

GLOSSARY

- Accounting risk** The risk associated with accounting standards that vary from country to country or with any uncertainty about how certain transactions should be recorded.
- Add-on interest** A procedure for determining the interest on a bond or loan in which the interest is added onto the face value of a contract.
- American option** An option that can be exercised on any day through the expiration day. Also referred to as *American-style exercise*.
- Amortizing and accreting swaps** A swap in which the notional principal changes according to a formula related to changes in the underlying.
- Arbitrage** The condition in a financial market in which equivalent assets or combinations of assets sell for two different prices, creating an opportunity to profit at no risk with no commitment of money. In a well-functioning financial market, few arbitrage opportunities are possible. Equivalent to the *law of one price*.
- Arrears swap** A type of interest rate swap in which the floating payment is set at the end of the period and the interest is paid at that same time.
- At the money** An option in which the underlying value equals the exercise price.
- Backwardation** A condition in the futures markets in which the benefits of holding an asset exceed the costs, leaving the futures price less than the spot price.
- Basis point value (BPV)** Also called *present value of a basis point* or *price value of a basis point (PVBP)*, the change in the bond price for a 1 basis point change in yield.
- Basis swap** A swap in which both parties pay a floating rate.
- Bear spread** An option strategy that involves selling a put with a lower exercise price and buying a put with a higher exercise price. It can also be executed with calls.
- Beta** A measure of the relationship between the return on a stock portfolio and the return on the market portfolio, which is a portfolio containing *all* risky assets in the market.
- Binomial model** A model for pricing options in which the underlying price can move to only one of two possible new prices.
- Binomial tree** A diagram representing price movements of the underlying in a binomial model.
- Bond option** An option in which the underlying is a bond; primarily traded in over-the-counter markets.
- Box spread** An option strategy that combines a bull spread and a bear spread having two different exercise prices, which produces a risk-free payoff of the difference in the exercise prices.
- Brokers** See *futures commission merchants*.
- Bull spread** An option strategy that involves buying a call with a lower exercise price and selling a call with a higher exercise price. It can also be executed with puts.
- Butterfly spread** An option strategy that combines two bull or bear spreads and has three exercise prices.
- Call** An option that gives the holder the right to buy an underlying asset from another party at a fixed price over a specific period of time.
- Cap** A combination of interest rate call options designed to hedge a borrower against rate increases on a floating-rate loan.
- Caplet** Each component call option in a cap.
- Capped swap** A swap in which the floating payments have an upper limit.
- Cash flow at risk (CFAR)** A variation of VAR that reflects the risk of a company's cash flow instead of its market value.
- Cash price or spot price** The price for immediate purchase of the underlying asset.
- Cash settlement** A procedure used in certain derivative transactions that specifies that the long and short parties engage in the equivalent cash value of a delivery transaction.
- Centralized risk management or companywide risk management** When a company has a single risk

management group that monitors and controls all of the risk-taking activities of the organization. Centralization permits economies of scale and allows a company to use some of its risks to offset other risks. See also *enterprise risk management*.

Cheapest to deliver A bond in which the amount received for delivering the bond is largest compared with the amount paid in the market for the bond.

Cherry-picking When a bankrupt company is allowed to enforce contracts that are favorable to it while walking away from contracts that are unfavorable to it.

Clearinghouse An entity associated with a futures market that acts as middleman between the contracting parties and guarantees to each party the performance of the other.

Closeout netting Netting the market values of *all* derivative contracts between two parties to determine one overall value owed by one party to another in the event of bankruptcy.

Collar An option strategy involving the purchase of a put and sale of a call in which the holder of an asset gains protection below a certain level, the exercise price of the put, and pays for it by giving up gains above a certain level, the exercise price of the call. Collars also can be used to provide protection against rising interest rates on a floating-rate loan by giving up gains from lower interest rates.

Commodity forward A contract in which the underlying asset is oil, a precious metal, or some other commodity.

Commodity futures Futures contracts in which the underlying is a traditional agricultural, metal, or petroleum product.

Commodity option An option in which the asset underlying the futures is a commodity, such as oil, gold, wheat, or soybeans.

Commodity swap A swap in which the underlying is a commodity such as oil, gold, or an agricultural product.

Constant maturity swap or CMT swap A swap in which the floating rate is the rate on a security known as a constant maturity treasury or CMT security.

Constant maturity treasury or CMT A hypothetical U.S. Treasury note with a constant maturity. A CMT exists for various years in the range of 2 to 10.

Contango A condition in the futures markets in which the costs of holding an asset exceed the benefits, leaving the futures price more than the spot price.

Contingent claims Derivatives in which the payoffs occur if a specific event occurs; generally referred to as options.

Continuous time Time thought of as advancing in extremely small increments.

Convenience yield The nonmonetary return offered by an asset when the asset is in short supply, often associated with assets with seasonal production processes.

Conversion factor An adjustment used to facilitate delivery on bond futures contracts in which any of a number of bonds with different characteristics are eligible for delivery.

Cost of carry The costs of holding an asset.

Cost of carry model A model for pricing futures contracts in which the futures price is determined by adding the cost of carry to the spot price.

Covariance A measure of the extent to which the returns on two assets move together.

Covered call An option strategy involving the holding of an asset and sale of a call on the asset.

Covered interest arbitrage A transaction executed in the foreign exchange market in which a currency is purchased (sold) and a forward contract is sold (purchased) to lock in the exchange rate for future delivery of the currency. This transaction should earn the risk-free rate of the investor's home country.

Credit derivatives A contract in which one party has the right to claim a payment from another party in the event that a specific credit event occurs over the life of the contract.

Credit risk or default risk The risk of loss due to nonpayment by a counterparty.

Credit spread option An option on the yield spread on a bond.

Credit swap A type of swap transaction used as a credit derivative in which one party makes periodic payments to the other and receives the promise of a payoff if a third party defaults.

Credit VAR, Default VAR, or Credit at Risk A variation of VAR that reflects credit risk.

Credit-linked notes Fixed-income securities in which the holder of the security has the right to withhold payment of the full amount due at maturity if a credit event occurs.

Cross-product netting Netting the market values of all contracts, not just derivatives, between parties.

Currency forward A forward contract in which the underlying is a foreign currency.

Currency option An option that allows the holder to buy (if a call) or sell (if a put) an underlying currency at a fixed exercise rate, expressed as an exchange rate.

Currency swap A swap in which each party makes interest payments to the other in different currencies.

Current credit risk The risk associated with the possibility that a payment currently due will not be made.

- Daily settlement** See *marking to market*.
- Day trader** A trader holding a position open somewhat longer than a scalper but closing all positions at the end of the day.
- Decentralized risk management** A system that allows individual units within an organization to manage risk. Decentralization results in duplication of effort but has the advantage of having people closer to the risk be more directly involved in its management.
- Deep in the money** Options that are far in-the-money.
- Deep out of the money** Options that are far out-of-the-money.
- Delivery** A process used in a deliverable forward contract in which the long pays the agreed-upon price to the short, which in turn delivers the underlying asset to the long.
- Delivery option** The feature of a futures contract giving the short the right to make decisions about what, when, and where to deliver.
- Delta** The relationship between the option price and the underlying price, which reflects the sensitivity of the price of the option to changes in the price of the underlying.
- Delta hedge** An option strategy in which a position in an asset is converted to a risk-free position with a position in a specific number of options. The number of options per unit of the underlying changes through time, and the position must be revised to maintain the hedge.
- Delta-normal method** A measure of VAR equivalent to the analytical method but that refers to the use of delta to estimate the option's price sensitivity.
- Derivative** A financial instrument that offers a return based on the return of some other underlying asset.
- Derivatives dealers** The commercial and investment banks that make markets in derivatives. Also referred to as market makers.
- Diff swaps** A swap in which the payments are based on the difference between interest rates in two countries but payments are made in only a single currency.
- Discount interest** A procedure for determining the interest on a loan or bond in which the interest is deducted from the face value in advance.
- Discrete time** Time thought of as advancing in distinct finite increments.
- Duration** A measure of the size and timing of the cash flows paid by a bond. It quantifies these factors by summarizing them in the form of a single number. For bonds without option features attached, duration is interpreted as a weighted average maturity of the bond.
- Dynamic hedging** A strategy in which a position is hedged by making frequent adjustments to the quantity of the instrument used for hedging in relation to the instrument being hedged.
- Earnings at risk (EAR)** A variation of VAR that reflects the risk of a company's earnings instead of its market value.
- Economic exposure** The risk associated with changes in the relative attractiveness of products and services offered for sale, arising out of the competitive effects of changes in exchange rates.
- Enhanced derivatives products companies (EDPC) or special purpose vehicles (SPVs)** A type of subsidiary engaged in derivatives transactions that is separated from the parent company in order to have a higher credit rating than the parent company.
- Enterprise risk management** A form of *centralized risk management* that typically encompasses the management of a broad variety of risks, including insurance risk.
- Equitizing cash** A strategy used to replicate an index. It is also used to take a given amount of cash and turn it into an equity position while maintaining the liquidity provided by the cash.
- Equity forward** A contract calling for the purchase of an individual stock, a stock portfolio, or a stock index at a later date at an agreed-upon price.
- Equity options** Options on individual stocks; also known as stock options.
- Equity swap** A swap in which the rate is the return on a stock or stock index.
- Eurodollar** A dollar deposited outside the United States.
- European option** An option that can be exercised only at expiration. Also referred to as *European-style exercise*.
- Exchange for physicals (EFP)** A permissible delivery procedure used by futures market participants, in which the long and short arrange a delivery procedure other than the normal procedures stipulated by the futures exchange.
- Exercise or exercising the option** The process of using an option to buy or sell the underlying.
- Exercise price, strike price, striking price, or strike** The fixed price at which an option holder can buy or sell the underlying.
- Exercise rate or strike rate** The fixed rate at which the holder of an interest rate option can buy or sell the underlying.
- Expiration date** The date on which a derivative contract expires.
- Fiduciary call** A combination of a European call and a risk-free bond that matures on the option expiration day and has a face value equal to the exercise price of the call.

