

OAKLAND BUSINESS & Finance

Refine your talents at demystifying derivatives

MORE THAN MONEY

SID MITTRA
Ph.D.

First of two parts.

If you are nervous and baffled by all this talk about financial derivatives, there is a good reason for this. Until recently, without much fanfare, derivatives were quietly used by federal government agencies, banks commanding stellar reputation, and scores of highly rated mutual funds. However, all that is changed now. Today, most investors feel that derivatives are a time bomb, waiting for the right set of circumstances to explode and take the financial system with them.

The recent explosion
As is the case with any finan-

cial instrument, in the initial stages, derivatives were used to minimize risk. However, as profits of derivatives users rose, so did their desire to invest and speculate in more exotic instruments carrying high degrees of risk. The results were devastating. Here are a couple of incidents to illustrate that point.

The potential problems with mutual funds using derivatives were brought to the forefront with a closed-end bond fund's experience in 1993. The shares were presented as AAA credit-rating investments. However, the fund's management had taken an aggressive derivatives position in the hope that interest rates would go up. Unfortunately, the rates dropped and the fund's NAV dropped 15 percent.

In February 1994, a U.S. Army welfare and recreation fund invested \$15 billion in two-year, AAA-rated, U.S. government

agency notes yielding 4.75 percent. But in just three months, the note's yield was reset to zero percent under a complex formula and the Army fund took a 7.9 percent paper loss on the note.

Instrument of risk reduction

Let's suppose John Jones, a bond mutual fund manager, is convinced that the Federal Reserve is about to raise interest rates. However, John cannot be absolutely sure that interest rates will rise, and is, therefore, reluctant to dump the fixed-income securities for his portfolio. Consequently, John settles for another option. He enters into an agreement with the Chicago Board of Trade to sell five-year Treasury futures contracts. A futures contract is simply an agreement to buy or sell a security at a set price at some specified date. By agree-

ing to sell, John is counting on the price of the underlying bonds to decrease. In the process, John has made a quick and relatively inexpensive portfolio adjustment without sacrificing liquidity. If interest rates rise, as John expects, the futures contracts will help offset the losses by the bonds in his portfolio. But if he is wrong and interest rates decline, the bonds will increase in value only to be somewhat offset by the losses from his deal in the futures contract. Incidentally, futures contracts are one of several instruments that fall under the category of derivatives.

A much more common form of derivatives is the option, which is also a means of reducing risk. An option gives its buyer the right, but not the obligation, to buy or sell a specified underlying item at some agreed-upon price known as

the exercise, or strike price. Assume an investor wants to buy 100 shares of IBM because she believes that IBM stock is poised for a dramatic price increase in the near future. But if she is wrong, she stands to lose a huge sum of money in the process. As an alternative, therefore, she buys a six-month call option to buy 100 shares of IBM at a predetermined price. If the stock price does go up within the next six months, as she expects, she will exercise, or sell, the option and realize a capital gain. If she is wrong, however, she will let the option expire and only lose the premium she paid for the option.

Concept of derivatives

Derivatives are financial instruments that "derive" their value from underlying assets, such as stocks, bonds, mortgages, index funds or foreign currencies. Because a derivative's price is linked to any underlying asset, the derivative's price changes when the price of the underlying

asset changes, though not always proportionately, or in the same direction. In fact, frequently changes in the value of the underlying asset are magnified in the price of the derivative.

To recapitulate, "derivative" is a broad term that covers a wide range of financial instruments. Their common element is that their value is derived from another security, and their general purpose is to transfer risk. One can transfer risk away by hedging, or increase it through speculating. Put differently, by using derivatives an investor can transfer risk away from the portfolio, or transfer risk to the portfolio in the hope of realizing substantial gains through speculation.

Sid Mittra is professor of finance, Oakland University, Rochester Hills, and owner, Mittra & Associates, a Troy financial consulting firm. Oakland University Professor Jerrold Grossman critically reviewed this column.

IN NEED OF A
CENTRAL
AIR CONDITIONER
LENNOX
FREE ESTIMATES
525-1930
UNITED TEMPERATURE
8919 Middlebelt • Livonia

JUNE SALE
20% OFF Entire Stock
(Original Orders & Exchanges Not Included)
June 15, 16 & 17
10 A.M. - 5 P.M.
40% OFF Playable Items
(Games Only & Not for Sale)
Call Now For Seminar Class Schedule
Miniature Makers Workshop
4315 N. Woodward
Cl. 2nd & E. 1st St.
Livonia, MI 48150
481-6222

Robert J. Bielski, MD
is seeking
VOLUNTEERS
for research studies to test an investigational medication for
DEPRESSION
and the SIDE EFFECTS of
ANTIDEPRESSANT MEDICATIONS
MOOD DISORDERS INSTITUTE
If you are having persistent feelings of sadness or hopelessness, are tired, feel slowed down, or have sleep disturbances, appetite or weight changes.
CALL 1-800-682-MOOD
Brighter Tomorrow Through Investigational Research
Orchard Lake Rd., Farmington Hills

