Contents

Introduction xxii
Acknowledgments xxiv

PART I Overview of Financial Derivatives 1

1 Derivative Instruments: Forwards, Futures, Options, Swaps, and Structured Products 3
   G. D. Koppenhaver
   Introduction 3
   A Generalist’s Approach to Derivative Contracts 6
   Forward Contracts 7
   Futures Contracts 9
   Swap Contracts 11
   Option Contracts 13
   Structured Products and an Application to Derivative Contracts 16
   Conclusion 19
   Endnotes 19
   References 20
   About the Author 20

2 The Derivatives Marketplace: Exchanges and the Over-the-Counter Market 21
   Sharon Brown-Hruska
   Introduction 21
   Standardization versus Customized Products: Differences in Structure and Approach 22
   Competition and Consolidation: Impetus for Change 25
   Moving from Bilateral to Multilateral Risk Management 29
   Collateral in Exchange and OTC Markets 29
   Netting and Novation in Exchange and OTC Markets 31
   Transparency and Information in the Exchange and OTC Marketplaces 36
   Conclusion 39
   Endnotes 40
viii

Contents

References 41
About the Author 42

3 Speculation and Hedging 43
Greg Kuserk
Hedging Transactions 44
Speculation 48
From Hedging to Speculation 50
Interaction between Hedgers and Speculators 52
Conclusion 54
Endnotes 54
References 54
About the Author 55

4 The Social Functions of Financial Derivatives 57
Christopher L. Culp
Hedging and Risk Transfer 58
Price Discovery 58
Price Discovery, Commoditization, and Market Structure 59
Intertemporal Resource Allocation 60
Forward Contracts as Synthetic Storage 60
Commodity Interest Rates 60
Asset Finance 61
Commodities Lending 62
Project Finance 63
Trade Finance 64
Financial Asset Inventory Management 65
Synthetic Asset Allocation 65
Derivatives and Public Policy 66
Endnotes 67
Further Reading 68
References 69
About the Author 71

PART II Types of Financial Derivatives 73

5 Agricultural and Metallurgical Derivatives: Pricing 77
Joan C. Junkus
Introduction 77
Commodities 77
Seasonality in Spot and Futures Prices 78
Futures Pricing 79
Theory of Storage 80
Theory of Normal Backwardation 84
## Contents

Conclusion 85  
References 86  
Suggested Further Reading 86  
About the Author 87  

### 6 Agricultural and Metallurgical Derivatives: Speculation and Hedging 89

**Joan C. Junkus**

Introduction 89  
Commodities 89  
Derivatives 90  
Commodity Investment Strategies 90  
- Commodity Indexes 90  
- Diversification and Inflation 91  
- Passive Investment Strategies 91  
- Active Strategies 94  
- Measuring Investment Performance 94  
Hedging 95  
- Commodity Marketing 95  
- Risk Management 97  
Spreads 99  
Conclusion 100  
References 100  
Suggested Further Reading 101  
About the Author 101

### 7 Equity Derivatives 103

**Jeffrey H. Harris and L. Mick Swartz**

Introduction 103  
Stock Options 104  
- Call Options 105  
- Put Options 106  
- Stock Options on an Index 106  
- Employee Stock Options 107  
- Convertible Bonds 107  
- Warrants 108  
Equity Futures 108  
- Single-Stock Futures 108  
- Futures on Stock Indexes 109  
Equity Swaps 110  
Future of Equity Derivatives 111  
References 112  
Further Reading 112  
About the Authors 113
8 Foreign Exchange Derivatives

Robert W. Kolb

Basic Pricing Principles
Purchasing Power Parity Theorem
Interest Rate Parity Theorem
Foreign Exchange Forward and Futures Contracts
Foreign Exchange Options
FX Option Pricing
Plain Vanilla Foreign Exchange Swaps
Flavored Currency Swaps
Conclusion
Endnotes
References
About the Author

