

Contents

Preface	v
Authors	vii
Introductory Note	ix
List of Abbreviations	xi
1 How derivative exchanges and markets are structured	1
1.1 A history of derivative exchanges	1
1.2 What are derivatives?	2
1.3 Standardized derivatives trading – Why is it common?	4
1.4 What functions do derivative exchanges fulfill?	6
1.5 Who are the market participants at derivative exchanges?	7
1.6 How are derivative exchanges organized?	8
1.7 Understanding derivative exchanges and markets – what do we need to know?	9
1.8 “Bursa Mater et Magistra”: How can reasonable trading behaviour at derivatives exchange be described?	12
2 Set-up and structure of derivatives exchanges – the Eurex case study	15
2.1 How do electronic exchanges work?	15
2.2 What is the market-maker principle?	16
2.3 How is trading carried out at Eurex?	17
2.4 What products can be traded at Eurex?	19
2.5 What does the term “clearing” mean?	20
2.6 What categories of order specifications exist?	21
2.7 What expiration dates are used by Eurex?	24

3	Options – Conditional derivatives	25
3.1	What are options and how do call options and put options differ?	25
3.2	What types of options do exist?	27
3.3	Options trading	28
3.4	What are weekly options?	30
3.4.1	When does it make sense to trade in weekly options?	30
3.5	What are Low-Exercise-Price Options?	30
3.6	Closing out a derivative position	31
3.7	Roll-over	32
4	The pricing of options	33
4.1	How are option prices determined in theory?	33
4.2	What value drivers influence option prices?	36
4.3	What do the so-called Greeks mean?	40
4.4	What is the put-call parity all about?	44
4.5	How are option prices determined under the Black-Scholes model?	45
4.6	How are option prices determined under the Binominal model?	46
4.7	Tradable option prices	49
5	Strategies involving options	51
5.1	What are the four basic options trading strategies all about?	51
5.1.1	What is the strategy behind basic position 1 – long call?	52
5.1.2	What is the strategy behind basic position 2 – short call?	54
5.1.3	What is the strategy behind basic position 3 – long put?	56
5.1.4	What is the strategy behind basic position 4 – short put?	57
5.2	How to hedge with options	59
5.3	What option combinations are common?	60
5.4	How to set up a strategy for options trading	68
5.5	What is the significance of market opinion?	69
6	Futures – unconditional derivative instruments	71
6.1	What are futures?	71
6.2	Futures markets	72
6.3	Futures trading	73
6.3.1	Delivery	74

6.4	Index-based futures	74
6.5	Interest-rate futures	76
6.6	Foreign-currency futures	78
6.7	Commodity futures	79
6.8	Single-Stock futures	80
6.9	The market for futures trading	80
7	Pricing of futures	83
7.1	Future pricing – how is it done?	83
7.2	Pricing of interest rate futures	84
7.3	What is a CTD bond?	86
7.4	What does “final settlement” mean?	87
7.5	What are common maturity dates for futures?	87
8	Strategies involving futures	89
9	Options on futures, synthetic structures and combinations	101
9.1	What are options on futures?	101
9.2	How are options on futures set up and structured?	102
9.3	What is the future-style method?	102
9.4	What strategies do investors pursue with options on futures?	103
9.5	What is a synthetic derivatives market position?	105
9.6	What combination and linkage deals are used in business practice?	106
9.7	What are possible motives for combination or linkage deals?	107
10	Foreign currency derivatives	109
10.1	A history of foreign currency trading	109
10.2	Some basic information on foreign exchange trading	109
10.2.1	Foreign exchange spot trading	110
10.2.2	Foreign exchange derivative transactions via banks	111
10.2.3	Determining the forward rate	112
10.2.4	Foreign exchange derivative transactions at exchanges	113
10.2.5	Overview of foreign exchange derivatives	113
10.2.6	Cross rate	114

