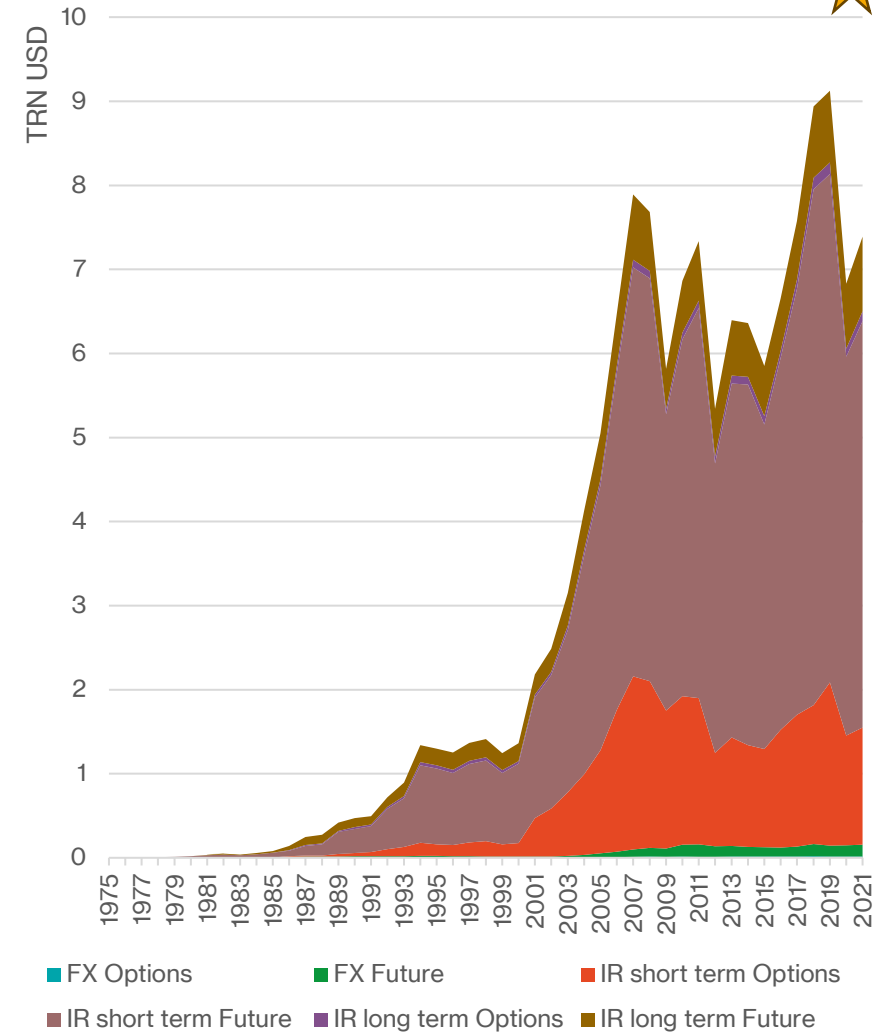
Gross market values - OTC



Notional amount (OTC)



Daily avg turnover (exchange traded)



EXAMPLES: market trends

FORWARD / FUTURE

- Two parties agree on settling a **transaction** on an **underlying** (stocks, bonds, IR, ...) at the **expiration date** at a **strike price**

