Janus Henderson INVESTORS

A SIMPLE GUIDE TO DERIVATIVES

The earliest examples of financial derivatives date back to Ancient Greece and the olive harvest. Today, they are important in the global financial system and can be used for many purposes. They are often misunderstood as complex and risky. While this is true for some derivatives, many are relatively simple and when used correctly they can prove helpful for fund managers.

What is a derivative?

A derivative is a financial instrument that derives its value from the performance of an underlying asset or reference benchmark. Examples of underlying assets include company shares, bonds or commodities, while a reference benchmark could be something like a stock market index or an interest rate. It is essentially a contract that is traded between two parties, each of which is referred to as a 'counterparty'. One counterparty is the buyer, the other is the seller.

Derivatives exist across all asset classes. Common types used include forwards that allow portfolio managers to lock in currency exchange rates, credit default swaps that can help offset the risk of a bond failing to meet repayments (defaulting) and 'contracts for difference' that can allow a portfolio manager to potentially profit from the decline in price of an asset. Derivatives can be used to offset (hedge) the risk of loss or to speculate about the direction of the price of an asset.

This is best explained by some examples:

HEDGING

Imagine a fund manager who manages a portfolio of shares for European-based investors. The fund manager wants to buy shares in US-based company Enterprise Inc, because she thinks the share price is set to increase. Enterprise inc's shares are denominated in dollars, however, and the manager thinks that the dollar may fall against the euro, which would damage her investor's returns even if Enterprise Inc's shares rise.

The fund manager could enter into a derivative contract called an 'FX forward'. This locks in the exchange rate (in this example the euro/dollar rate) for a set time. When it comes to selling the shares the fund manager can be confident that they will receive the exchange rate in the contract. She has hedged or offset her exchange rate risk. Of course, she cannot be sure what the share price itself will be until she sells as that is set by market forces.

SPECULATING

Consider a fund manager who thinks the price of supermarket company Grocery Group will fall. One method of profiting from a falling share price is for him to take a 'short' position, which he can achieve through a derivative known as a 'contract for difference'. Short positions are useful for absolute return funds that typically seek to deliver positive returns regardless of market direction.

The manager takes the short position in Grocery Group and, after seeing the price fall, exits the trade with a profit for his investors.

Of course – as with investing in traditional assets – in both the above examples circumstances could work against the fund manager. If the dollar appreciates against the euro, the Enterprise Inc position will miss out on a currency gain, while a rise in Grocery Group's share price will result in a loss for the fund manager going short. The derivative is the instrument used to express the manager's view, which may not always be right.

The benefits and risks of derivatives

Benefits

- **Reducing risk:** When used correctly, derivatives can be effective ways of protecting ('hedging') investors against risks such as interest rate rises, inflation or falling markets.
- **Speed and cost:** It may be quicker and cheaper for a fund manager to buy a derivative than the underlying asset.
- **Choice:** The range of derivatives on offer in financial markets is huge, helping to meet specific investor requirements.

Risks

- **Default:** There is a risk that either counterparty in the derivative trade may be unable to meet their contractual obligations. Fund managers can aim to limit this risk by carefully researching and limiting their exposure to each counterparty. Furthermore, many contracts require assets to be pledged upfront as security, or ongoing payments in order to protect both counterparties from the risk of default.
- **Potentially large losses:** If a fund manager makes the wrong investment decision, some derivatives could cause large losses, particularly if combined with 'leverage'. Leverage is, in effect, a form of borrowing, which increases exposure to the relevant underlying security or market. Fund managers can control their losses through various techniques such as a 'stop loss order' – an automatic order to close a position once a certain price has been reached.

At a glance

- ✓ Derivatives derive their value from the performance of an underlying asset.
- ✓ They can be used to speculate about the direction of an underlying asset's price or offset the risk of loss ('hedge').
- ✓ There are two parties in a derivative transaction – a buyer and a seller.
- ✓ Their initial low cost and availability may make them more attractive than buying the underlying instrument.
- ✓ Certain derivatives carry the risk of large losses.
- ✓ **By speaking to a financial adviser, you can discuss whether investment funds that use derivatives may be right for you.**

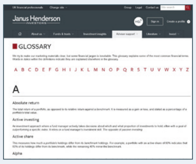
Glossary

Counterparty: One of the parties that participates in a financial transaction, ie, the buyer or the seller.

Hedge: To reduce the risk of adverse price movements, by taking an offsetting position.

Short: A position designed to profit from a fall in the price of an asset. Short positions can be achieved through derivatives.

Underlying: The asset or benchmark from which a derivative derives its value. For example, the price of a company's shares.



Glossary

Please see HGi.co/glossary for a glossary of financial terms used in this document.

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