9 Energy Derivatives

Craig Pirrong

Introduction
Products: An Overview
History
Petroleum Derivatives: Details
Natural Gas Derivatives: Details
Electricity Derivatives: Details
Pricing
Clearing
Recent Developments
References
About the Author

10 Interest Rate Derivatives

Ian Lang

Exchange-Traded (Listed) Derivatives
Over-the-Counter Derivatives
OTC Options
Rate Locks
Swaps and Swaptions
Mortgage Derivatives
Further Reading
About the Author

11 Exotic Options

Robert W. Kolb

Overview
Forward-Start Options
# Contents

<table>
<thead>
<tr>
<th>Topic</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compound Options</td>
<td>144</td>
</tr>
<tr>
<td>Chooser Options</td>
<td>145</td>
</tr>
<tr>
<td>Barrier Options</td>
<td>146</td>
</tr>
<tr>
<td>Binary Options</td>
<td>147</td>
</tr>
<tr>
<td>Lookback Options</td>
<td>149</td>
</tr>
<tr>
<td>Asian or Average Price Options</td>
<td>150</td>
</tr>
<tr>
<td>Exchange Options</td>
<td>151</td>
</tr>
<tr>
<td>Rainbow Options</td>
<td>151</td>
</tr>
<tr>
<td>Conclusion</td>
<td>152</td>
</tr>
<tr>
<td>Endnotes</td>
<td>153</td>
</tr>
<tr>
<td>References</td>
<td>154</td>
</tr>
<tr>
<td>About the Author</td>
<td>154</td>
</tr>
<tr>
<td>12 Event Derivatives</td>
<td>157</td>
</tr>
<tr>
<td>Justin Wolfers and Eric Zitzewitz</td>
<td></td>
</tr>
<tr>
<td>Types of Prediction Markets</td>
<td>158</td>
</tr>
<tr>
<td>Applications and Evidence</td>
<td>160</td>
</tr>
<tr>
<td>Accuracy of Prediction Markets</td>
<td>160</td>
</tr>
<tr>
<td>Possibilities for Arbitrage</td>
<td>164</td>
</tr>
<tr>
<td>Can Event Markets Be Manipulated Easily?</td>
<td>168</td>
</tr>
<tr>
<td>Market Design</td>
<td>168</td>
</tr>
<tr>
<td>Making Inferences from Prediction Markets</td>
<td>170</td>
</tr>
<tr>
<td>Innovative Future Applications?</td>
<td>173</td>
</tr>
<tr>
<td>Acknowledgments</td>
<td>173</td>
</tr>
<tr>
<td>Endnotes</td>
<td>174</td>
</tr>
<tr>
<td>References</td>
<td>174</td>
</tr>
<tr>
<td>About the Authors</td>
<td>176</td>
</tr>
<tr>
<td>13 Credit Default Swaps</td>
<td>177</td>
</tr>
<tr>
<td>Steven Todd</td>
<td></td>
</tr>
<tr>
<td>Credit Default Swaps on Corporate Debt</td>
<td>177</td>
</tr>
<tr>
<td>Credit Default Swaps on Asset-Backed Securities</td>
<td>178</td>
</tr>
<tr>
<td>Credit Default Swaps on Collateralized Debt</td>
<td></td>
</tr>
<tr>
<td>Obligations</td>
<td>180</td>
</tr>
<tr>
<td>The Basis</td>
<td>182</td>
</tr>
<tr>
<td>CDS Indices</td>
<td>182</td>
</tr>
<tr>
<td>Tranches of CDS Indices</td>
<td>186</td>
</tr>
<tr>
<td>Trading Strategies Using Indexes and Tranches</td>
<td>188</td>
</tr>
<tr>
<td>Market Dynamics: CDS and CDOs</td>
<td>189</td>
</tr>
<tr>
<td>Synthetic CDOs and Bespokes</td>
<td>189</td>
</tr>
<tr>
<td>Correlation</td>
<td>191</td>
</tr>
<tr>
<td>Conclusion</td>
<td>196</td>
</tr>
<tr>
<td>Endnotes</td>
<td>196</td>
</tr>
<tr>
<td>References</td>
<td>197</td>
</tr>
<tr>
<td>About the Author</td>
<td>198</td>
</tr>
</tbody>
</table>
Contents