F.i. John agrees today to pay Susan 50 €/g for 10 Kg of gold on 1st July

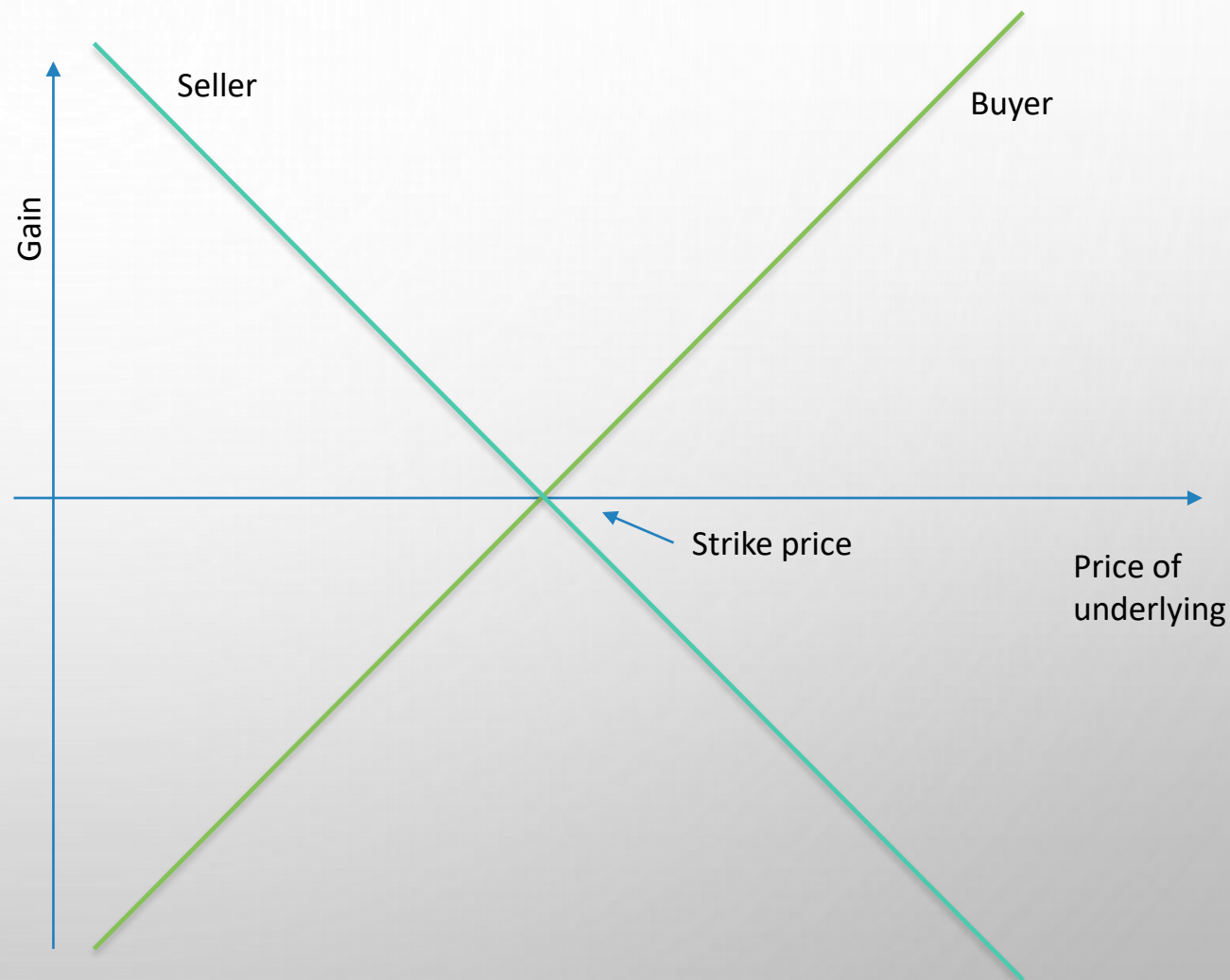
- **OTC**, finding counterparties is **difficult**, **illiquidity** and **credit risk**

F.i. what happens if on 1st July John does not have the money or Susan the gold?

- Futures are **standardized** to be exchange-traded:

- clearing houses and daily margins
- “negotiability” through standard conditions
- extension of deliverables increase volumes
- cash-settlement VS physical settlement

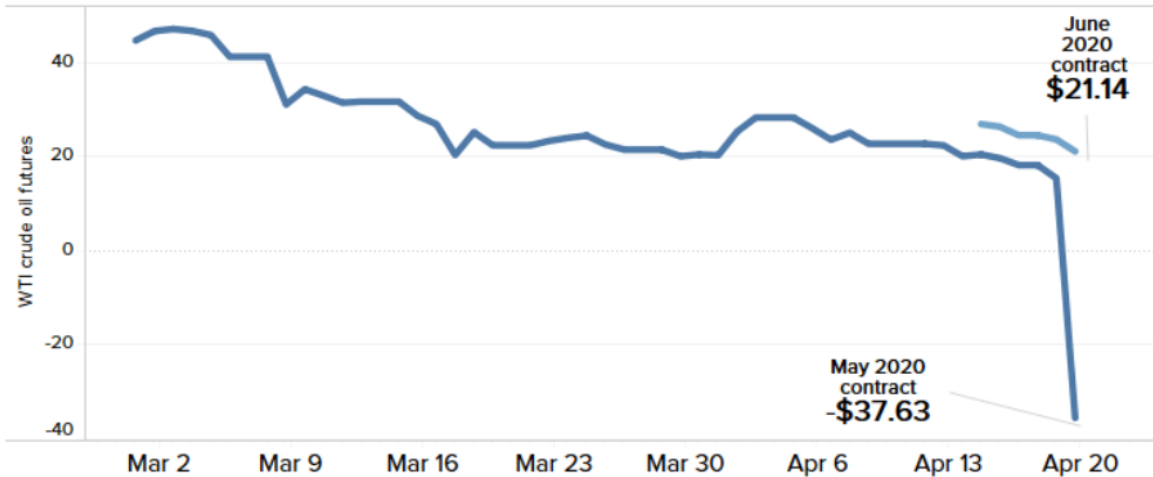
F.i. if on 1st July gold trades at 52 €/g would it be the same for John to receive 10 Kg of gold or 20.000 €? And for Susan to deliver gold or the money?



WTI future crash (20th April 2020)