- Financial futures** Futures contracts in which the underlying is a stock, bond, or currency.
- Fixed-income forward** A forward contract in which the underlying is a bond.
- Floating-rate loan** A loan in which the interest rate is reset at least once after the starting date.
- Floor** A combination of interest rate put options designed to hedge a lender against lower rates on a floating-rate loan.
- Floor traders or locals** Market makers that buy and sell by quoting a bid and an ask price. They are the primary providers of liquidity to the market.
- Floored swap** A swap in which the floating payments have a lower limit.
- Floorlet** Each component put option in a floor.
- Forward contract** An agreement between two parties in which one party, the buyer, agrees to buy from the other party, the seller, an underlying asset at a later date for a price established at the start of the contract.
- Forward price or forward rate** The fixed price or rate at which the transaction scheduled to occur at the expiration of a forward contract will take place. This price is agreed on at the initiation date of the contract.
- Forward rate agreement (FRA)** A forward contract calling for one party to make a fixed interest payment and the other to make an interest payment at a rate to be determined at the contract expiration.
- Forward swap** A forward contract to enter into a swap.
- Futures commission merchants (FCMs)** Individuals or companies that execute futures transactions for other parties off the exchange.
- Futures contract** A variation of a forward contract that has essentially the same basic definition but with some additional features, such as a clearinghouse guarantee against credit losses, a daily settlement of gains and losses, and an organized electronic or floor trading facility.
- Futures exchange** A legal corporate entity whose shareholders are its members. The members of the exchange have the privilege of executing transactions directly on the exchange.
- Gamma** A numerical measure of how sensitive an option's delta is to a change in the underlying.
- Hedge ratio** The relationship of the quantity of an asset being hedged to the quantity of the derivative used for hedging.
- Hedging** A general strategy usually thought of as reducing, if not eliminating, risk.
- Historical method** A method of estimating VAR that uses data from the returns of the portfolio over a recent past period and compiles this data in the form of a histogram.
- Historical simulation method** Another term for the historical method of estimating VAR. This term is somewhat misleading in that the method involves not a *simulation* of the past but rather what *actually happened* in the past, sometimes adjusted to reflect the fact that a different portfolio may have existed in the past than is planned for the future.
- Homogenization** Creating a contract with standard and generally accepted terms, which makes it more acceptable to a broader group of participants.
- Implied repo rate** The rate of return from a cash-and-carry transaction implied by the futures price relative to the spot price.
- Implied volatility** The volatility that option traders use to price an option, implied by the price of the option and a particular option-pricing model.
- Implied yield** A measure of the yield on the underlying bond of a futures contract implied by pricing it as though the underlying will be delivered at the futures expiration.
- Index amortizing swap** An interest rate swap in which the notional principal is indexed to the level of interest rates and declines with the level of interest rates according to a predefined schedule. This type of swap is frequently used to hedge securities that are prepaid as interest rates decline, such as mortgage-backed securities.
- Index option** An option in which the underlying is a stock index.
- Initial margin requirement** The margin requirement on the first day of a transaction as well as on any day in which additional margin funds must be deposited.
- Interest rate call** An option in which the holder has the right to make a known interest payment and receive an unknown interest payment.
- Interest rate cap or cap** A series of call options on an interest rate, with each option expiring at the date on which the floating loan rate will be reset, and with each option having the same exercise rate. A cap in general can have an underlying other than an interest rate.
- Interest rate collar** A combination of a long cap and a short floor, or a short cap and a long floor. A collar in general can have an underlying other than an interest rate.
- Interest rate floor or floor** A series of put options on an interest rate, with each option expiring at the date on which the floating loan rate will be reset, and with each option having the same exercise rate. A floor in

general can have an underlying other than the interest rate.

Interest rate forward (See *forward rate agreement*)

Interest rate option An option in which the underlying is an interest rate.

Interest rate parity A formula that expresses the equivalence or parity of spot and forward rates, after adjusting for differences in the interest rates.

Interest rate put An option in which the holder has the right to make an unknown interest payment and receive a known interest payment.

Interest rate swap A swap in which the underlying is an interest rate. Can be viewed as a currency swap in which both currencies are the same and can be created as a combination of currency swaps.

In-the-money Options that, if exercised, would result in the value received being worth more than the payment required to exercise.

Intrinsic value or exercise value The value obtained if an option is exercised based on current conditions.

Inverse floater A floating-rate note or bond in which the coupon is adjusted to move opposite to a benchmark interest rate.

Law of one price The condition in a financial market in which two financial instruments or combinations of financial instruments can sell for only one price. Equivalent to the principle that no arbitrage opportunities are possible.

Legal risk The risk that the legal system will not enforce a contract in case of dispute or fraud.

Leveraged floating-rate note or leveraged floater A floating-rate note or bond in which the coupon is adjusted at a multiple of a benchmark interest rate.

Limit down A limit move in the futures market in which the price at which a transaction would be made is at or below the lower limit.

Limit move A condition in the futures markets in which the price at which a transaction would be made is at or beyond the price limits.

Limit up A limit move in the futures market in which the price at which a transaction would be made is at or above the upper limit.

Liquidity The ability to trade a futures contract, either selling a previously purchased contract or purchasing a previously sold contract.

Liquidity risk The risk that a financial instrument cannot be purchased or sold without a significant concession in price due to the size of the market.

Locked limit A condition in the futures markets in which a transaction cannot take place because the price would be beyond the limits.

London Interbank Offer Rate (LIBOR) The Eurodollar rate at which London banks lend dollars to other London banks; considered to be the best representative rate on a dollar borrowed by a private, high-quality borrower.

Long The buyer of a derivative contract. Also refers to the position of owning a derivative.

Long-term equity anticipatory securities (LEAPS) Options originally created with expirations of several years.

Lower bound The lowest possible value of an option.

Macaulay duration The duration before dividing by $1 + y_B$. The term, named for one of the economists who first derived it, is used to distinguish the calculation from modified duration. See also *modified duration*.

Maintenance margin requirement The margin requirement on any day other than the first day of a transaction.

Margin The amount of money that a trader deposits in a margin account. The term is derived from the stock market practice in which an investor borrows a portion of the money required to purchase a certain amount of stock. In futures markets, there is no borrowing so the margin is more of a down payment or performance bond.

Market risk The risk associated with interest rates, exchange rates, and equity prices.

Marking to market A procedure used primarily in futures markets in which the parties to a contract settle the amount owed daily. Also known as the *daily settlement*.

Model risk The use of an inaccurate pricing model for a particular investment, or the improper use of the right model.

Modified duration An adjustment of the duration for the level of the yield. Contrast with *Macaulay duration*.

Moneyness The relationship between the price of the underlying and an option's exercise price.

Monte Carlo simulation method An approach to estimating VAR that produces random outcomes to examine what might happen if a particular risk is faced. This method is widely used in the sciences as well as in business to study a variety of problems.

Netting When parties agree to exchange only the net amount owed from one party to the other.

