

A SIMPLE GUIDE TO DERIVATIVES

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The earliest examples of financial derivatives date back to Ancient Greece and the olive harvest. Today they are important in the global financial system and can be used for many purposes.

They are often misunderstood and regarded as 'complex and risky'. While this is true for some derivatives, many are relatively simple. When understood and used properly, they can be very helpful for fund managers. This simple guide explains what derivatives are, and describes their main uses and risks.

What is a derivative?

A derivative is a financial instrument that derives its value from the performance of another financial instrument (the 'underlying instrument'). Derivatives are contracts traded between two parties, referred to as 'counterparties'. One counterparty is the buyer, the other is the seller.

Underlying instruments could be company shares ('stocks'), bonds or commodities. Derivatives exist in all financial asset classes. They can be used to speculate about the direction of an underlying price, or used to offset ('hedge') the risk of loss.

This is best explained by some examples:

HEDGING



Imagine a fund manager who manages a portfolio of shares for European-based investors. The fund manager wants to buy shares in US-based company Enterprise Inc, because she thinks the share price is set to increase. However, Enterprise Inc's shares are denominated in dollars, and the manager thinks that, over time, the dollar will fall in value against the euro. A fall in the dollar's value could seriously damage her investors' returns, even if the price of Enterprise Inc's shares rises.

So the fund manager could buy an exchange-rate derivative known as a 'future' for a small price. This locks in the exchange rate (in this example, the euro/dollar exchange rate) for a set time. By doing this, she knows that when she sells the shares, the euro/dollar exchange rate will be at the rate she has locked in. She has 'hedged' or offset her exchange-rate risk. Of course, she cannot be sure what the share price itself will be until she sells, as that is set by market forces.

SPECULATING



Imagine a fund manager who thinks the share price of supermarket company Grocery Group will fall. One method of profiting from a falling share price is for him to take a 'short' position, which he can achieve through a derivative known as a 'contract for difference'. Short positions are useful for absolute return funds, because they aim to profit from falling share prices. Absolute return funds are funds that aim to deliver a positive return regardless of market direction.

The manager takes the short position in Grocery Group and, after seeing a fall in the share price, exits the trade with a profit for his investors.

Of course – as with investing in traditional assets – in both the above examples circumstances could work against the fund manager. If the value of the dollar appreciates against the euro, the Enterprise Inc position will miss out on a currency gain, while a rise in Grocery Group's share price will result in a loss for the fund manager going short. Therefore it is the fund manager's view that carries the majority of the risk, while the derivative is the instrument used to express this view.

The benefits and risks of derivatives



BENEFITS

- **Reducing risk:** When used correctly, derivatives can be effective ways of protecting ('hedging') investors against risks such as interest-rate rises, inflation or falling markets.
- **Speed and cost:** It may be quicker and cheaper for a fund manager to buy a derivative than the underlying instrument.
- **Choice:** The range of derivatives on offer in financial markets is huge, helping to meet specific investor requirements.



RISKS

- **Default:** There is a risk that either counterparty in the derivative trade may be unable to meet their contractual obligations. Fund managers can aim to limit this risk by carefully researching and limiting their exposure to each counterparty. Furthermore, many contracts require assets to be pledged upfront as security, or ongoing payments in order to protect both counterparties from the risk of default.
- **Potentially large losses:** If a fund manager makes the wrong investment decision, some derivatives could cause large losses, particularly if combined with 'leverage'. Leverage is, in effect, a form of borrowing, which increases exposure to the relevant underlying security or market. Fund managers can control their losses through various techniques such as a 'stop loss order' – an automatic order to close a position once a certain price has been reached.

At a glance

- ✓ Derivatives derive their value from the performance of an underlying asset.
- ✓ They can be used to speculate about the direction of an underlying price or offset the risk of loss ('hedge').
- ✓ There are two parties in a derivative transaction – a buyer and a seller.
- ✓ Their initial low cost and availability may make them more attractive than buying the underlying instrument.
- ✓ Certain derivatives carry the risk of large losses.
- ✓ **By speaking to a financial adviser, you can discuss whether investment funds that use derivatives may be right for you.**

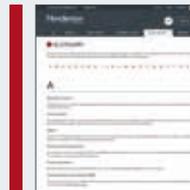
Glossary

Counterparty: One of the parties that participates in a financial transaction, ie, the buyer or the seller.

Hedge: To reduce the risk of adverse price movements, by taking an offsetting position.

Short: A position designed to profit from a fall in the price of an asset. Short positions can be achieved through derivatives.

Underlying: The financial instrument or factor from which a derivative derives its value. For example, the price of a company's shares.



Glossary

Please see [HGI.co/glossary](https://hgi.co/glossary) for a glossary of financial terms

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