Oil futures crash

Crude oil WTI futures, dollars per barrel



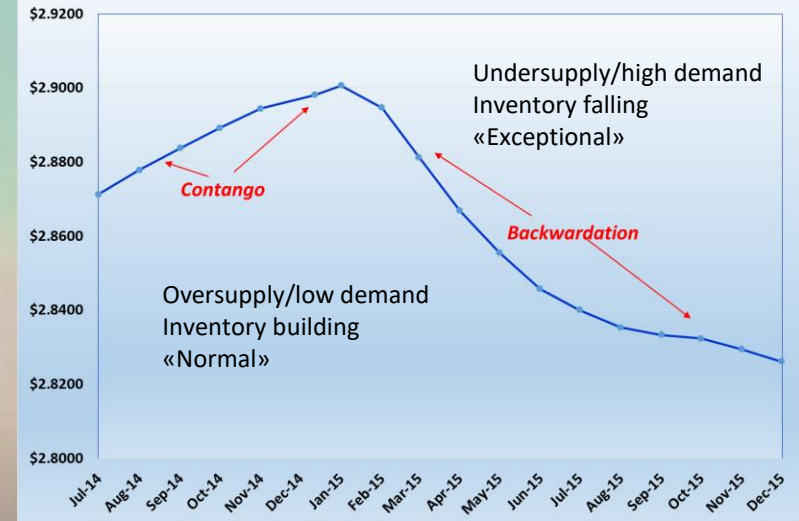
SOURCE: FactSet, CNBC data



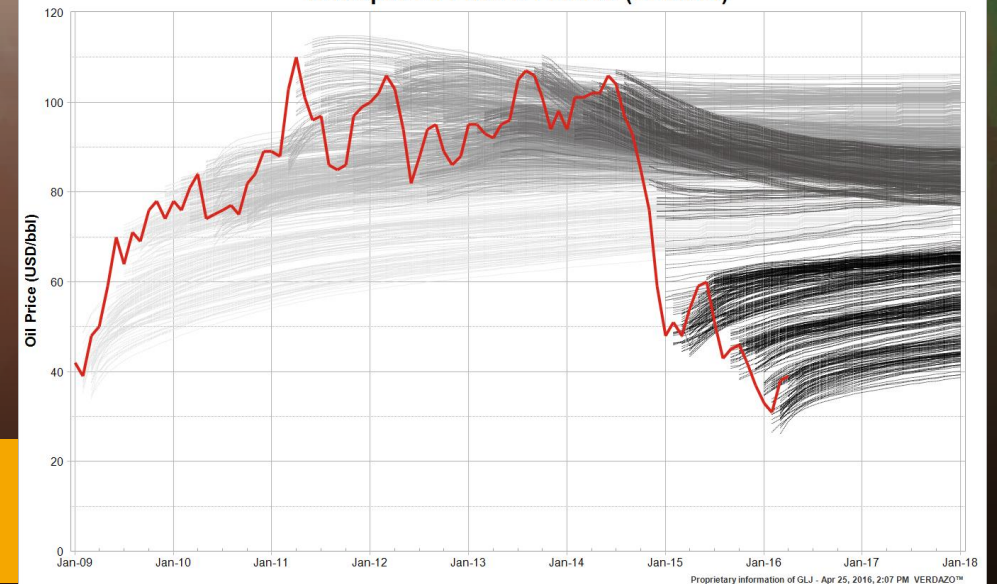
Commodities: supply VS demand, cost of carry and convenience yield due to physical underlying!

EXAMPLES

NYMEX HO Forward Curve - 6/6/14



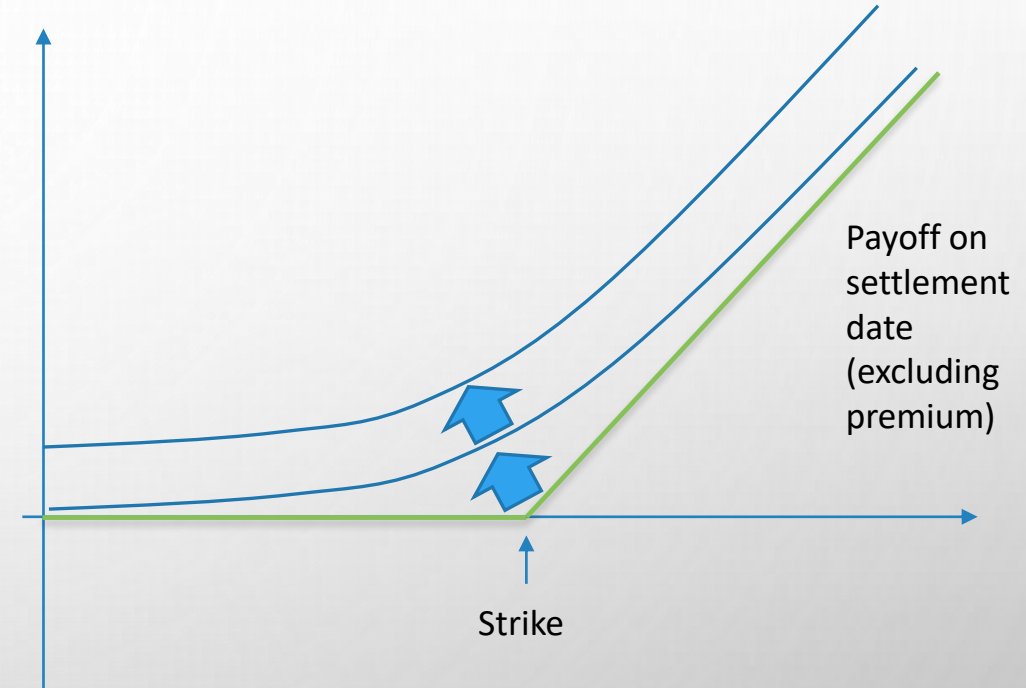
WTI Spot Oil Price & Futures (USD/bbl)