Nondeliverable forwards (NDFs) Cash-settled forward contracts, used predominately with respect to foreign exchange forwards.

Normal backwardation The condition in futures markets in which futures prices are lower than expected spot prices.

- Normal contango** The condition in futures markets in which futures prices are higher than expected spot prices.
- Off-market FRA** A contract in which the initial value is intentionally set at a value other than zero and therefore requires a cash payment at the start from one party to the other.
- Offsetting** A transaction in exchange-listed derivative markets in which a party re-enters the market to close out a position.
- Operations risk or operational risk** The risk of loss from failures in a company's systems and procedures (for example, due to computer failures or human failures) or events completely outside of the control of organizations (which would include "acts of God" and terrorist actions).
- Option** A financial instrument that gives one party the right, but not the obligation, to buy or sell an underlying asset from or to another party at a fixed price over a specific period of time. Also referred to as contingent claims.
- Option price, option premium, or premium** The amount of money a buyer pays and seller receives to engage in an option transaction.
- Out-of-the-money** Options that, if exercised, would require the payment of more money than the value received and therefore would not be currently exercised.
- Overnight index swap (OIS)** A swap in which the floating rate is the cumulative value of a single unit of currency invested at an overnight rate during the settlement period.
- Payer swaption** A swaption that allows the holder to enter into a swap as the fixed-rate payer and floating-rate receiver.
- Payment netting** A means of settling payments in which the amount owed by the first party to the second is netted with the amount owed by the second party to the first; only the net difference is paid.
- Payoff** The value of an option at expiration.
- Performance guarantee** A guarantee from the clearinghouse that if one party makes money on a transaction, the clearinghouse ensures it will be paid.
- Plain vanilla swap** An interest rate swap in which one party pays a fixed rate and the other pays a floating rate, with both sets of payments in the same currency.
- Position trader** A trader who typically holds positions open overnight.
- Potential credit risk** The risk associated with the possibility that a payment due at a later date will not be made.
- Pre-investing** The strategy of using futures contracts to enter the market without an immediate outlay of cash.
- Present (price) value of a basis point (PVBP)** The change in the bond price for a 1 basis point change in yield. Also called *basis point value* (BPV).
- Price discovery** A feature of futures markets in which futures prices provide valuable information about the price of the underlying asset.
- Price limits** Limits imposed by a futures exchange on the price change that can occur from one day to the next.
- Protective put** An option strategy in which a long position in an asset is combined with a long position in a put.
- Put** An option that gives the holder the right to sell an underlying asset to another party at a fixed price over a specific period of time.
- Put-call parity** An equation expressing the equivalence (parity) of a portfolio of a call and a bond with a portfolio of a put and the underlying, which leads to the relationship between put and call prices.
- Put-call-forward parity** The relationship among puts, calls, and forward contracts.
- Ratio spread** An option strategy in which a long position in a certain number of options is offset by a short position in a certain number of other options on the same underlying, resulting in a risk-free position.
- Receiver swaption** A swaption that allows the holder to enter into a swap as the fixed-rate receiver and floating-rate payer.
- Regulatory risk** The risk associated with the uncertainty of how derivative transactions will be regulated or with changes in regulations.
- Replacement value** The market value of a swap.
- Rho** The sensitivity of the option price to the risk-free rate.
- Risk budgeting** The establishment of objectives for individuals, groups, or divisions of an organization that takes into account the allocation of an acceptable level of risk.
- Risk governance** The setting of overall policies and standards in risk management.
- Risk management** The process of identifying the level of risk an entity wants, measuring the level of risk the entity currently has, taking actions that bring the actual level of risk to the desired level of risk, and monitoring the new actual level of risk so that it continues to be aligned with the desired level of risk.
- Risk-neutral probabilities** Weights that are used to compute a binomial option price. They are the probabilities that would apply if a risk-neutral investor valued an option.

- Risk-neutral valuation** The process by which options and other derivatives are priced by treating investors as though they were risk neutral.
- Sandwich spread** An option strategy that is equivalent to a short butterfly spread.
- Scalper** A trader who offers to buy or sell futures contracts, holding the position for only a brief period of time. Scalpers attempt to profit by buying at the bid price and selling at the higher ask price.
- Scenario analysis** A risk management technique involving the examination of the performance of a portfolio under specified situations. Closely related to *stress testing*.
- Seats** Memberships in a derivatives exchange.
- Settlement date or payment date** The date on which the parties to a swap make payments.
- Settlement period** The time between settlement dates.
- Settlement price** The official price, designated by the clearinghouse, from which daily gains and losses will be determined and marked to market.
- Settlement risk** When settling a contract, the risk that one party could be in the process of paying the counterparty while the counterparty is declaring bankruptcy.
- Short** The seller of a derivative contract. Also refers to the position of being short a derivative.
- Single-payment loan** A loan in which the borrower receives a sum of money at the start and pays back the entire amount with interest in a single payment at maturity.
- Spread** An option strategy involving the purchase of one option and sale of another option that is identical to the first in all respects except either exercise price or expiration.
- Storage costs or carrying costs** The costs of holding an asset, generally a function of the physical characteristics of the underlying asset.
- Straddle** An option strategy involving the purchase of a put and a call with the same exercise price. A straddle is based on the expectation of high volatility of the underlying.
- Strangle** A variation of a straddle in which the put and call have different exercise prices.
- Strap** An option strategy involving the purchase of two calls and one put.
- Stress testing** A risk management technique in which the risk manager examines the performance of the portfolio under market conditions involving high risk and usually high correlations across markets. Closely related to *scenario analysis*.
- Strip** An option strategy involving the purchase of two puts and one call.
- Structured note** A variation of a floating-rate note that has some type of unusual characteristic such as a leverage factor or in which the rate moves opposite to interest rates.
- Swap** An agreement between two parties to exchange a series of future cash flows.
- Swap spread** The difference between the fixed rate on an interest rate swap and the rate on a Treasury note with equivalent maturity; it reflects the general level of credit risk in the market.
- Swaption** An option to enter into a swap.
- Synthetic call** The combination of puts, the underlying, and risk-free bonds that replicates a call option.
- Synthetic forward contract** The combination of the underlying, puts, calls, and risk-free bonds that replicates a forward contract.
- Synthetic index fund** An index fund position created by combining risk-free bonds and futures on the desired index.
- Synthetic put** The combination of calls, the underlying, and risk-free bonds that replicates a put option.
- Tax risk** The uncertainty associated with tax laws.
- Tenor** The original time to maturity on a swap.
- Termination date** The date of the final payment on a swap; also, the swap's expiration date.
- Theta** The rate at which an option's time value decays.
- Time to expiration** The time remaining in the life of a derivative, typically expressed in years.
- Time value decay** The loss in the value of an option resulting from movement of the option price toward its payoff value as the expiration day approaches.
- Time value or speculative value** The difference between the market price of the option and its intrinsic value, determined by the uncertainty of the underlying over the remaining life of the option.
- Total return swap** A swap in which one party agrees to pay the total return on a security. Often used as a credit derivative, in which the underlying is a bond.
- Tracking error** The condition in which the performance of a portfolio does not match the performance of an index that serves as the portfolio's benchmark.
- Transaction exposure** The risk associated with a foreign exchange rate on a specific business transaction such as a purchase or sale.
- Translation exposure** The risk associated with the conversion of foreign financial statements into domestic currency.
- Underlying** An asset that trades in a market in which buyers and sellers meet, decide on a price, and the seller then delivers the asset to the buyer and receives payment. The underlying is the asset or other

derivative on which a particular derivative is based. The market for the underlying is also referred to as the spot market.

Valuation The process of determining the value of an asset or service.

Value The amount for which one can sell something, or the amount one must pay to acquire something.

Value at risk (VAR) A probability-based measure of loss potential for a company, a fund, a portfolio, a transaction, or a strategy over a specified period of time.

Variation margin Additional margin that must be deposited in an amount sufficient to bring the balance up to the initial margin requirement.

Vega The relationship between option price and volatility.

Yield beta A measure of the sensitivity of a bond's yield to a general measure of bond yields in the market that is used to refine the hedge ratio.

Yield spread The difference between the yield on a bond and the yield on a default-free security, usually a government note, of the same maturity. The yield spread is primarily determined by the market's perception of the credit risk on the bond.

Zero-cost collar A transaction in which a position in the underlying is protected by buying a put and selling a call with the premium from the sale of the call offsetting the premium from the purchase of the put. It can also be used to protect a floating-rate borrower against interest rate increases with the premium on a long cap offsetting the premium on a short floor.

