

# MAKING SENSE OF DERIVATIVES

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# MAKING SENSE OF DERIVATIVES

Dangerous weapons or useful tools?

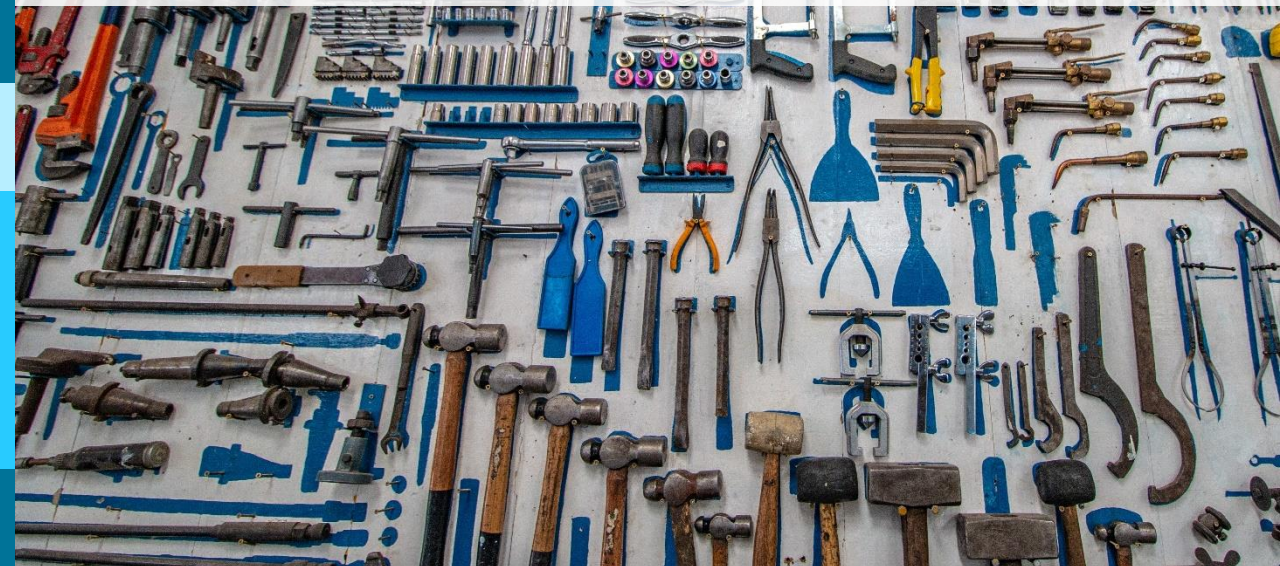


“Derivatives are **financial weapons of mass destruction**, carrying dangers that, while now latent, are potentially lethal.”

**Warren Buffett**  
CEO,  
Berkshire Hathaway

“Derivatives should be seen as a **help rather than a hindrance** in the context of pension portfolio management and trustees and fund managers, rather than simply ignoring them...”

**OECD  
Secretariat**





# WHY ARE DERIVATIVES USED?



Manage Risk



Take Risk



Free Up Cash



Implement Views Quickly, Efficiently and Cheaply

# TYPES OF DERIVATIVES



# FORWARDS

## The original derivative

1

Fri 18 June, 9:07AM

I'll sell you my wheat, for £100  
a tonne in 3 months' time

Agreed.  
I'll buy your wheat for £100 a tonne  
in 3 months' time 📄🌾. Thx!