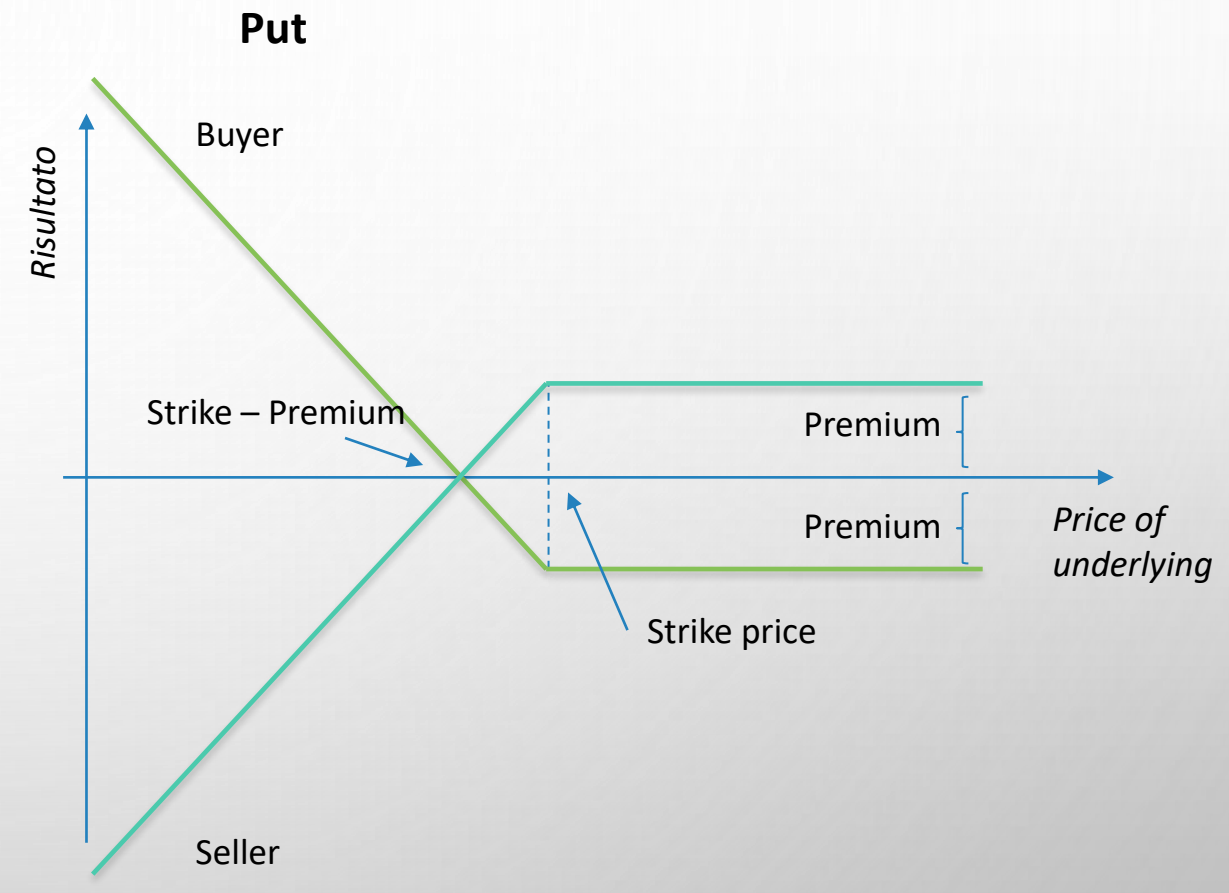
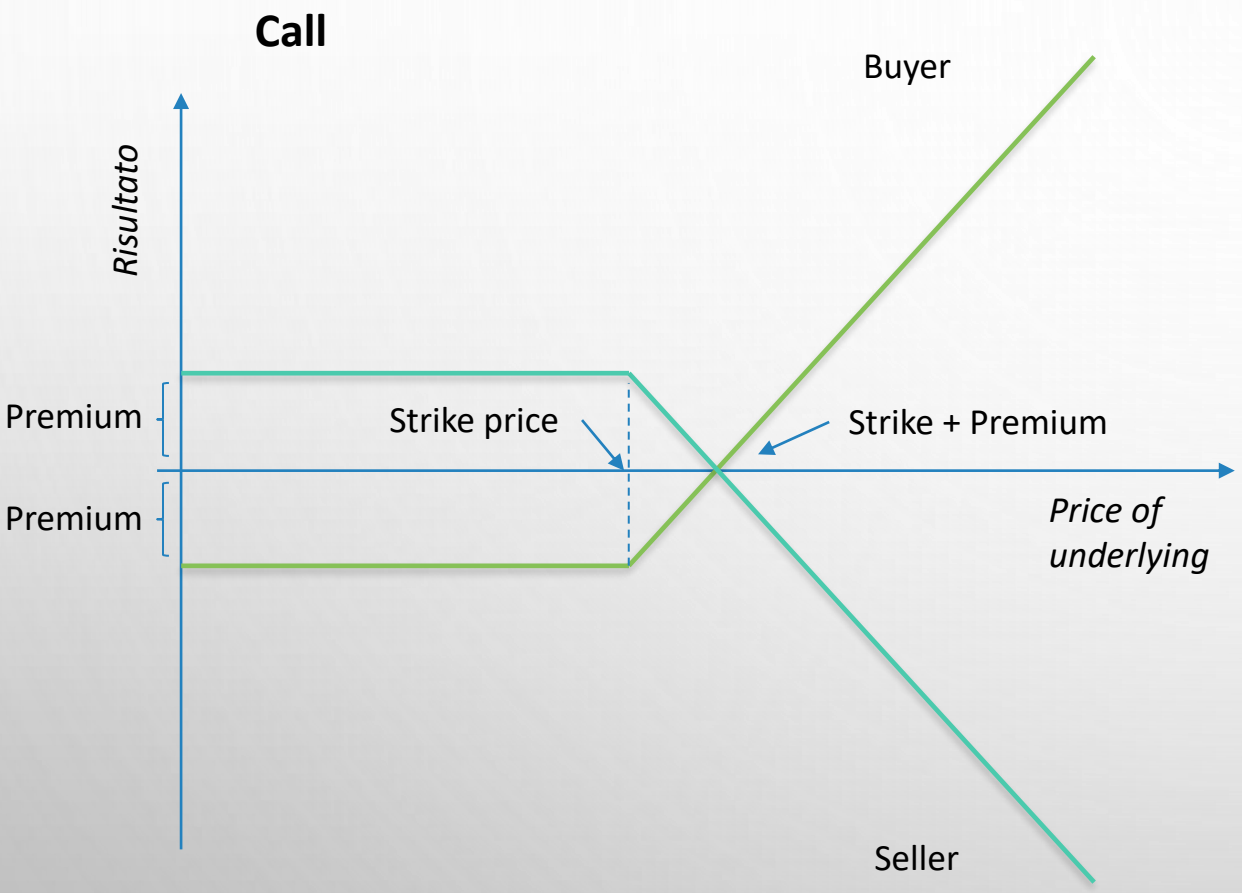
OPTIONS

