Are you an informed investor?
DERIVATIVES

Derivatives are complex financial products that have generated profits for some investors, but also have resulted in significant losses for others. These products have been around in one form or another for generations. Before you invest in complex financial products like derivatives, you should completely understand how your money is invested and the risks involved.

So what are derivatives?

Derivatives: A derivative is a financial product based on an agreement between parties, where the value is determined by reference to some other asset (i.e. stocks, bonds, warrants, options, etc.).

What are some of the common types of derivatives?

Futures: Futures are financial contracts obligating the buyer to purchase an asset, or the seller to sell the asset, at a set price on a given date.

There are different types of futures contracts. For example, commodities futures are traded on the commodities market; stock futures are traded on the stock market; and in more complex transactions, derivative contracts relating to one market may be lawfully traded on another market. These separate types of financial products are not all alike, and often similar products carry terms with substantially different risks.

Consider this example of a commodities future contract: Susan Citrus, owner of Citrus Grove, Inc., is concerned about the forecast of an unusually cold winter. Susan enters into a futures contract with an investor who agrees to purchase Susan's oranges at $20 per bushel at harvest, regardless of market price.

The investor hopes the market price of oranges will be more than $20 at harvest, so he can sell the oranges for a profit. The investor's risk is that the oranges may be worth less than $20 due to factors such as weather, crop management and consumer demand.

The commodities futures contract helps guarantee Susan a minimum return on her crop, regardless of external factors.

Options and Warrants: A warrant is issued along with a bond or preferred stock entitling the holder to purchase a specific additional amount of the security at a certain price. Options can be exchange-traded options, options issued by a company (stock options), or a variety of puts, calls, call warrants and put warrants, both covered and uncovered. A stock option – either exchange-traded or held by a corporate officer or director – entitles the holder to buy or sell a stated amount of a security at a stated price during a specified period of time. An option is different from a futures contract in that a futures contract must be carried out.

As an example of an option, Susan Citrus says she will sell a bushel of oranges to an investor for $20 in two weeks. After the two weeks, the price of oranges is $10. The investor likely would not exercise the option. Conversely, if oranges were selling for $30, the investor likely would exercise the $20 option and turn around and sell the oranges at $30 for a $10 profit.

As an example of a warrant, Citrus Grove, Inc. has a stock value of $1 per share and is looking to raise capital to expand. The company offers five-year warrants with an exercise price of $10 per share. The investor hopes that the stock price rises above the warrant price of $10 within the five-year period. The investor can then sell the shares

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for a profit. The investor's risk is that the Citrus Grove stock will not rise above $10 per share during the same five-year period. If after that five-year period the stock does not exceed $10 per share, the warrant expires and is worthless.

Swap: A swap is a customized agreement between private parties who agree to exchange or "swap" certain benefits (i.e., interest rates, currency rates, credit default, etc.). Unlike futures and options, swaps are not typically traded on a stock or commodity exchange, but in the Over-The-Counter (OTC) market. There are different kinds of swaps. Some are essentially forms of insurance and are known as "covered" swaps. Others are more like side bets between parties and are traded privately in the OTC market.

An example of a "covered swap" is: Investor Ivan owns a bond in Citrus Grove, Inc. He is concerned Citrus Grove might lose value and his bond may become worthless. Ivan enters into a swap agreement with Bob. In exchange for an upfront fee, Bob agrees to cover Ivan's cost of his bond should Citrus Grove, Inc. lose value. Both Ivan and Bob hope that Citrus Grove thrives. Ivan's bond will increase in value so Bob will not have to pay out the value of the bond to Ivan. Bob's risk is that if Citrus Grove loses value, Bob will have to cover the loss in value of Ivan's bond.

An example of the "uncovered swap" or "synthetic swap" is: Joe bets Bill that Ivan will never need to collect on the Citrus Grove bond, while Bill bets that Ivan will collect. Joe pays Bill a non-refundable fee, hoping Citrus Grove defaults. Bill gets the fee and hopes Citrus Grove pays off. To complicate matters, Joe and Bill can each separately sell their sides of the bet to others. The value of the bet fluctuates depending on the market assessment of risk.

Convertible Bonds: A convertible bond is a corporate bond that can be converted into common stock of the issuing company. The holder has the option to exchange the bond for a predetermined number of shares in the issuing company.

The investor hopes the aggregate stock price will exceed the conversion value of the bond, so he can convert the bond into stock. If the stock price goes up, the issuer will have an incentive to try to buy back or "call" the bond, thereby limiting the investor's profit.

If the underlying stock performs poorly, and there is no conversion before the bond matures, the investor will receive no less than the face value of the bond, assuming the issuer remains solvent.

For example, Susan Citrus needs money to expand Citrus Grove, Inc. Instead of issuing corporate bonds at 5 percent per year that would mature in 10 years, Citrus Grove issues convertible bonds at 3 percent per year for 10 years. If the convertible bonds give the bond holder the option to convert the bond to shares of stock in the company at or after a specified time or when the stock price attains a certain level, the bond holder can convert when the stock goes up, allowing the bond holder to participate in the upside growth of Citrus Grove. The investor's risk is somewhat limited with interest payments from the bond. Citrus Grove will benefit because the company is able to offer the bond at a good price even though it is offering a lower interest payment rate or "lower coupon rate" – less than it would have to pay on a straight bond. The later insolvency won't affect the rate, unless there are other provisions.

If considering an investment in convertible bonds, it is important for the investor to know all the features of the bonds and the conditions under which the bonds can be converted. It is also important to know whether it is the issuer or the buyer who can elect to convert the bond from a debt instrument to an equity instrument. Such important details must be disclosed in the issuing documents for the bonds.

Are these investments suitable for you?

Before you invest in any of these sophisticated financial products, you should thoroughly understand the risks involved.

- Derivatives are extremely complicated and risky investments that even professionals have difficulty understanding. Investors should use great caution when considering this kind of investment product.
- Do not invest more than you can afford to lose. Make sure you understand the risks.
- Risk and return go hand-in-hand.
- All of these investment products have tax implications. Check with a licensed tax professional before making an investment.
- Contact your state securities regulator for more information.

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