Your Furs Need
A Summer Vacation
At The Only
5 ★ FUR SPA
★ Refreshing 34°F Storage Vaults
★ Attentive Staff Catering To Your Fur's Every Need
★ Expert Cleaning in the Most Modern Facilities
★ Comprehensive Fur Check-up
★ Spacious Individual Vault Space
Tours of Spa Are Encouraged
Free Pick-Up
Call (313) 873-8300
or (810) 642-3003
Dittrich
ESTABLISHED 1954
15151 Duff Road
Livonia, MI 48150
481-6422

GIFT CERTIFICATES FOR FATHER'S DAY
Phone Orders Accepted
Executive Custom
Shirtmakers & Tailors
223 South Woodward
Downtown Birmingham
Just South of the Birmingham Theatre
(205) 442-6666
MON-SAT. 9:30-5:30 • THURS. 10-8:00

Ring Dad
on
Father's Day!
M.B. Design offers full service — appraisals, watch repair, lapidary service and jewelry repair. We carry many stones, diamonds and colored gems.
M.B. JEWELRY DESIGN & MFG. LTD.
Applegate Square • 29847 Northwestern Hwy.
Southfield, Michigan 48034 • (810) 356-7007

SAVE \$180.00
Junior Gym Package
NOW ONLY
\$738.00
(Reg. \$888.00)
MODELS ON DISPLAY
Hand Sanded • Rounded Edges
Safety Tested • Modular
Installation Available
Wide Selection for Every Budget
The Doll Hospital & Toy Soldier Shop
3947 W. 12 Mile Rd., Berkley
(Conveniently Located Near I-96)
At Sat. 10-5:30, Fri. 10-8
(810) 543-3115

If Your Central Air Conditioner Is Over 12 Years Old...
It's Freezing Your Assets.
It's keeping a lot of your cash out of your pockets. That's why, make sure you don't have an air conditioning unit that's 4 to 12 years old. A money saving new Air-Ease Central Air Conditioner's Air-Ease technology has created some of the most innovative and cost efficient cooling systems ever. Tap to your Air-Ease Dealer today to find out about the most cost efficient way to keep your cool.
AIR-EASE
A Division of...
REGISTER JUNE 12-18 AT CENTER COURT
TO WIN DAD A NEW WARDROBE FROM JCPENNEY.
DRAWING WILL BE HELD
SUNDAY, JUNE 18 AT 12:00 NOON.
NO PURCHASE NECESSARY.
DETAILS AT INFORMATION BOOTH.

TO CELEBRATE OUR ANNIVERSARY, WE'RE HOSTING 108 PRIVATE CHAMPAGNE PARTIES.
Consider this your invitation to join the first anniversary celebration of The River Place, a Grand Heritage Hotel. As our way of thanking you for making Detroit's most distinctive hotel a success, we're offering a special \$79* rate, a complimentary split of champagne, and free valet parking. Any of our 108 rooms will provide the perfect setting for your personal celebration, and have you returning for many anniversaries to come. For reservations call 313-259-9500 or 800-890-9505.
THE RIVER PLACE
A Grand Heritage Hotel
1000 River Place, Detroit, Michigan 48207
For information on other Grand Heritage Hotels, call 800-HERITAGE.
*Offer valid weekends through 6/30/95 and based on space availability.

LIMITED TIME OFFER!
Programmable Thermostat...
ABSOLUTELY FREE!
With purchase of any Air-Ease air conditioning system. While supplies last. Call Today!
FREE HUMIDIFIERS!
With purchase of complete system. Limited.
CALL YOUR AIR-EASE WINNING TEAM DEALER TODAY
ABSOLUTE CLIMATE CONTROL
(810) 360-2802
ROYAL HEATING & COOLING • VALLEY HEATING & COOLING
(800) 745-4379 (313) 278-4310

Fit to be tied?
HAD IT UP TO HERE FINDING A GIFT FOR DAD? LOOSEN UP! FIND FATHER'S DAY FASHIONS FAST AT OAKLAND MALL.
DON'T FORGET: FATHER'S DAY, SUNDAY, JUNE 18
REGISTER JUNE 12-18 AT CENTER COURT
TO WIN DAD A NEW WARDROBE FROM JCPENNEY.
DRAWING WILL BE HELD
SUNDAY, JUNE 18 AT 12:00 NOON.
NO PURCHASE NECESSARY.
DETAILS AT INFORMATION BOOTH.
OAKLAND MALL
WHAT SHOPPING SHOULD BE
Hudson's, JCPenney, Sears and over 130 great stores and services.
Mon-Sat. 10 a.m.-9 p.m., Sun. 11 a.m.-7 p.m. & 14 Mo.