- **Plain-vanilla** (vs exotic such as Asian, path-dependent, ...): a party gets the **faculty/right** to buy (**call**) or sell (**put**) the underlying at a specific **strike price**, exercise within (**American**) or at (**European**) a future date, from a counterparty (**writer**), by paying a **premium** today
- The premium prices the **asymmetry**: more likely exercises increase its level
- *In/at/out of-the-money*
- Premium based on maturity, spot price, expectations, IR, strike price, type of option, ...:

PREMIUM = INTRINSIC VALUE (*what if today*) + TIME VALUE (*uncertainty*)



OPTIONS



Example: can you tell me what happens if I buy (sell) a call (put) on a stock, strike 250, premium 10, with price at the settlement date of 235, 255 or 270?

OPTIONS

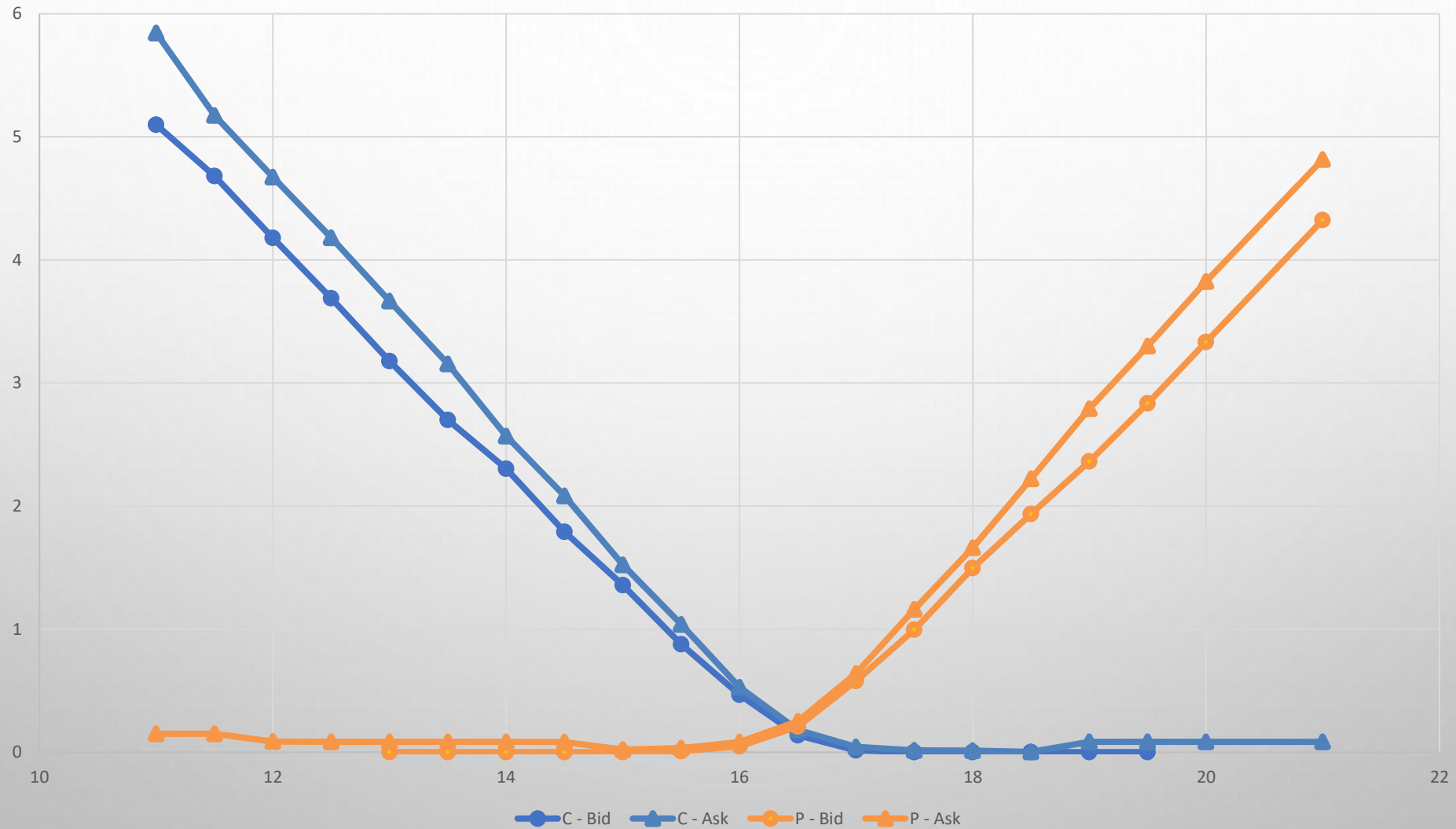
Example: can you tell me what happens if I buy (sell) a call (put) on a stock, strike 250, premium 10, with price at the settlement date of 235, 255 or 270?

