Derivatives: 'Plain vanillas' or 'exotic'

MORE THAN MONEY

SID MITTRA Ph.D

Second of two parts.

Derivatives can be divided into two general classes: "Plain vanilla" and "Exotic." As their names suggest, there are significant differences between these two classes.

Plain-vanillas

Many of the plain-vanilla derivatives, such as futures, options and currency forwards, have been around for more than two decades. They trade on exchanges in standardized contracts or over-the-counter among a wide range of institutions. Exchange-traded derivatives (futures and most options) are closely regulated and their prices are published daily in the Wall Street Journal, just like stock prices. Plain-vanilla derivatives generally can be bought and sold easily. However, these derivatives can also become quite volatile and lose liquidity, especially under volatile market conditions. Some commonly traded plain-vanilla derivatives are discussed next.

Forward currency contracts

One instrument that derivative managers frequently use is the forward currency contract. Typically, these managers enter into forward currency contracts only with major banks or brokerage firms. Entering into these contracts does involve business risk, should one of these companies falter.

Forward currency contracts help protect stock holdings against declines in the value of foreign currencies relative to the U.S. dollar. A decline in the value of a foreign currency can reduce or even eliminate any gains in a foreign stock.

Options

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 within some agreed-upon time period. There are two types of options — calls and puts. The call option gives the buyer the right to buy the underlying item at the strike price, while a put option gives the buyer the right to sell the underlying item at a specified price.

Perhaps the best-known options are stock options. Standardized stock options are traded in the United States on the American Stock Exchange, the Chicago Board Options Exchange, the New York Stock Exchange, the Pacific Stock Exchange and the Philadelphia Options Exchange. In addition, many firms award their key executives compensation packages that include stock options. Such compensation packages often are flavored by a firm's shareholders because they give management an incentive to pursue strategies that increase the firm's stock prices.

As an example of how firms use call options, suppose the Board of Directors of Pine Corp. awards the company's vice president of finance, George Segar, an option to buy 100,000 shares of the company's stock at $50 per share within a specified time period. When George receives the option, however, Pine Corp.'s stock is selling at $45 a share; so he has no reason to exercise the option immediately. If Pine Corp.'s stock price never rises above $50, the option will not be exercised before the specified time runs out. On the other hand, if the stock price rises to, say, $70 per share, George can exercise the option to earn a handsome profit. The call shares is $7 million, George can earn $2 million (less commission) by exercising the option, buying the underlying shares, and then immediately selling them at $70 a share.

Exotic derivative

Exotic derivatives are the new arrivals. Due to their short histories, exotics are relatively untested. Most are not exchange-traded and some are highly specialized and frequently customized for institutional investors. They are sometimes based on relationships between diverse markets: for example, changes in European interest rates and the price of copper. As a result, exotics can be *highly illiquid and difficult to* price accurately.

Exotic derivatives can be subdivided into two subcategories. The first included relatively straightforward products that managers use to hedge. The second category consists of customized contracts that managers use to gamble on stock or currency prices, the direction of interest rates, or indices, or some interrelationships between any or all of these factors. Collateralized mortgage obligations (CMOS), which are a popular derivative, can fall into both categories.

Derivative myths

There are four derivative myths that never seem to fade away. They are discussed below:

■ **Myth No. 1: Derivatives are new and untested.** Plain-vanilla derivatives have been around for a long time. Contracts guaranteeing crop prices have been traded on the Chicago Board of Trade since 1848. Also, mutual funds have used currency futures ever since they started investing overseas. Other derivatives like options have been around a lot longer.

■ **Myth No. 2: All derivatives are complex.** Not all derivatives are complex. In fact, the more conventional derivatives, like options and forwards, were originally designed in a simple manner to control risks. For instance, many mutual funds routinely use call and put options to lower their portfolio risk.

■ **Myth No. 3: Derivatives are more risky than the associated security.** Derivatives are usually no riskier than the underlying securities to which they are tied. For instance, an investor who wished to participate in the market could invest in various stocks. However, if he is not sophisticated enough to construct an efficient portfolio, he could buy S&P 500 index futures. If the market rises, the investor wins; if not, the investor may suffer the same result he would have if common stocks were acquired. Of course, if stocks were purchased, the investor could wait for a rise, in contrast, the owner of the option is forced to realize a loss when the times runs out.

■ **Myth No. 4: The real problem is that derivatives are overly risky.** As mentioned, the risk of derivatives is intimately related to the risk of the securities they represent. The real problem, however, has to do with disclosure. Admittedly, the investment community has done a poor job of communicating to the general public the true nature and use of derivatives. Consequently, investors panic when they discover that their mutual fund managers are using this esoteric instrument that they do not understand or approve.

BUSINESS MILESTONES

This column highlights promotions, transfers, hirings and other key personnel moves within the Farmington-area business community. Send a brief biographical summary — including the towns of residency and employment and a black-and-white photo, if desired — to: Business Editor, Farmington Observer, 33411 Grand River, Farmington, Michigan 48335. The Observer's fax number is 1-810-477-9722.

David J. Butler of Farmington Hills has been named general manager of Suburban Oldsmobile/Cadillac of Troy. As general manager, Butler will oversee the day-to-day operations of the entire dealership, including sales, leasing, service and customer relations. A member of the Michigan Association of Certified Public Accountants, Butler has a business and finance degree from Michigan State University and an MBA from Wayne State University.

Butler

Kira Helsom of Farmington Hills has been appointed administrative assistant for Hadley and Associates, according to Lawrence D. Hadley, president of the full service commercial mortgage banking firm. Hadley and Associates is the Michigan correspondent for Franklin Life Insurance Company and Great Northern Annuity, which is a General Electric Company. With a degree in finance from the University of Michigan, Helsom served as loan counselor at Source One Mortgage, where she administered and serviced residential loans.

Helsom

James W. Sturtz of Farmington Hills was promoted to vice president by Compass Group Ltd., a management consulting and retained executive search firm based in Birmingham. Sturtz was employed by General Motors Corp. in a variety of human resource activities including, Director of College Relations for GM. Compass Group was founded in 1983, and has offices in Birmingham and Chicago.

Joseph M. Hafner of Farmington Hills has been named account executive for Marx Layne & Company, a full-service marketing and public relations firm with offices in Farmington Hills and Detroit. As account executive, Hafner has responsibilities for clients in the financial, retail, manufacturing, health care, travel and professional service industries. He joined Marx Layne as an account assistant in October, 1994. Previously, he worked for Detroit's Olde Financial Corp. as an assistant trader and as a communications specialist for The ReHabilitation Center in Olean, N.Y.

Carrie Benigsohn of Farmington Hills has been named account manager at Brogan & Partners Advertising/Pulic Relations. As account manager he will manage a wide range of public relations activities for clients in the travel/tourism, telecommunications, retail and health care industries. Benigsohn is a 1994 graduate of Michigan State University and has worked on public relations activities for Brogan & Partners including Northland Center, Home Depot, the Grand Hotel on Mack-

See MILESTONES, 10A