14 Structured Credit Products 199
Steven Todd

Asset-Backed Securities 202
Collateralized Debt Obligations 204
Commercial Mortgage-Backed Securities 208
Endnotes 209
References 210
About the Author 210

15 Executive Stock Options 211
Robert W. Kolb

Introduction 211
Basic Features of Executive Stock Options 211
Rationales for ESOs 212
Pricing of Executive Stock Options 214
Executive Stock Options and Incentives 216
Conclusion 218
Endnotes 218
References 219
About the Author 220

16 Emerging Derivative Instruments 221
Steve Swidler

Economic Derivatives 222
Real Estate Derivatives 224
The Next Frontier 226
Endnotes 228
References 228
Suggested Further Reading 229
About the Author 230

PART III The Structure of Derivatives Markets and Institutions 231

17 The Development and Current State of Derivatives Markets 233
Michael A. Penick

Introduction: The Situation in the 1960s 233
Financial Futures and Options 234
Foreign Markets 236
OTC Markets 237
Energy Derivatives 238
The Rise of Electronic Trading 240
Current Conditions: Consolidation and Crisis 243
CONTENTS

Endnotes 245
References 247
About the Author 248

18 Derivatives Markets Intermediaries: Brokers, Dealers, Pools, and Funds 249
James L. Carley

Intermediaries for Exchange-Traded Derivatives 250
Providers of Trade Execution Services 251
Providers of Money Management Services 256

Intermediaries for OTC Derivatives 257
Swap Brokers 258
Swap Dealers 258
Interdealer Brokers 258
Next Step: Clearinghouse(s) for Swaps 259

Endnotes 260
References 261
About the Author 261

19 Clearing and Settlement 263
James T. Moser and David Reiffen

Introduction 263
Functions of Clearinghouses 264
Contracts for Immediate Performance 264
Contracts for Deferred Performance 265
Clearing and Liquidity 273
Competition between Exchanges 275
Nature of the Clearing Organization 276
Innovation and Clearing Structure 278
Conclusion 278
Endnotes 279
References 281
About the Authors 282

20 Counterparty Credit Risk 283
James Overdahl

Measuring Counterparty Credit Risk Exposure 284
Presettlement versus Settlement Risk 284
Replacement Cost, Current Exposure, and Potential Exposure 284
Simulation Techniques and the Exposure Profile 285
Wrong-Way and Right-Way Risk 287
Managing Counterparty Credit Risk 287
Evaluating the Creditworthiness of Counterparties 287
Using Counterparty Credit Risk Measures in the Trade Authorization Process 288
21 The Regulation of U.S. Commodity Futures and Options

Walter L. Lukken

Tiered Regulatory Design 296
Statutory Exclusions for Certain OTC Derivatives 297
Security Futures Products 298
Retail Foreign Currency Fraud 299
Exempt Commercial Markets 300
CFTC Reauthorization Act of 2008 300
Future Legislative Reforms 301
Endnotes 302
About the Author 303

22 Accounting for Financial Derivatives

Ira G. Kawaller

Alternative Accounting Categories 305
Cash Flow Hedges 306
Fair Value Hedges 309
Hedges of Net Investments in Foreign Operations 311
Conclusion 312
References 312
About the Author 312

23 Derivative Scandals and Disasters

John E. Marthinsen

Introduction 313
Anatomy of Derivative-Related Failures 313
Investment Strategies and Exogenous Shocks behind Our Five Derivative Fiascos 315
MGRM’s Strategy 315
LTCM’s Strategy 316
Amaranth’s Strategy 317
Barings’ and Société Générale’s Speculative Traders 318
CONTENTS