CALL	Price	Buyer	Seller
	235		
	255		
	270		

PUT	Price	Buyer	Seller
	235		
	255		
	270		

OPTIONS

GENERALI (2019): 1 month bid-ask call and put prices, stock priced 16,43

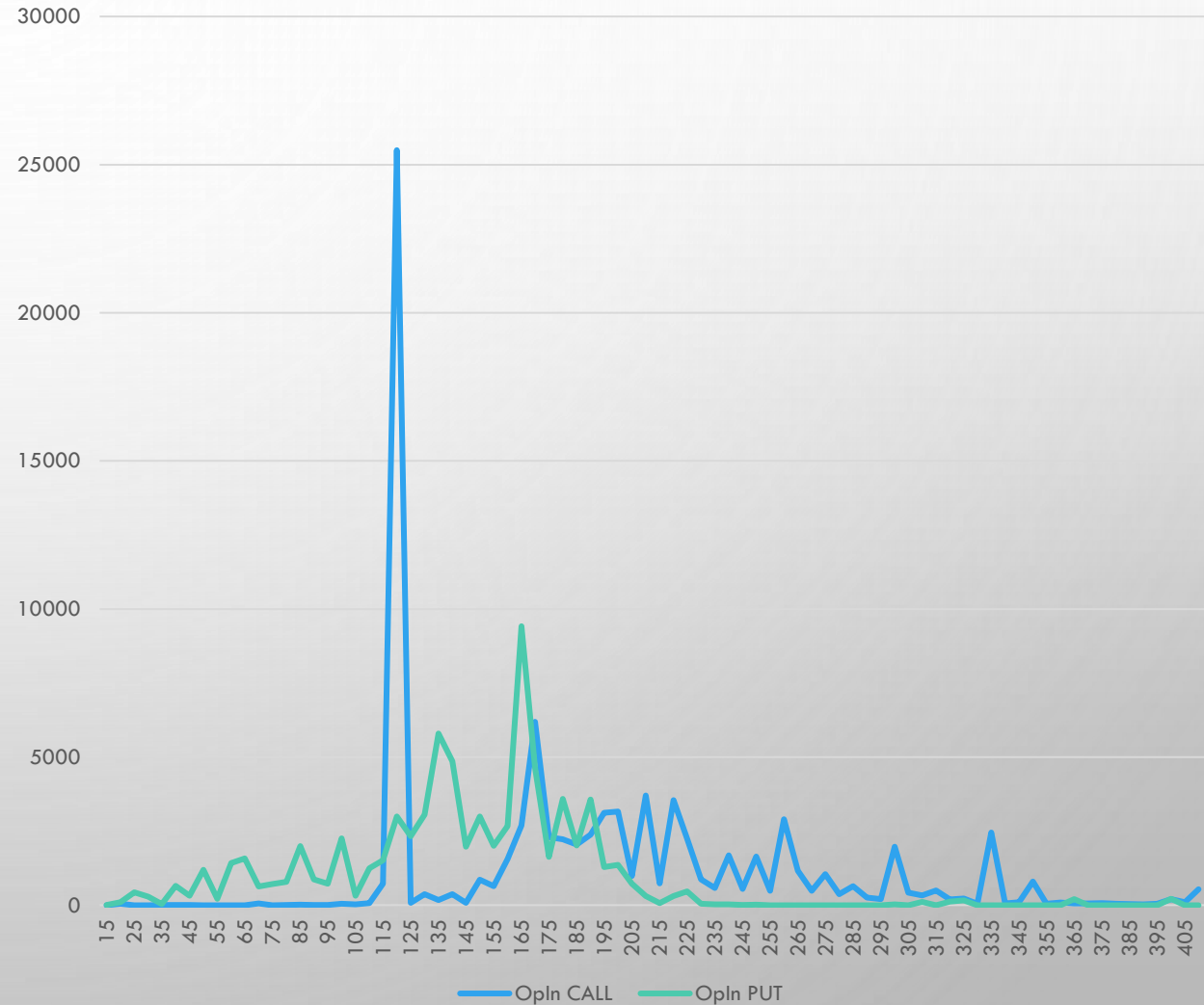
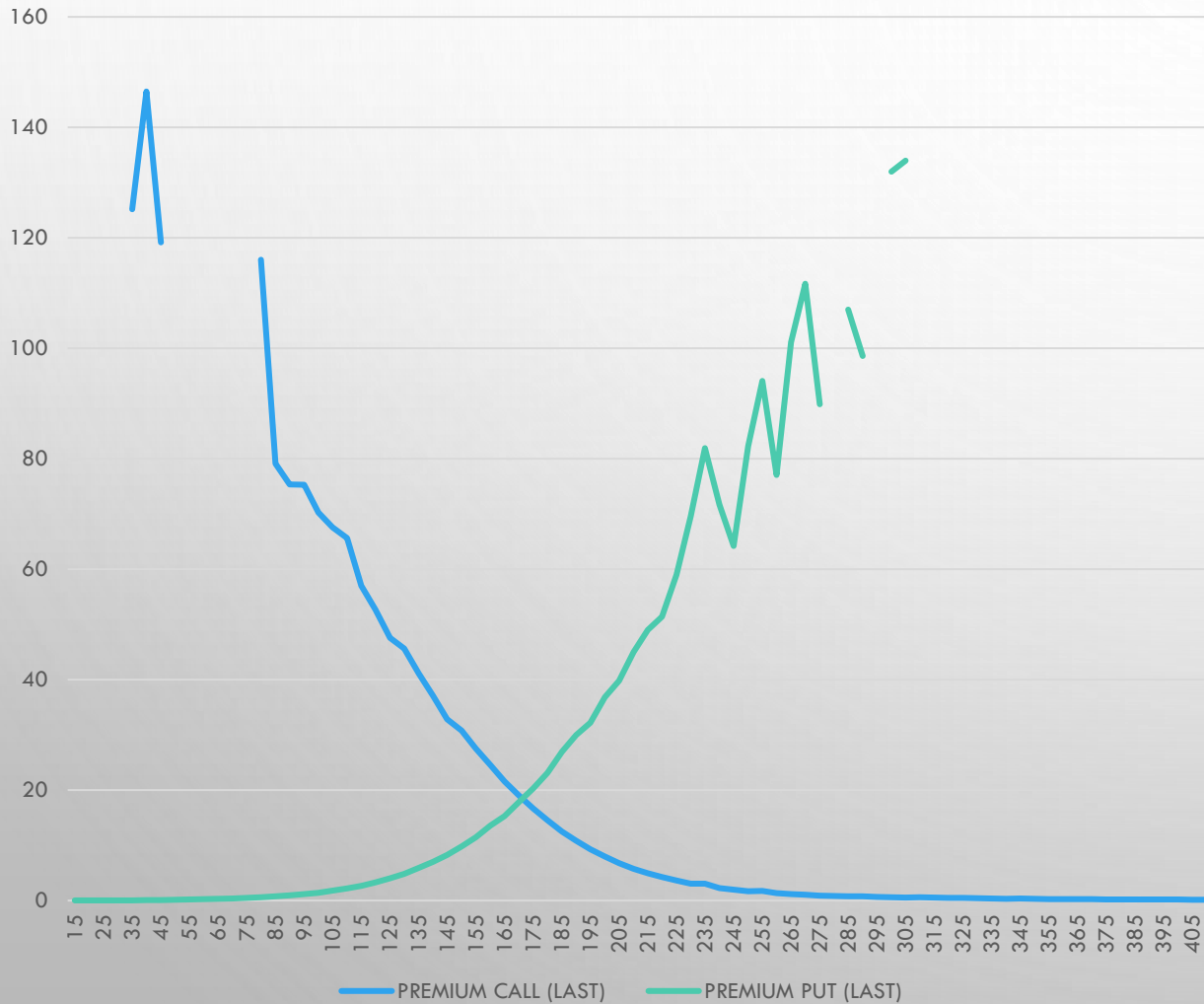