INDEX

A

- Accounting risk, 607-608, 635
- Add-on interest, 34, 635
- American option(s), 162, 163, 413
 - binomial model and, 211
 - credit risk and, 593
 - definition, 635
 - early exercise of, 192-193
 - on forward and futures contracts, 233
 - lower bounds, 181, 184
 - model risk and, 605-606
 - swaption and, 537, 541-543
- Amortizing and accreting swaps, 305, 635
- Analytical or variance-covariance method for estimating VAR, 578-582, 613
- Arbitrage, 16-19, 342
 - box spread and, 447
 - convenience yield and pricing futures contracts, 113
 - covered interest, 58
 - definition, 635
 - futures and options link, 173
 - one-period binomial and, 198-199
 - opportunity for, 16-17, 19
 - points, 19
 - pricing currency futures and, 135
 - pricing futures contracts and, 107, 108, 109
 - regulatory risk and, 606
 - strategies for put-call parity, 190-192
- Arrears swap, 305, 635
- Asset allocation with futures, 369-378
 - adjusting among classes, 370-376
 - preinvesting in asset class, 376-378
- At the money, 164, 167, 635

B

- Backwardation, 115, 141
 - definition, 635
 - normal, 116
- Bank for International Settlements, 11-12
 - credit derivatives usage survey by, 604
 - on notional principal of global over-the-counter derivatives market, 270
 - on swaps percentage of market, 507
- Bankruptcy
 - credit risk of forward contracts and, 592
 - creditor's claims and, 589

- default causing, 591
 - managing risk and, 571, 572
 - netting and, 597
 - remaining in business after, 595
 - risk governance and, 610
 - settlement risk and, 606
 - subsidiary when parent company declares, 598
- Basis point value, 348, 635
 - Basis swap, 279, 304, 635
 - Bear spread, 433-436
 - definition, 635
 - profit from, 482
 - Beta, 356-357
 - definition, 635
 - duration versus, 357
 - equity portfolio and adjusting, 358-361, 369
 - market risk and, 574
 - measuring, 387
 - Binomial model, 195-212, 241
 - American options, 211
 - bond valuation and, 309
 - definition, 635
 - extending, 211-212
 - interest rate option pricing, 205-211
 - one-period, 195-200, 241
 - put option pricing, 204-205
 - two-period, 200-204, 241
 - vega from, 480
 - Binomial tree, 241
 - American options and, 211
 - definition, 635
 - example, 195-196, 200
 - interest rate type, 206
 - more than two time periods type, 205
 - BIS. See Bank for International Settlements
 - Black model, 233-235, 242
 - Black-Scholes-Merton model and, 234
 - bond valuation and, 309
 - interest rate options and applications of, 235-238
 - Black-Scholes-Merton model, 212-228, 241, 242, 414
 - assumptions, 212-213
 - binomial model versus, 195
 - Black model and, 234
 - bond valuation and, 309

- cash flows in underlying effect, 224-225
 - estimating historical volatility, 226-227
 - European options and, 213
 - exercise price, 220
 - formula, 213-216, 441
 - inputs to, 216-224
 - normal probability distribution, 214-215
 - risk usage, 605-606
 - risk-free rate, 220-221
 - rounding errors and, 215
 - time to expiration, 222-223
 - underlying price, 216-220, 428
 - vega from, 480
 - volatility role, 223-224, 225-228
- Bond option(s), 169-170, 635
 - Bond portfolio risk, managing, 347-355
 - bond futures versus, 349-351
 - government type of, 351-354
 - measuring risk, 347-349
 - measuring risk of bond futures and, 349
 - variations and problems, 354-355
 - Box spread, 447-449, 482-483
 - definition, 635
 - profit from, 448, 483
 - reasons to use, 447
 - value at expiration, 447, 448, 483
 - BPV. See Basis point value
 - Brokers definition. See Futures commission merchants
 - Bull spread, 430-433
 - collars and, 443
 - definition, 635
 - profit from, 482
 - Butterfly spread, 436-440
 - definition, 635
 - profit from, 482
 - sandwich spread and, 439
 - value at expiration illustration, 438
 - volatility in underlying, 439, 444

C

- Call(s), 415-419
 - adding feature in noncallable debt, 547-550, 553
 - combined with puts, 440-449
 - covered, 422-426, 441
 - definition, 635
 - long, 422

- option and, 6, 161, 173
 - profit from buying, 481
 - removing feature in callable debt, 544–547, 553
 - short, 422
 - Callable bond
 - definition, 544
 - swaption to sell, 544–550
 - Cap
 - definition, 172, 239, 460, 635, 638
 - floor versus, 464
 - Caplet, 172, 235, 237, 239, 460–463
 - definition, 635
 - exercise rate on, 460
 - payoff of, 483
 - Capped swap, 305, 635
 - Carrying costs, 109, 641
 - Cash flow at risk, 588, 635
 - Cash price, 2, 635
 - Cash settlement, 26
 - definition, 635
 - forward contract, 591
 - futures contracts and, 92
 - options and, 161
 - CBOT. *See* Chicago Board of Trade
 - Centralized risk management, 610, 611, 635–636
 - CFAR. *See* Cash flow at risk
 - CFTC. *See* Commodity Futures Trading Commission
 - Cheapest to deliver (bond), 100, 101
 - definition, 636
 - determining, 127–128
 - futures contract and, 349
 - Cherry-picking, 597, 636
 - Chicago Board of Trade, 83
 - Clearinghouse
 - clearing firms and, 94
 - daily settlement, 88
 - definition, 636
 - futures exchange and, 4, 82, 85, 86, 91–92, 140
 - margin setting by, 87
 - options and, 167–168
 - Closeout netting, 597, 636
 - CMT. *See* Constant maturity treasury
 - CMT swap. *See* Constant maturity swap
 - Collar(s), 172, 429, 440–444
 - bull spreads versus, 443
 - definition, 636
 - interest rate, 443
 - profit from, 482
 - zero-cost, 441, 443
 - Collateral and credit risk reduction, 596–597
 - Commodity forward(s), 37, 636
 - Commodity futures, 95
 - definition, 636
 - most active, 96
 - Commodity Futures Trading Commission, 85, 173, 354
 - Commodity option(s), 174, 636
 - Commodity swap(s), 270, 285, 506, 636
 - Companywide risk management definition, 635–636
 - Constant maturity swap, 304, 305, 636
 - Constant maturity treasury definition, 636
 - Contango, 115, 141
 - definition, 636
 - normal, 116
 - Contingent claims, 6–8, 636
 - Continuous time, 195
 - definition, 636
 - options pricing. *See* Black–Scholes–Merton model
 - Convenience yield
 - definition, 636
 - pricing futures contracts and, 111–113
 - Conversion factor, 100, 636
 - Convexity, 574
 - Cost of carry, 112
 - definition, 636
 - formula for stock index futures, 130
 - Cost of carry model, 112, 116, 636
 - Covariance, 356–357
 - definition, 636
 - estimating VAR, 578–582, 613
 - Covered call(s), 422–426
 - collar and, 441
 - definition, 636
 - profit from, 482
 - Covered interest arbitrage, 58, 636
 - Credit at risk, 598, 636
 - Credit derivatives, 599–604, 614
 - definition, 636
 - insurance versus, 600
 - market size of, 604
 - types, 600–603, 614
 - Credit risk, 106
 - collateral and reduction of, 596–597
 - controlling, 614
 - credit standards (minimum) and derivative product companies (enhanced) and reduction of, 597–599
 - current, 311, 589
 - definition, 636
 - dimensions of, 614
 - forward contracts and, 27–28, 61–63, 591–592, 614
 - Group of 30 on measurement and management of, 617–618
 - insurance and, 599–600
 - limiting exposure and reduction of, 595
 - managing, 588–604
 - marking to market and reduction of, 595–596
 - netting and reduction of, 597
 - option pricing theory and, 589–591
 - of options, 593–595, 614
 - potential, 311, 589
 - swaps and, 311–314, 318, 592–593, 614
 - techniques for managing, 595–599
 - traditional notions of, 588–595
 - value at risk and, 598, 614
 - Credit spread option, 602–603, 614, 636
 - Credit swap(s), 600–601, 614, 636
 - Credit VAR, 598, 599, 636
 - Credit-linked notes, 603–614, 636
 - Cross-product netting, 597, 636
 - Currency forward contracts, 36–37
 - pricing and valuation formulas for, 59–60
 - pricing and valuation of, 56–61, 135
 - Currency forward hedge, 37
 - Currency futures
 - contracts, 102–103
 - pricing, 135–137
 - Currency option(s), 165, 172–173, 636
 - Currency risk. *See* Foreign currency risk, managing
 - Currency swap(s), 271, 274–278, 315–316, 506
 - converting foreign cash receipts into domestic currency, 523–524, 552
 - converting loan in one currency to loan in another currency, 519–523, 551
 - to create and manage risk of dual-currency bond, 525–527
 - credit risk and, 312, 318, 593, 595
 - currency options and, 165
 - dealers in, top, 273
 - definition, 636
 - exchange rate risk managed by using, 519–527
 - fixed rates on, 317
 - interest rate swap versus, 521
 - payments, 593
 - payments calculation, 316
 - pricing and valuation, 294–299
 - types, 294
 - uses, 523
 - Current credit risk, 311, 589, 614, 636
- ## D
- Daily settlement. *See* Marking to market
 - Day trader, 94, 637
 - Dealer strategies for hedging, 470–480, 483
 - Dealers and legal risk, 607
 - Decentralized risk management, 610, 637
 - Deep in the money, 167, 637
 - Deep out of the money, 167, 637
 - Default risk. *See also* Credit risk
 - bilateral, 593
 - definition, 636
 - forward contracts and, 4, 27
 - future contracts and, 4
 - over-the-counter instruments and, 271
 - swaps and, 271, 272
 - Default VAR, 598, 636
 - Delivery, 26
 - definition, 637
 - futures contract and, 92
 - Delivery option, 93, 140, 637