10.2.7	Economic drivers of foreign currency pricing	114
10.3	What are foreign currency derivatives?	114
10.3.1	Swap rate	115
10.4	What are currency options?	117
10.5	What are currency futures?	118
10.5.1	Possible applications	118
10.5.2	Basic intentions of an investor	119
11	Commodity futures trading	121
11.1	Commodity futures vs. spot transactions	121
11.1.1	Commodity futures	122
11.1.2	Opening and closing of positions and settlement	123
11.1.3	Application of various settlement modes	124
11.2	Which commodities are eligible for futures trading?	125
11.3	Executing commodity futures contracts	126
11.3.1	When should an investor enter into commodity futures transactions?	126
11.4	Future developments and outlook	127
12	Pricing and influencing factors in commodity futures trading	129
12.1	How are prices for commodity futures determined?	129
12.1.1	Prices of commodity futures	130
12.1.2	How prices are determined	130
12.1.3	What inherent problem does a contango quotation pose?	132
12.1.4	Futures trading	133
12.1.5	Warehousing and/or storage	133
12.2	How pricing is influenced by certain issues	134
12.3	Gathering information	135
13	Strategies with commodity futures and currency futures	137
13.1	Common strategies in the commodity futures sector	137
13.1.1	Hedging with commodity futures instruments	137
13.1.2	Speculating with commodity futures instruments	138
13.1.3	Arbitrage with commodity futures instruments	139

13.1.4	Spreading in commodity futures trades	139
13.2	Foreign currency and commodity futures	139
13.3	What strategies are common in currency futures trading?	140
13.3.1	Hedging strategies	140
13.3.2	Strategies for speculation	141
14	Over the counter derivatives	143
14.1	Non-exchange-traded derivatives	143
14.2	What is a swap?	143
14.2.1	Interest rate swaps	144
14.2.2	Currency swap	145
14.2.3	Stock index swap	145
14.2.4	Commodity swap	145
14.2.5	Swap trading	146
14.2.6	Variable interest rates	147
14.2.7	When and how to apply swaps	147
14.3	What are Swaptions and IRGs?	147
14.3.1	Swaptions	147
14.3.2	IRGs	148
14.4	What are exotic options?	148
14.4.1	What sorts of exotic options are there?	149
14.5	What is a forward?	153
15	Credit derivatives	155
15.1	What are the basics of credit derivatives?	155
15.2	What is a credit?	155
15.3	What types of credit derivatives exist?	156
15.3.1	Traditional credit derivatives	156
15.3.2	Modern credit derivatives	157
15.4	What are the iTraxx® Futures at Eurex?	158
15.5	What are securitized credit derivatives?	159
16	Structuring complex portfolios with derivatives	161
16.1	What are the basics of position management and what are possible expansion strategies?	161

16.2	What is averaging and pyramiding?	162
16.2.1	What can be possible purposes of expanding one's exposure?	163
16.3	What is a roll-over?	165
16.3.1	Roll-over due to adverse market trends	165
16.3.2	Preventing premature assignment	166
16.3.3	Extending high-performing investments	166
16.3.4	Cross roll-over	167
16.4	How are positions set up?	168
16.4.1	Combinations	168
16.4.2	Setting up a portfolio	170
16.5	What is trading presence?	171
16.6	What is risk controlling?	172

17 Margining 173

17.1	What is margining?	173
17.2	What is risk-based margining?	174
17.3	Why must a margin be posted and how is it calculated?	174
17.4	What types of margins are common?	175
17.4.1	Premium margin	175
17.4.2	Additional Margin	175
17.4.3	Variation margin	175
17.4.4	Futures-spread margin	176
17.5	Margins for options	176
17.5.1	Long positions	176
17.5.2	Short positions	176
17.5.3	Margin during delivery period	178
17.6	Margins on futures	178
17.7	Margining for futures-style options	179
17.8	How are margins calculated for option positions?	180
17.8.1	Determining close-out costs	180
17.9	Ensuring that the margin obligation is met	180
17.10	Settlement price	181
17.11	The margin call from an investor's point of view	181
17.12	Forced liquidation from a bank's or broker's vantage point	181

Appendix	183
A.1 Questions and answers	185
A.2 Glossary	203
A.3 Single stock futures	211
A.4 Equity options	221
A.5 Equity index derivatives	231
A.6 Equity index options	237
A.7 Weekly options	243
A.8 Volatility index derivatives	247
A.9 Exchange traded funds® derivatives	249
A.10 Credit derivatives	253
A.11 Interest rate derivatives	257
A.12 Derivatives exchanges worldwide – An overview	267
A.13 Eurex-Disclaimer	269
A.14 Eurex – one of the leading derivatives exchanges in the world	273
A.15 List of Literature	277
 Subject Index	 279