

Lecture 1

Advanced Derivative Securities

- Class Organization
- Types of Pure Derivative Securities
- History of Derivative Securities

Class Organization

Review of Course Syllabus

- Discussion of Course Objectives
- Course Text and Reading Materials
Required Text is “Risk Management, Speculation and Derivative Securities” (RSD)
- Evaluation of Grade
- Formation of Groups

Types of Pure Derivative Securities

Reading: RSD, Sec. 1.1

- What are Derivative Securities?
 - ◆ Various possible designs:
 - ✦ Forward vs. Futures Contracts
 - ✦ Types of Options
 - ✦ Swaps and Other Variations



The Exchanges

- **US Exchanges**

- ◆ *Chicago Board of Trade*
- ◆ *Chicago Mercantile Exchange*

- **Offshore Exchanges**

- ◆ *Europe and East Asia*
- ◆ *Canadian Trading*

Basics of Futures Contracts

- **Contract Features**
 - ◆ **Standardization**
- **Daily Marking to Market**
 - ◆ **Hedgers vs. Speculators**
- **How do Margins Work?**
 - ◆ **Types of Margin Requirements**



Exchanges vs. OTC

- Center of trading activity differs across commodities, examples:
 - ◆ Currencies
 - ◆ Oil
 - ◆ Eurodollars
- **Public Policy Issues**
 - ◆ Innovation and Secrecy
 - ◆ Regulatory Oversight

History of Derivative Securities

- Reading: RSD, sec. 1.2
 - ◆ The Origins in Antiquity
 - ✦ Mechanics of Trading in Early Markets
 - ✦ The Bill of Exchange
 - ◆ From Antwerp to Amsterdam
 - ✦ Unbundling the Embedded Option
 - ✦ The Evils of Derivative Securities

The Canadian and US History

- The US History
 - ◆ Transplanting of European Practices
 - ◆ Origins of the CBOT
 - ◆ The Distrust of Derivatives
 - ◆ The Experience with Options
- The Canadian History
 - ◆ The Winnipeg Exchange and the Wheat Board

Recent Derivative Debacles

- Reading, RSD, sec. 1.3
- The Hunt Silver Crisis
 - ◆ Mechanics of a Short Squeeze
 - ◆ Events in the Silver Market
- Portfolio Insurance and the Crash of '87

More Debacles

- The Collapse of Long Term Capital Management
 - ◆ What is a Hedge Fund?
 - ◆ Derivatives and Hedge Fund Strategies
 - ◆ When Genius Failed
- Nick Leeson and Barings Bank
 - ◆ The Leeson Strategy
 - ◆ Types of Risks: Operational vs. Market