- Delta, 217-219, 241, 470-471, 484
 bonds and, 574
 definition, 194, 241-242, 470, 637
 effect of time on, 473-474
 gamma and risk of, 479
 option risk sensitivity and, 473
 risk and, 574, 575
 risk measurement and, 217
- Delta hedge, 218, 242, 470-472, 483
 definition, 637
 example, 471
 option over time using, 472-479
 short options position example, 475-476
 volatility and, 480
- Delta-normal method, 582, 637
- Derivative(s)
 classification of, 7
 definition, 2, 637
 global exchanges of, 9
 life of, 2
 pricing principles of, elementary, 16-20
 top dealers per *Risk* magazine, 29-30
 transaction costs, 15, 388
 types, 2
- Derivative markets
 criticisms of, 15-16
 instruments and, 1-24
 introduction, 1-2
 key points, 20
 measuring, 10-13
 past and present, 8-10
 purposes, 13-15
 size, 10-13
 types of, 2
- Derivatives dealers, 10, 637
- Diff swaps, 305, 637
- Discount interest, 33, 637
- Discrete time, 195, 637
- Diversification
 concentrated portfolio and, 528-530, 552
 international, 530-531, 552
- Dual-currency bond, using swaps to create
 and manage risk of, 525-527, 552
- Duration, 347-349
 beta versus, 357
 definition, 637
 dollar-implied modified, 357, 389
 fixed-rate loan and, 551
 floating-rate bond and, 509-510
 implied, 349
 interest-rate swap and, 551
 measuring, 387
 modified, 355, 389
 portfolio, 508
 risk and, 574
 swaps and, 510, 512
- Dynamic hedging, 218, 637
- E**
- e-trading, 10, 84, 85-86
 futures exchanges and, 94, 95, 139
 options and, 167
- EAR. See Earnings at risk
- Earnings at risk, 588, 637
- Economic exposure, 379, 637
- EDPC. See Enhanced derivatives products
 companies
- EFP. See Exchange for physicals
- Electronic trading. See e-trading
- Enhanced derivatives products companies
 credit risk reduction and, 597-599
 definition, 637
- Enterprise risk management, 611, 637
- Equitizing cash, 364-366, 637
- Equity forward
 basis for, 30-32
 definition, 30, 637
 dividends effect on, 32
 pricing and valuation formulas, 48-49
 pricing and valuation of, 45-50
- Equity market risk, managing, 343
 achieving international diversification,
 530-531
 changing asset allocation between stocks
 and bonds, 532-535
 creating cash out of equity, 366-369
 creating equity out of cash, 361-366
 diversifying a concentrated portfolio,
 528-530
 insider exposure, reducing, 535-537
 measuring, 356-358
 portfolio, 358-361
 strategies and applications, 356-369,
 527-537
- Equity options, 169, 637
- Equity portfolios, option strategies for,
 413-449
 bear spreads, 433-436
 box spreads, 447-449
 bull spreads, 430-433
 butterfly spreads, 436-440
 calls, 415-419
 collars, 440-444
 combination of calls and puts, 440-449
 covered calls, 422-426
 money spreads, 430-440
 protective puts, 426-429
 puts, 419-422
 standard long and short positions,
 415-422
 straddle, 444-447
- Equity swap, 270, 281-285, 506
 cash flow problems and, 552
 changing asset allocation between stocks
 and bonds, 532-535, 552
 credit risk and, 312, 318
 definition, 528, 637
 diversification using, 528-530, 552
 expiration date of, 528
 features, 281-282
 fixed rate on, 317
 insider exposure, reducing, 535-537
 international diversification using,
 530-531, 552
 payments calculation, 316
 pricing and valuation, 299-303
 types of, 299, 316
- Eurodollar, 34
 definition, 637
 futures, 11, 84, 98-99
 pricing futures and, 124-125
 time deposits, 34
- European option(s), 162, 163, 239, 413
 Black model for pricing of, 233-235
 Black-Scholes-Merton model and, 213,
 222
 credit risk and, 593
 definition, 637
 lower bounds, 181, 184
 model risk and, 605-606
- Exchange for physicals, 93-94, 637
- Exchange rate risk, strategies and
 applications for managing, 519-527
 converting foreign cash receipts into
 domestic currency, 523-524
 converting loan in one currency to loan
 in another currency, 519-523
 currency swaps use to create and man-
 age risk of dual-currency bond,
 525-527
- Exchange-traded contracts, 2, 414, 470, 588
- Exercise (exercising) the option, 161
 American-style, 162
 definition, 627
 European style, 162
- Exercise price, 6, 161, 216, 220
 collars and, 441
 definition, 637
 spreads and, 430
 swaptions and, 537
- Exercise rate, 170, 171
 definition, 637
 swaptions and, 537
- Exercise value, 178, 639
- Expiration date, 271
 definition, 637
 options, 161
- F**
- FCMs. See Futures commission merchants
- Fiduciary call
 definition, 637
 as option strategy, 187-188, 190, 240
- Financial futures, 95
 definition, 638
 most active, 96
- Financial risks, 570, 572, 612
- Fixed-income forward
 definition, 638
 pricing and valuation of, 50-51
- Fixed-income portfolio, using swaps to
 adjust duration of, 512-514
- Fixed-income swaps, 533