Lessons Learned from Derivative Scandals and Disasters 319

Controlling Risks Is Possible Only If They Can Be Measured Effectively 319
Risk Management Systems Must Cauterize Losses Immediately after the Initial Shocks 320
Creative Ways Are Needed to Supply Liquidity during Turbulent Times 321
Risk Management Systems Must Control Traders and Fund Managers 321
Compensation Incentives and Promotion Criteria Must Be Scrutinized 323
Risk Management Systems Are Only as Strong as Their Weakest Risk Managers 325
Broader Implications of Derivative Scandals and Disasters 326
Conclusion 327
Acknowledgements 328
Endnotes 328
References 330
Suggested Further Reading 331
About the Author 332

PART IV Pricing of Derivatives: Essential Concepts 333

24 No-Arbitrage Pricing 335
Robert A. Strong

Free Lunches 335
Theory of Put/Call Parity 336
Binomial Option Pricing Model 341
Put Pricing in the Presence of Call Options: Further Study 345
Binomial Put Pricing 346
Binomial Pricing with Asymmetric Branches 346
Effect of Time 347
Effect of Volatility 348
Intuition into Black-Scholes 348
Endnotes 349
References 349
Further Reading 349
About the Author 350

25 The Pricing of Forward and Futures Contracts 351
David Dubofsky

Cost of Carry Model 352
 Carry Return 354
Commodity Futures 355
Convenience Yield 356
Delivery Options 357
Contents

Interest Rate Futures and Forwards: Eurodollar Futures and Forward Rate Agreements 358
Interest Rate Futures and Forwards: Treasury Bond and Treasury Note Futures 360
Should Futures and Forward Prices Be the Same? 362
Expectations Model: An Alternative Theory for the Pricing of Forwards and Futures 363
Electricity Forwards and Futures 364
Conclusion 366
Endnotes 367
References 367
About the Author 369

26 The Black-Scholes Option Pricing Model 371
A. G. Malliaris

Introduction 371
Brief History 372
Black-Scholes Formula 372
Assumptions of the Black-Scholes Model 373
Discussion of Assumptions 374
Ito Process 374
Example 375
Excel Application 376
Simple Derivation of Black-Scholes 376
Numerical Example 380
The Greeks
  Delta 381
  Gamma 381
  Theta 381
  Vega 381
  Rho 382
Risk-Neutral Pricing 382
Conclusion 384
References 384
About the Author 385

27 The Black-Scholes Legacy: Closed-Form Option Pricing Models 387
António Câmara

Introduction 387
The Black-Scholes Model 388
First Generation of Models (One Lognormal Underlying) 392
Second Generation of Models (Two Lognormal Underlyings) 395
Third Generation of Models (One Nonlognormal Underlying) 397
Fourth Generation of Models 401
Conclusion 402
28 The Pricing and Valuation of Swaps 405

Gerald Gay and Anand Venkateswaran

Introduction 405
Illustration 1: An End User Swap Application 406
Framework for Pricing and Valuation 407
Illustration 2: A Simple Example 409
Steps for Swap Pricing 410
Obtain Market Inputs 410
Make Convexity Adjustments to Implied Futures Rates 411
Build the Zero Curve 413
Identify Relevant Swap Features 415
Price/Value the Swap 415
Illustration 3: Pricing an Interest Rate Swap 416
Illustration 4: Valuing an Existing Interest Rate Swap 416
Other Swaps 417
Currency Swaps 417
Illustration 5: Pricing and Valuing a Currency Swap 418
Commodity Swaps 419
Illustration 6: Pricing a Commodity Swap 419

Endnotes 420
References 421
About the Authors 422

PART V Advanced Pricing Techniques 423

29 Monte Carlo Techniques in Pricing and Using Derivatives 425

Cara M. Marshall

Introduction 425
Pricing a Classic Black-Scholes Option 427
Simulation Results 432
Price Return 432
Pricing a Rainbow Option 435
Endnotes 439
References 439
About the Author 440

30 Valuing Derivatives Using Finite Difference Methods 441

Craig Pirrong

Introduction 441
An Overview 441
31 **Stochastic Processes and Models** 455
   George Chalamandaris and A. G. Malliaris