OPTIONS

TESLA (2023): PRICE 169,15 ON 10/05/23 - SETTLEMENT AUG, 18

Premium (last)

OPEN INTEREST

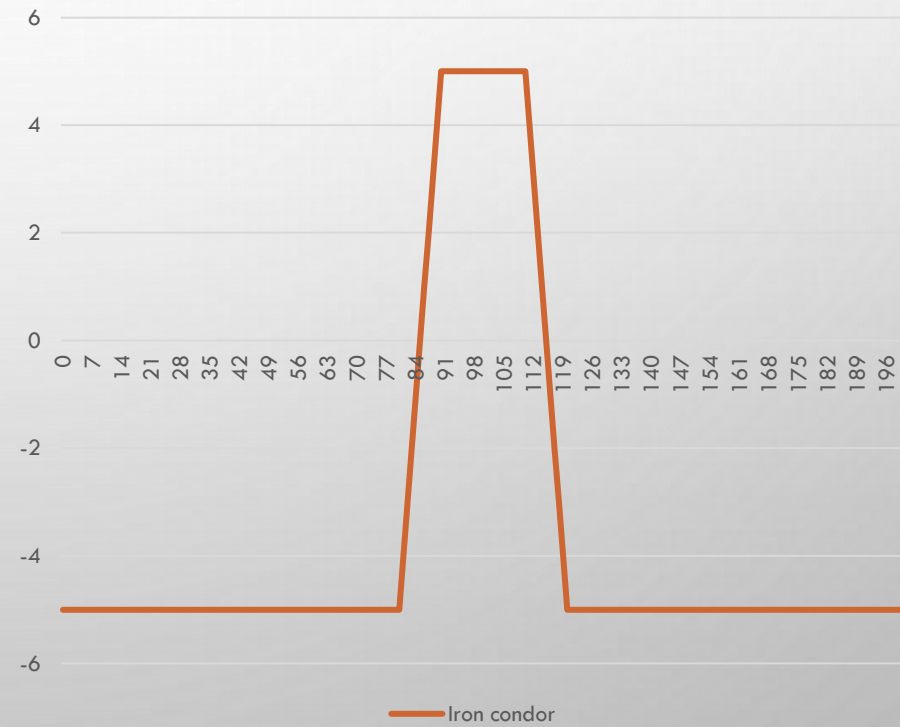
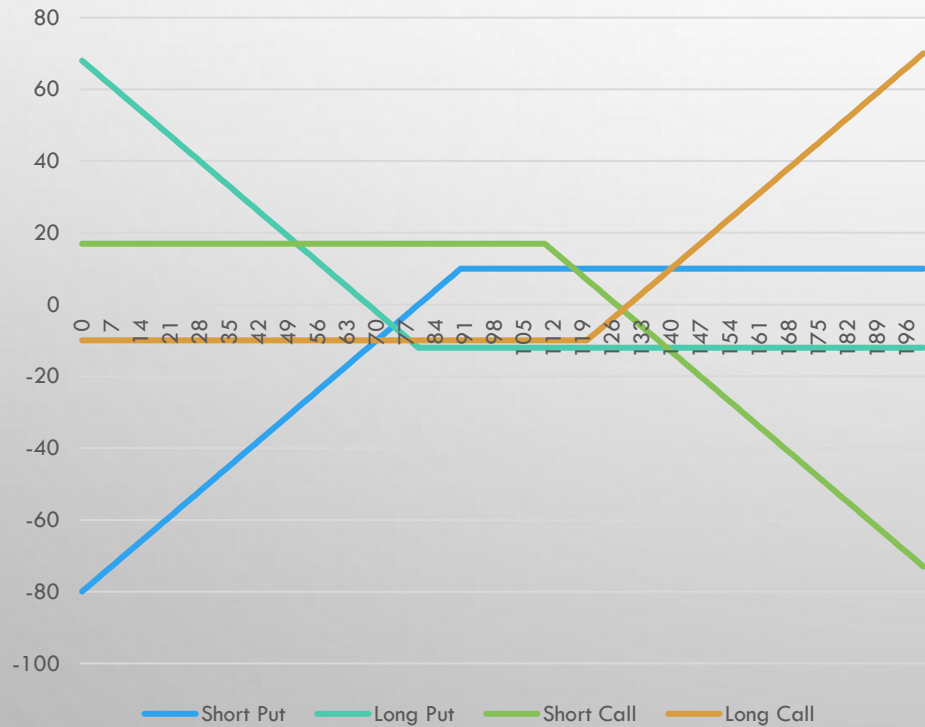


OPTIONS

Options' asymmetry (and variants) allow for interesting investment strategies. Example: *iron condor* (but many, many others exist!)

Same settlement date, same underlying

- | | | | | |
|----|------|------|------------|------------|
| 1. | SELL | PUT | STRIKE 90 | PREMIUM 10 |
| 2. | BUY | PUT | STRIKE 80 | PREMIUM 12 |
| 3. | SELL | CALL | STRIKE 110 | PREMIUM 17 |
| 4. | BUY | CALL | STRIKE 120 | PREMIUM 10 |



SWAP

- Each party pays to the other a **stream of payments** at **specific dates** within a **maturity date**
- Each party has a **long** exposure (“leg”) and a **short** exposure **simultaneously** at each settlement date
- Typically, the two streams differ for **currency** (f.i. € Vs. \$) or **IR** (f.i. variable Vs. fixed) underlying streams
- **OTC**: illiquid, credit risk, but tailor-made

Example: payoff

A and B are in a 5-year swap from 1/1/18, notional 1 mln €. A pays annually EURIBOR1y+100bps and receives 1,5% fixed EURIBOR1a + 100bps in cambio di un tasso fisso all’1.5%.



	2018	2019	2020	2021	2022
EURIBOR1a	-0.2	-0.1	-0,2	-0,5	2,9

	FLOATING	FIXED	NET FOR A
2017	8.000	15.000	+7.000
2018	9.000	15.000	+6.000
2019	8.000	15.000	+7.000
2020	5.000	15.000	+10.000
2021	39.000	15.000	-24.000

SWAP



Today (17/04):

20y – 2,75%

10y – 2,82%

EURIRS10y EURIRS20y

CREDIT DERIVATIVES

- OTC in large denominations
- *Protection buyers* pay a cost to *sellers* (as a premium, or embedded in differences in payoffs)
- *Sellers* pay extra (notional, risk premiums, ...) to the *buyer* in case of a *credit event* (default, rating downgrade, ...) of a *reference entity/asset*

Main instruments:

- *Total return swaps* (TRS): exchange a given (variable/fixed) rate with the return (with capital gains) of a reference asset (f.i. a stock index)
- *Credit-default-swap* (CDS): *sellers* pay if a credit event occurs, receiving a periodic premium meanwhile
- *Credit-linked note* (CLN): structured bonds with the option, triggered by credit events, to lower coupons, the face value or otherwise change payouts
- Others include options, or are built on credit spreads, or are built on a multi-name basis (f.i. basket default swaps)