- Floating-rate loan, 171, 172, 288
 definition, 638
 for interest rate cap with, 460-464
 for interest rate collar with, 466-470
 for interest rate floor with, 464-466
 for interest rate swaps to fixed-rate loan to, 508-511, 551
 managing interest rate risk on, 346-347
- Floor(s), 172, 239, 464
 cap versus, 464
 definition, 638
- Floor traders, 94, 638
- Floor-based trading. *See* Pit trading
- Floored swap, 305, 638
- Floorlet, 172, 239, 464, 483, 638
- Foreign currency risk, managing, 343
 asset portfolio, foreign-market, 382-385
 forward contracts and, 386
 hedging and, 382-385, 390
 payment, 380-382, 390
 receipt, 379-380, 390
 strategies and applications for, 378-385
- Forward commitments, 2-6
- Forward contract(s), 25-79
 credit risk in, 27-28, 61-63, 591-592, 614
 currency, 36-37
 default and, 4
 default risk and, 27
 definition, 2, 3, 26, 638
 delivery and settlement of, 26-27
 feature of, important, 26
 futures contract versus, 3-5, 6, 63, 82, 85, 138, 385-387
 on individual bonds and bond portfolios, 33-34
 on individual stocks, 30-31
 on interest rates, 34-36
 key points about, 64-66
 liquidity, 388, 391
 to manage risk of foreign cash flow, 379-385
 place for, 3
 pricing and valuation formulas for, 43-44
 pricing and valuation of, 37-61
 pricing options on, 228-238
 process of pricing summary, 41
 put-call parity for options on, 229-233
 risk management. *See* Risk management applications of forward and futures strategies
 on stock indices, 32
 on stock portfolios, 31
 swaps versus, 5, 63, 506-507
 termination of, 27-28
 types, 3, 30-37
 valuing summary, 43
- Forward market(s)
 contracts and, 25-79
 introduction, 26-28
 key points about, 64-66
 regulation and, 3
 role of, 63
 structure of global types of, 28-30
 types, 30
- Forward price, 38
 definition, 638
 futures versus, 106-107
- Forward rate, 38, 638
- Forward rate agreement(s), 34-36
 definition, 3, 64, 638
 interest rate forwards as, 29
 interest rate options using, 170, 171
 interest rate swaps and, 316
 locking in rate on loan using, 344-345, 389
 managing interest rate risk of loan using, 344-347
 maturities, common, 36
 off-market, 41
 pricing and valuation of, 53-55
- Forward swap(s), 311, 318, 507, 550, 638
- FRA. *See* Forward rate agreement
- Futures commission merchants, 94, 638
- Futures contract(s), 3, 81-157
 asset allocation with, 369-378
 cash flows on underlying asset and pricing, 110-111
 closeout versus physical delivery versus cash settlement of, 93
 convenience yield and pricing, 111-113
 currency type of, 102-103
 default and, 4
 definition, 3, 82, 638
 delivery and cash settlement, 92-94
 determining value, 105-106
 expiration date setting, 84
 forward contracts versus, 3-5, 6, 63, 82, 85, 138, 385-387
 forward prices versus, 106-107
 global exchange-traded volume of, 11
 intermediate- and long-term interest rate type of, 99-101
 introduction, 82-85
 key points about, 139-142
 liquidity, 388, 391
 managing risk of equity portfolios and, 356-369
 marking to market and, 85
 most active, 96
 price at expiration, 104
 prices and expected spot prices, 115-116
 pricing and valuation of, 103-138
 pricing currency futures, 135-137
 pricing interest rate futures, 116-129
 pricing options on, 228-238
 pricing recap, 137-138
 pricing stock index futures, 129-134
 regulation of, 82, 85
 risk management. *See* Risk management applications of forward and futures strategies
 short-term interest rate type of, 97-99
 stock index type of, 101-102
 storage costs and pricing, 109-110
 swaps versus, 287
 trading, 85-86
 types, 95-103
 values before and after marking to market, 105
- Futures exchange(s), 2, 82, 84, 94-95
 clearinghouse and, 4, 82, 85
 contract characteristics determined by, 84
 definition, 3-4, 638
 members, 94
 world's leading, 95
- Futures markets
 history of, brief, 8, 83
 margins in, 86-87
 options on, 173-174
 price discovery and, 13-14
 role of, 138-139, 142
- FX swap, 274
- ## G
- G-30. *See* Group of 30
- Gamma, 194, 219-220, 242
 bonds and, 574
 definition, 638
 hedge, 479, 484
 risk and, 574, 575
 risk of delta and, 479
- Global derivatives exchanges, 9
- Global exchange-traded futures and options contract volume, 11
- Group of 30, 609, 610, 616-620
- ## H
- Hedge ratio, 196, 638
- Hedging, 14-15, 343, 568; *See also* Delta hedge
 amount of, 568
 currency risk, 382-385, 390
 dealer strategies for, 470-480, 483
 definition, 638
 Eurodollar futures and, 124
 market risks and, 574, 575
 options and, 14
 risk management and, 14, 569, 570, 571, 612
 speculation versus, 14
 for stabilizing income, 571
- Historical method
 advantages and disadvantages, 582, 613
 definition, 638
 for estimating value at risk, 582-584, 613
- Historical simulation method, 582, 583, 638
- Homogenization, 84-85, 638

- I**
- Implied discount rate, 118, 120
 - Implied repo rate, 119, 126, 141, 638
 - Implied volatility, 227–228, 638
 - Implied yield, 349, 389, 638
 - Index amortizing swap, 305, 638
 - Index option(s), 165, 167, 169
 - definition, 638
 - sizes, 167
 - Initial margin requirement, 87, 140, 638
 - Insider exposure reducing, 535–537
 - Installment options, 601
 - Interest rate call(s), 170, 172
 - for borrowing, 450–455
 - definition, 638
 - long position in, 483
 - payoff of, 450, 483
 - Interest rate cap, 172, 483
 - definition, 638
 - using with floating-rate loan, 460–464
 - Interest rate collar, 172, 443, 483
 - definition, 638
 - using with floating-rate loan, 466–470
 - Interest rate floor, 172, 483
 - definition, 638–639
 - using with floating-rate loan, 464–466
 - Interest rate option(s), 165, 170–172, 239, 450
 - Black model application, 235–238
 - definition, 639
 - leading dealers in, 165–166
 - strategies, 449–470
 - Interest rate parity, 58, 639
 - Interest rate put, 170, 172
 - definition, 639
 - long position in, 483
 - payoff of, 450, 483
 - using with lending, 455–460
 - Interest rate risk, 343
 - bond portfolio risk, 347–355
 - of loan using forward rate agreement, 344–347
 - strategies and applications for managing, 343–355, 507–518
 - Interest rate swap(s), 165, 270, 278–281, 506
 - to convert floating-rate loan to fixed-rate loan, 508–511
 - credit risk and, 312, 313, 318, 593
 - currency swaps versus, 521
 - dealers in, top, 273
 - definition, 639
 - duration obtaining, 551
 - fixed rate on, 317
 - forward rate agreements and, 316
 - notational principal and, 512, 551
 - payments calculation, 316
 - plain vanilla type, 279, 317
 - popularity of, 315
 - pricing and valuation of, 289–294
 - risk and, 507
 - structured note risk and, 551
 - swaptions and, 538–550
 - use of, 481
 - Interest rate swaption
 - for anticipation of future borrowing, 538–541, 552
 - for terminating a swap, 541–544, 552
 - International diversification, achieving, 530–531
 - International Monetary Market (IMM), 97, 98, 121, 173
 - In-the-money, 164, 167, 168, 186, 416, 593, 639
 - Intrinsic value, 178, 179, 239, 639
 - Inverse floater
 - definition, 639
 - swaps to create and manage risk of, 516–518
- K**
- Kappa, 223
- L**
- Law of one price, 17, 639
 - LEAPS. *See* Long-term equity anticipatory securities
 - Legal risk, 607, 612, 639
 - Leveraged floater, 514, 639
 - Leveraged floating-rate note(s)
 - definition, 639
 - swaps to create and manage risk of, 514–516
 - LIBOR. *See* London Interbank Offer Rate
 - Limit down, 91, 140, 639
 - Limit move, 91, 140, 639
 - Limit up, 91, 140, 639
 - Liquidity, 84–85, 388, 391
 - definition, 639
 - risk, 604–605, 615
 - Locals, 94
 - Locked limit, 91, 140, 639
 - London Interbank Offer Rate, 34
 - Black model and, 236
 - definition, 64, 639
 - Eurodollar futures and, 98, 99, 124
 - forward rate agreements and, 35, 36
 - interest rate options and, 170, 171, 172
 - swaps and payment at rate of, 509
 - Long, 26, 82, 389
 - definition, 639
 - standard positions, 415–422
 - Long-term equity anticipatory securities, 167, 639
 - Lower bound(s), 180–184, 192, 193, 240, 639
- M**
- Macaulay duration, 348, 639
 - Maintenance margin requirement, 88, 140, 639
- Margin(s)**
- balance determination, 140
 - definition, 639
 - futures markets and, 86–91, 139
 - requirements, 87
 - stock market versus futures market and, 87
- Market risk**
- beta as measure of, 574
 - data for, 576
 - definition, 574, 613, 639
 - Group of 30 on independent management of, 616–617
 - Group of 30 on measuring of, 616
 - managing, 574–588
 - sources, 575
 - traditional notions of, 574–576, 613
 - value at risk and. *See* Value at risk
 - volatility and, 573–574
- Marking to market**
- definition, 639
 - Eurodollar futures and, 99
 - example, 88–89
 - forward and futures prices and, 106, 107
 - forward contracts credit risk and, 63
 - forward versus futures contracts and, 4
 - futures contracts and, 63, 85, 86, 88, 91, 104, 105, 140, 351
 - Group of 30 on, 616
 - options and, 596
 - reducing credit risk by, 595–596
- Model risk, 605–606, 639**
- Modified duration, 348, 639**
- Modigliani–Miller (MM) propositions of corporate finance, 571**
- Moneyness, 542**
- definition, 639
 - of an option, 164, 239
- Monte Carlo simulation method**
- advantage and disadvantage, 613
 - definition, 639
 - for estimating value at risk, 584–586, 613
- N**
- National Futures Association (NFA), 85
 - NDFs. *See* Nondeliverable forwards
 - Netting, 271, 311, 312, 318, 509
 - definition, 639
 - Group of 30 on recognizing, 619
 - reducing credit risk with, 597, 614
 - settlement risk and, 606
 - Nondeliverable forwards, 27, 639
 - Normal backwardation, 116, 639
 - Normal contango, 116, 640
- O**
- Off-market forward rate agreement, 41, 640
 - Off-market swaps, 506
 - Offsetting, 86, 140
 - definition, 640
 - swaps, 272