   Introduction 455
   Stochastic Processes 456
     Definitions and Properties 456
     Constructing the Continuous Time Model: Brownian Motion 458
     The Ito Process and the Need for Stochastic Calculus 459
   Basic Elements of Stochastic Calculus 462
     Ito Integral 462
     Ito’s Lemma 464
   Binomial Tree: Another Way of Visualizing a Stochastic Process 468
     Construction of a Binomial Tree and Properties 469
   Conclusion 472
   Endnotes 472
   References 472
   Appendix: Heuristic Derivation of Ito’s Formula 473
   About the Authors 475

32 **Measuring and Hedging Option Price Sensitivities** 477
   R. Brian Balyeat

   Delta 477
     Example 1 479
     Example 2 479
   Gamma 484
     Example 3 485
   Theta 487
     Example 4 488
   Vega 491
     Example 5 492
   Rho and Other Option Sensitivities 493
     Example 6 493
     Example 7 494
   Hedging Delta, Gamma, and Vega 496
   Conclusion 498
   References 499
   About the Author 499
CONTENTS

PART VI  Using Financial Derivatives  501

33  Option Strategies  503

*Stewart Mayhew*

Building Blocks  505
Covered Calls and Protective Puts  507
Synthetic Positions  509
Bull and Bear Spreads  512
Cylinders  515
Straddles, Strangles, Strips, and Straps  516
Ratio Spreads  518
Box Spreads  518
Butterflies, Condors, and Seagulls  519
Time Strategies  522
Multi-Asset Strategies  523
Endnotes  523
References  523
About the Author  524

34  The Use of Derivatives in Financial Engineering:
Hedge Fund Applications  525

*John F. Marshall and Cara M. Marshall*

Introduction  525
Convertible Bond Arbitrage  526
Capital Structure Arbitrage  534
Endnotes  538
References  539
About the Authors  539

35  Hedge Funds and Financial Derivatives  541

*Tom Noel*

Introduction  541
Survey of Derivative Use by Hedge Funds  544
Modeling Hedge Fund Risks  547
Description of Some Popular Hedge Fund Strategies  548
Convertible Arbitrage  548
Risk Arbitrage  549
Global Macro  549
Market Neutral/Relative Value  550
Volatility Trades  550
Correlation Trading  551
Credit Hedge Funds  551
Hedge Fund Activism  552
Some Unusual Derivatives Trades Made by Hedge Funds  552
Empty Voting  552
Contents

Acquiring a Large Stake through Put Exercise 553
Toeholds via Contingent Contracts 553
Tax-Avoidance Strategies 554
Using Structures to Create Leverage 555
Conclusion 555
Endnotes 555
References 557
About the Author 558

36 Real Options and Applications in Corporate Finance 559
Betty Simkins and Kris Kemper
Introduction 559
A Brief History of Real Options 560
Distinction between Financial Options and Real Options 561
Types of Real Options and Examples in the Energy Industry 561
Option to Expand 563
Option to Wait 563
Option to Vary Production Inputs, Outputs, or Processes 564
Option to Abandon or Temporarily Shutdown 566
Hybrid Real Options 568
Valuing Real Options 568
Decision Trees 569
Monte Carlo Simulation 569
Option Pricing Models 569
Conclusion 570
Endnotes 570
References 572
About the Authors 573

37 Using Derivatives to Manage Interest Rate Risk 575
Steven L. Byers
Introduction 575
Forward-Based Instruments 575
Forward Rate Agreements 575
Interest Rate Futures Contracts 577
Basis Risk 578
Futures Hedge Ratio 579
Example of Hedging with Eurodollar Futures 580
Hedging a Portfolio of Coupon Bonds with Interest Rate Futures 581
Interest Rate Swaps 582
Option-Based Instruments 583
Interest Rate Guarantees 584
Interest Rate Caps and Floors 584
Swaptions 586
Mortgage Securitization Risk Management Using Interest Rate Derivatives 586
CONTENTS

Conclusion 588
References 588
Suggested Further Reading 589
About the Author 589

Index 591