Wheat Farmer



Miller

# WHAT IS A FORWARD?

1



This agreement is a **Futures Contract**

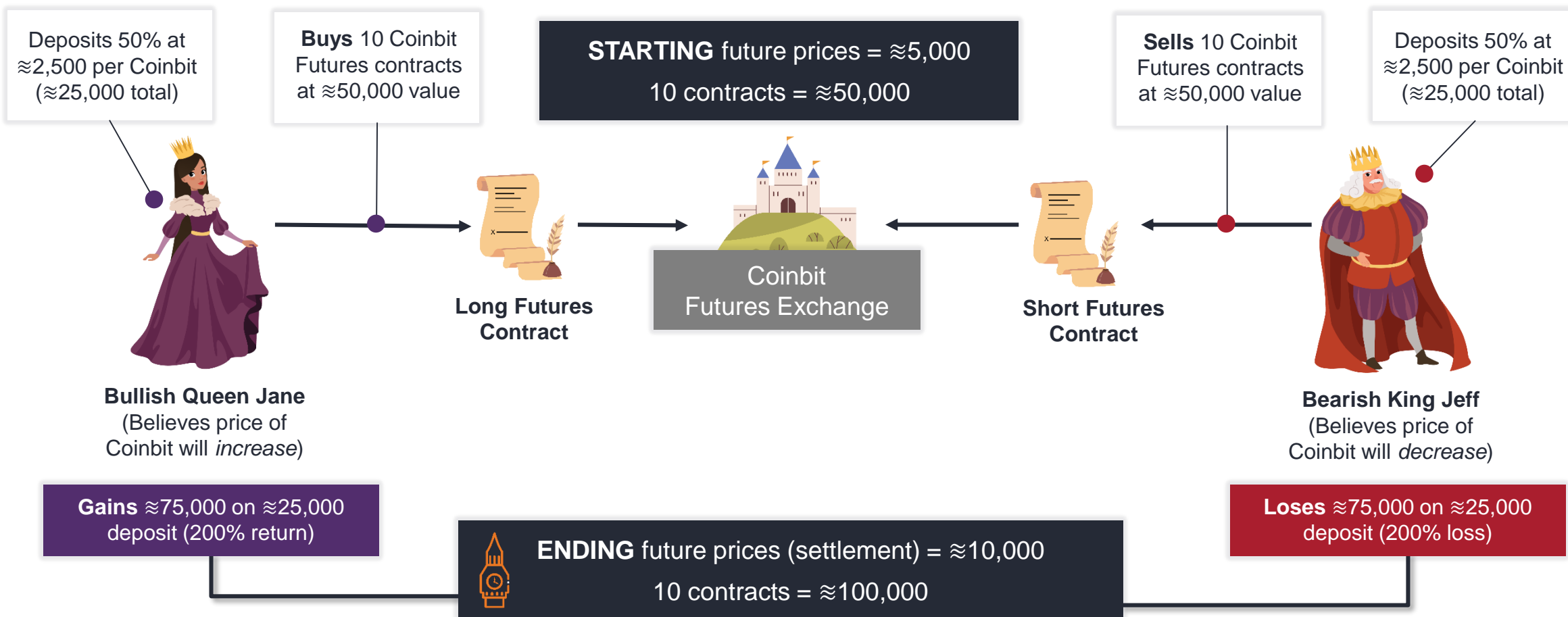
No money or steel changes hands now

It is an agreement to do a steel trade at an agreed price on an agreed future trade

# FUTURES

A 'packaged' forward

2



Note: Coinbit is a fictional currency. Example is an illustration and should not be construed as investment advice.

# SWAPS

Credit default swaps - a form of insurance

3

Mon 21 June, 16:23PM

I'll pay you £20 if you'll guarantee Jeff's mortgage for the next 6 months

Sure. If Jeff defaults within the next 6 months, I'll pay you £2000 🏠💰.