- OIS. *See* Overnight index swap
- Operations risk, 605, 612, 640
- Option(s)
- binomial model, 195–212; *See also* Binomial model
 - bond, 169–170
 - boundary conditions, 179–184
 - characteristics of, basic, 161–162
 - commodity, 174
 - contingent claims as, 6–8
 - correlation as risk source for, 575
 - credit put, 603
 - credit risk in, 593–595, 614
 - credit spread, 602–603
 - currency, 165, 172–173
 - dealers in, 165–166
 - definition, 6, 161, 239, 640
 - discrete-time pricing, 195–212
 - equity, 169
 - examples of, 162–164
 - exercise price difference effect, 184–186
 - exercising, 6
 - exotic, 7
 - financial, 169–173
 - on futures, 173–174
 - hedging and, 14
 - index, 165, 167, 169
 - installment, 601
 - interest rate, 165, 170–172
 - interest rates and volatility effect on, 194
 - lower bounds, 180–184
 - minimum and maximum values, 180
 - miscellaneous types of, 174–175
 - moneyness of option concept, 164
 - nonlinear payoffs, 412
 - over-the-counter, 162
 - payoff values, 176–179
 - price sensitivities, 194
 - pricing principles, 163, 175–194
 - put–call parity, 187–192
 - real, 174–175
 - stock, 169
 - swaps versus, 287
 - time to expiration difference effect, 186–187
 - trading, 167–168
 - types, 6–7, 161, 168–175
- Option(s) markets, 159–267
- exchange listed, 166–168
 - introduction, 160–161
 - key points about, 239–242
 - over-the-counter, 164–168
 - role of, 238–239
 - structure of, 164–168
- Option portfolio risk management strategies, 470–480
- Option price, 6, 161, 640
- Option pricing theory and credit risk, 589–591
- Option premium, 6, 161, 640
- Option strategies risk management
- applications, 411–503
 - comments on, 480–481
 - for equity portfolios, 413–449
 - interest rate, 449–470
 - introduction, 412–413
 - key points about, 481–484
- Options Clearing Corporation (OCC), 167
- Options exchange, 2, 239
- Out-of-the-money, 164, 167, 168, 186, 187, 416, 640
- Over-the-counter contracts, 2, 5, 6, 595
- Over-the-counter derivatives market, 10
- Eurodollar futures and, 124
 - marking to market and, 595
 - measuring, 11, 12
 - size, 13
- Over-the-counter option, 162, 164–168, 271, 272, 541
- Overnight index swap, 305, 640
- P**
- Payer swaption, 306, 317, 507, 537, 538, 547, 640
- Payment date, 271, 641
- Payment netting, 597, 640
- Payoff
- definition, 640
 - linear, 412
 - nonlinear, 412
 - options and, 176–179, 239
- Performance guarantee, 85, 640
- Pit trading, 10, 85, 86
- future exchanges and, 94, 95, 139
 - options and, 167
- Plain vanilla swap, 316, 592
- definition, 279, 640
 - ease of understanding, 315
 - fixed rate determination, 312
 - hedging, 287
- Position trader, 94, 140, 640
- Potential credit risk, 311, 589, 640
- Pre-investing
- in asset classes, 376–378
 - definition, 640
- Premium, 161, 640
- Present (price) value of basis point, 348, 640
- Price discovery, 13–14, 640
- Price limits, 91, 140, 640
- Property of fat tails, 581
- Protective put(s), 426–429, 440
- collar and, 441
 - definition, 640
 - as insurance, 429
 - modifying, 429
 - as option strategy, 187, 188, 190
 - profit from, 482
 - purchase choices, 429
- Put(s), 419–422
- combined with calls, 440–449
 - definition, 640
 - long, 422
 - option as, 6, 161, 382
 - profit from buying, 481
 - protective, 426–429, 440, 441
 - short, 422
- Put and Call Brokers and Dealers Association, 164–165
- Put–call parity, 187–192, 240, 241
- definition, 640
 - laying off risk using, 470
 - for options on forwards, 229–233
- Put–call–forward parity, 230–231, 640
- PVBP. *See* Present (price) value of basis point
- R**
- Ratio spread, 476, 640
- Real option, 174–175
- Receiver swaption, 306, 507, 537, 538
- buying, 547–550
 - callable bond versus, 545
 - definition, 537, 640
 - interest rate type of, 552–553
 - selling, 544–547
- Regulatory risk, 606–607, 640
- Replacement value, 304, 640
- Rho, 194, 220–221, 241, 640
- Risk
- accounting, 607–608
 - aversion versus neutrality, 197
 - correlation and, 575
 - credit, 588–604
 - engaging in, 568–569
 - financial, 570, 572, 612
 - idiosyncratic, 357
 - legal, 607, 612
 - liquidity, 604–605
 - market, 574–588
 - measuring, 1
 - model, 605–606
 - nonfinancial, 570, 572, 599
 - nonsystematic, 357, 612
 - operations, 605, 612
 - pricing and measuring, 573–574
 - reducing, 1–2
 - regulatory, 606–607
 - settlement (Herstatt), 606
 - sources of, 570
 - systematic, 357
 - tax, 607
 - time elements of, 589
 - types, 570
- Risk budgeting, 611, 615, 640
- Risk governance, 610–611, 615, 640
- Risk management, 1, 15, 567–633
- activities of, 610–611
 - back-office personnel and, 611
 - bankruptcy and, 571, 572
 - best practices in, 608–611
 - centralized system of, 610

