

Gambling on Financial Derivatives

“Derivatives have become the largest market in the world. The size of the derivatives market, estimated at \$55 trillion in 1996, is double the value of all U.S. stocks and more than ten times the entire U.S. national debt. Meanwhile, derivatives losses continue to multiply.”

-Frank Partnoy

From his 1999 Bestseller ‘FIASCO- The Inside Story of a Wall Street Trader’

Despite this information being 20 years old, the situation today in respect of the Derivatives market is not very different. If at all a change can be pointed out, the market has just grow even further.

The **derivatives market** is a financial market that specializes in derivatives, or derivative trading; and would include Futures, Options, and Swaps, among other types. **Derivatives**, are quite simply financial instruments whose values are derived from, or linked to, some other security. These “other securities” could be any stock or bond being traded in a market. For example, you could either buy Infosys stock, or you could buy what is known as a “call-option” on Infosys stock. The difference between the two is- A call-option will give you the right to buy Infosys stock at a certain price, and at a certain time in the future.

Call-option is a derivative in this regard because its value is derived from the value of the Infosys stock in question. So if the price of the Infosys stock went up, the

value of the call-option will also go up, and vice versa.

Coming to the types of derivatives which I mentioned earlier, **Options** are simply the *right* to buy or to sell a security in the future. (The right to buy is called a “call-option”, and the right to sell is a “put-option”). A **Forward** on the other hand, is an *obligation* to buy or sell a security in the future. **Swaps**, are derivatives that give the investor the opportunity to exchange (swap) the benefits of securities with each other. (For example- two parties contracting with each other to swap bonds in order to exchange interest rates.) There are also several other types of Derivatives, such as Basics, Futures, and Mortgage-backed securities, but I will not get into their details as they are not as significant, or do not play as big a role in derivative trading as the above three mentioned types of derivatives do.

Essentially, all derivatives are a combination of Options and Forwards. Trading in derivatives takes place in either organized exchanges throughout the world, or in privately negotiated over-the-counter (OTC) transactions; and much of the trade that makes up the activities in a derivatives market, involves the combination of different Options and Forwards being sold in **Packages**. To again quote Frank Partnoy from his book, *‘The most difficult aspect of creating these packages is calculating how much each component is worth. These calculations are the one element of derivatives sales that truly resemble rocket science, and mistakes can be catastrophic.’*

The mistakes are of a catastrophic nature because the derivatives market is valued at more than \$1.2 quadrillion in notional

value, and at least \$12 trillion in cash at risk. These values were calculated in March, 2013, so you can only imagine how large the derivatives market is today! The derivative market is a scary place also because it is extremely complex and complicated (hence Portnoy's reference to it being like rocket science), it is also too large to regulate, and it definitely ought to be of concern to world leaders because its notional value is 20 times the size of the world economy.

"Risk" is one main area of criticism when it comes to derivative trading. Investors are lured into buying derivatives because there is a chance of earning large returns from very small movements in the underlying stock prices. Like all other transactions of this nature however, the chance of investors losing large amounts of money if the security prices move against their favour is much greater. In fact, as per Frank Partnoy's account, he likens derivative trading and derivative salesmen, to barbarism and savages respectively, because of how ruthless the trading practice has grown to be over the years; with salesmen always looking for their next "victim" to "murder". He also talks of several instances of such "killings", as a result of which *"the battlefields of the derivatives world were littered with derivative salesmen's victims"*.

So considering their treacherous nature, why trade in derivatives at all?

From a banker's point of view, there is substantial increase in savings and investment in the long run due to the activities that any investor trading in derivatives would take up. Consider it all a gamble. If you have a chance of winning more- much more, than you are investing,

wouldn't you consider the prospect of investing more money as well, and possibly doubling your derivative profits while you're at it?

Derivatives are no different from your stocks, shares, and bonds in that respect. The basic structure is the same. What makes derivative trading more interesting and terrifying at the same time, is how gigantic a field derivatives are traded in. As far as numbers go, there is no limit as to how much money you can win or lose in a single derivative transaction; and I think this is exactly why derivative trading has grown to what it is today- The larger the risk, the more the thrill; and at the end of the day, it's the sheer thrill of the gamble that drives us toward gambling some more.



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