Wheat Farmer

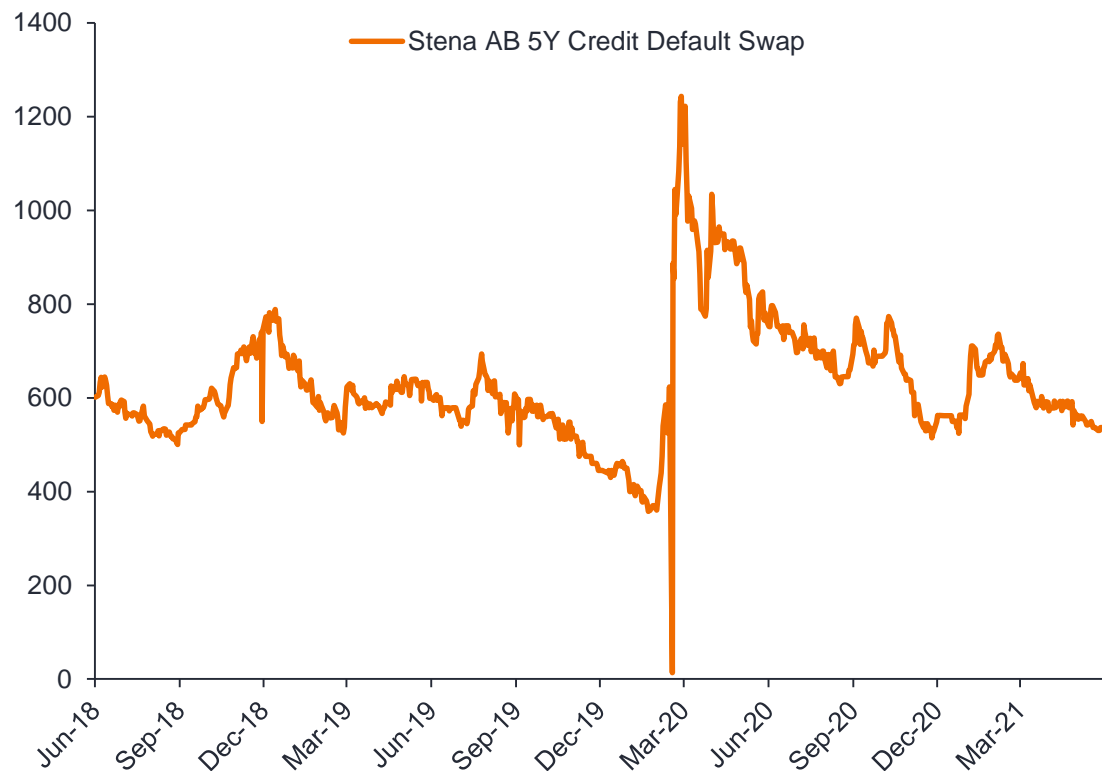


Queen Jane



# DERIVATIVES IN THE MODERN DAY

## Swaps



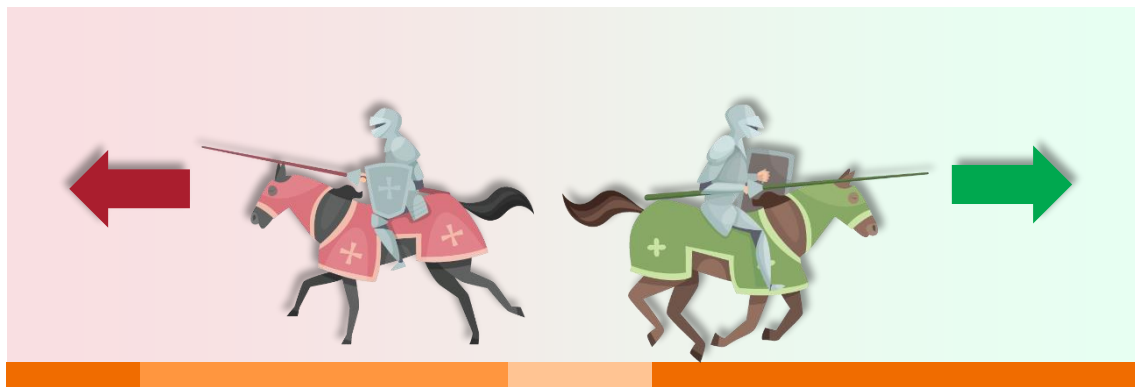
## Futures



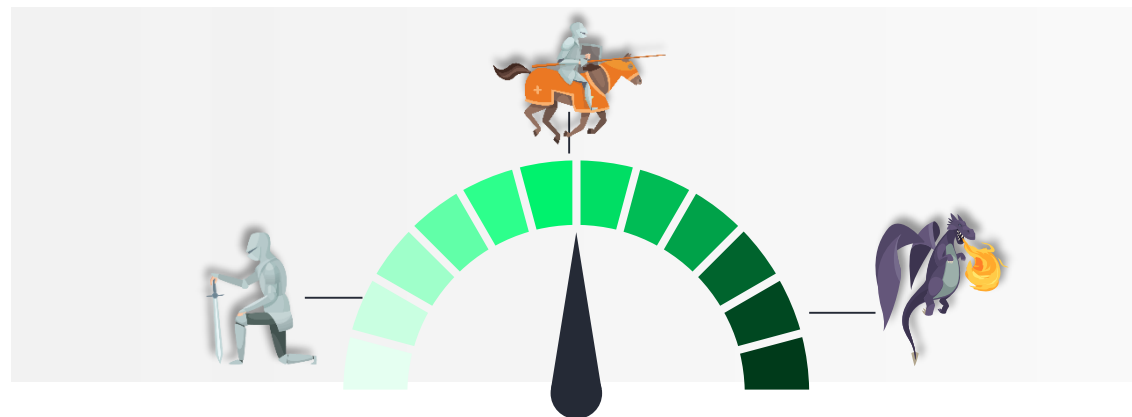
Source: Bloomberg, as at 22 June 2021

# NET & GROSS

Net Exposure



Gross Exposure



# WHAT ARE THE RISKS?



Underlying price changes



Basis risk



Counter-party risk



Leverage

# WHAT ARE THE RISKS?

The rogue wave that capsized our boat





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