- concept of, 569–574
- credit derivatives and, 599–604
- credit risk and, 588–604; *see also* Credit risk
- decentralized system of, 610
- definition, 14, 569, 612, 640
- enterprise, 611
- firmwide, 611
- insurance and, 569, 599
- introduction, 568–569
- market risk and, 574–588; *see also* Market risk
- Modigliani–Miller propositions of corporate finance and, 571
- performance evaluation, 611
- process, 572–574, 613
- professional organizations devoted to, 612
- reasons for, 570–572
- rules for, 612
- Securities and Exchange Commission and, 586
- value at risk and, 576–588; *see also* Value at risk
- Risk management applications of forward and futures strategies, 341–409**
 - asset allocation with futures, 369–378
 - comments on, 387–389
 - equity market risk, managing, 356–369
 - foreign currency risk, managing, 378–385
 - futures versus forwards, 385–387
 - interest rate risk, managing, 343–355
 - introduction, 342–343
 - key points about, 389–391
- Risk management applications of options strategies, 411–503**
 - comments on, 480–481
 - for equity portfolios, 413–449
 - interest rate, 449–470
 - introduction, 412–413
 - key points about, 481–484
 - option portfolio, 470–480
- Risk management applications of swap strategies, 505–566**
 - conclusions about, 550
 - equity market, 527–537
 - exchange rate, 519–527
 - interest rate, 507–518
 - introduction, 506–507
 - key points about, 551–553
 - swaptions, 537–550
- Risk Standards Working Group, 609, 610, 621–623
- Risk-neutral probabilities, 197, 640
- Risk-neutral valuation, 197, 641
- S**
- Sandwich spread, 439, 641
- Scalper, 94, 140, 641
- Scenario analysis, 588, 641
- Seats, 94, 641
- Securities and Exchange Commission (SEC), 168, 173, 586
- Settlement date, 271, 641
- Settlement period, 271
 - definition, 641
 - equity swaps and, 282
- Settlement price, 88, 91, 641
- Settlement risk, 606, 641
- Sharpe ratio, 611
- Short, 26, 82
 - definition, 641
 - standard positions, 415–422
- Single-payment loan
 - definition, 641
 - managing interest rate risk on, 344–346
- Special purpose vehicles, 598, 637
- Speculation, 14
- Speculative value, 178, 641
- Spot price, 2, 14
 - definition, 635
 - futures prices and expected spot prices, 115–116
- Spread(s), 274, 429
 - bear, 433–436
 - box spread, 447–449
 - bull, 430–433, 443
 - butterfly, 436–440, 444
 - definition, 430, 641
 - money, 430–440
 - sandwich, 439
 - time, 430
- SPV. *See* Special purpose vehicles
- Storage costs, 109–110, 641
- Straddle, 444–447
 - definition, 641
 - profit from, 482
- Strangle, 446, 641
- Strap, 446, 641
- Stress testing, 588, 641
- Strike (striking) price, 161, 637
- Strike rate, 170, 637
- Strip, 446, 641
- Structured note(s), 508
 - definition, 514, 641
 - swaps usage to create and manage risk of, 514–518, 551
- Swap(s), 5–6; *see also* Currency swaps; Equity swaps; Interest rate swaps
 - assets and, 286, 316
 - characteristics, 270–271
 - commodity, 270, 285, 506
 - to create and manage risk of inverse floaters, 516–518
 - to create and manage risk of leveraged floating-rate notes, 514–516
 - credit, 600–601
 - credit risk and, 311–314, 318
 - credit risk in, 592–593, 614
 - dealers in, tip, 273
 - definition, 5, 270, 315, 506, 641
 - duration of, 510, 512
 - fixed-income portfolio duration adjustment using, 512–514
 - fixed-rate payer, 270
 - floating-rate payer, 270
 - forward, 311, 318, 507, 550
 - forward contracts versus, 5, 63, 286–287, 506–507
 - futures contracts versus, 287
 - introduction, 270–272
 - off-market, 506
 - offsetting, 272
 - options versus, 287
 - over-the-counter options market and, 165, 271, 272
 - plain vanilla, 279, 287, 312, 315, 316, 592, 640
 - pricing and valuation of, 285–304, 316, 507
 - regulatory oversight of, 5
 - risk management applications and strategies, 505–566
 - structured notes risk management and creation using, 514–518
 - swaption to terminate, 541–544
 - termination, 271–272, 315, 541–544
 - total return, 282, 601–602
 - types, 274–285, 506
 - variations of, 304–305
- Swap markets, 269–339
 - introduction, 270–272
 - key points about, 315–318
 - role of, 314–315
 - structure of, global, 272–273
- Swap spread, 312, 641
- Swaption(s), 272, 305–311
 - for anticipation of future borrowing, 538–541, 552
 - call features and, 544–550
 - cash flow from, 308
 - characteristics of, basic, 306
 - definition, 272, 305, 317, 507, 537, 641
 - embedded call and, 544
 - expiration dates, 306, 317, 538
 - market value at expiration, 318
 - payoffs, 307–309, 317
 - pricing and valuation of, 309–311
 - reason for, 317
 - strategies and applications using, 537–550
 - for terminating a swap, 541–544, 552
 - types, 306, 317, 507, 537
 - underlying, 537
 - use of, 306
- Synthetic call, 188–189, 190, 240, 641
- Synthetic cash creation, 367
- Synthetic dual-currency bond, 525
- Synthetic forward contract, 231, 641
- Synthetic index fund
 - construction example, 363–364
 - creating, 361–364
 - definition, 361, 641

Synthetic put, 189, 190, 240, 641
 Synthetically adding call feature in
 noncallable debt, 547-550, 553
 Synthetically removing call feature in
 callable debt, 545-547, 553

T

T-bills. *See* Treasury bills
 Tax risk, 607, 641
 TED spread, 304
 Tenor, 271, 641
 Termination date, 271, 641
 Theta, 194, 222-223, 241, 641
 Time to expiration
 Black-Scholes-Merton model and,
 222-223
 definition, 641
 options, 161
 spreads and, 430
 Time value, 178, 179, 239, 641
 Time value decay, 222, 641
 Total return swap, 601-602
 definition, 282, 641
 resemblance to other swaps, 533, 601,
 614
 Tracking error, 530, 641
 Transaction exposure, 379, 390, 641
 Translation exposure, 379, 390
 Treasury bills, 33
 futures, 97-98
 pricing formula for futures contract, 122

 pricing futures and, 117-122
 Treasury bonds, 33-34, 84, 93
 futures contract, 99-101
 futures pricing, 125-129
 futures pricing formulas, 129
 Treasury notes, 99, 101

U

Underlying (asset), 2
 cash flows and pricing futures contracts,
 110-111
 cash flows effect on, 193-194, 224-225
 definition, 641-642
 forward contract and, 3
 notational principal and, 12
 options on, 160, 161, 228
 risk management strategies with options
 and, 422-429
 storage costs and pricing futures con-
 tracts and, 109
 swaps, 271, 537
 volatility of, 14

V

Valuation definition, 642
 Value definition, 642
 Value at risk, 576-587, 613
 analytical or variance-covariance
 method for estimating, 578-582
 credit risk and, 598, 614
 criticism of, 587

 definition, 576, 642
 elements of, 576
 example of investment portfolio, 576,
 577
 good versus bad risk and, 586
 historical method for estimating,
 582-584, 613
 improvements and supplements to, 588
 measuring elements, 577-578
 methods for estimating, 578-586
 Monte Carlo simulation method for esti-
 mating, 584-586
 reporting example, 587
 time period for, 577
 VAR. *See* Value at risk
 Variation margin, 89, 642
 Vega, 194, 223-224, 241
 definition, 642
 risk management and, 480, 484,
 574-575
 volatility risk and, 575

Y

Yield beta, 350, 389
 beta versus, 356
 definition, 642
 Yield spread definition, 642

Z

Zero-cost collar, 172, 441, 443, 466, 470,
 642

ANALYSIS OF DERIVATIVES FOR THE CFA[®] PROGRAM: EQUATIONS

CHAPTER 2: Forward Markets and Contracts

- 2-1. Value of Forward Contract at Expiration

$$V_T(0,T) = S_T - F(0,T)$$

- 2-2. Forward Price

$$F(0,T) = S_0(1+r)^T$$

- 2-3. Value of Forward Contract During Its Life

$$V_t(0,T) = S_t - F(0,T)/(1+r)^{(T-t)}$$

- 2-4. Forward Price for Stock Paying Dividends Based on Present Value of Dividends

$$F(0,T) = [S_0 - PV(D,0,T)](1+r)^T$$

- 2-5. Forward Price for Stock Paying Dividends Based on Future Value of Dividends

$$F(0,T) = S_0(1+r)^T - FV(D,0,T)$$

- 2-6. Forward Price for Stock Paying Continuous Dividends

$$F(0,T) = (S_0 e^{-\delta T}) e^{rT}$$

- 2-7. Value of Forward Contract for Stock Paying Discrete Dividends

$$V_t(0,T) = S_t - PV(D,t,T) - F(0,T)/(1+r)^{(T-t)}$$

- 2-8. Value of Forward Contract for Stock Paying Continuous Dividends

$$V_t(0,T) = S_t e^{-\delta(T-t)} - F(0,T) e^{-r(T-t)}$$

- 2-9. Forward Price for Bond Paying Interest Based on Present Value of Coupons

$$F(0,T) = [B_0^c(T+Y) - PV(CI,0,T)](1+r)^T$$

- 2-10. Forward Price for Bond Paying Interest Based on Future Value of Coupons

$$F(0,T) = [B_0^c(T+Y)](1+r)^T - FV(CI,0,T)$$

- 2-11. Value of Forward Contract for Bond Paying Interest

$$V_t(0,T) = B_t^c(T+Y) - PV(CI,t,T) - F(0,T)/(1+r)^{(T-t)}$$

- 2-12. Payoff of FRA

$$\frac{[L_h(m) - FRA(0,h,m)] \left(\frac{m}{360} \right)}{1 + L_h(m) \left(\frac{m}{360} \right)}$$

2-13. FRA Rate

$$\text{FRA}(0, h, m) = \left[\frac{1 + L_0(h + m) \left(\frac{h + m}{360} \right)}{1 + L_0(h) \left(\frac{h}{360} \right)} - 1 \right] \left(\frac{360}{m} \right)$$

2-14. Value of FRA During Its Life

$$V_g(0, h, m) = \frac{1}{1 + L_g(h - g) \left(\frac{h - g}{360} \right)} - \frac{1 + \text{FRA}(0, h, m) \left(\frac{m}{360} \right)}{1 + L_g(h + m - g) \left(\frac{h + m - g}{360} \right)}$$

2-15. Forward Price for Currency Based on Discrete Interest

$$F(0, T) = \left[\frac{S_0}{(1 + r)^T} \right] (1 + r)^T$$

2-16. Forward Price for Currency Based on Continuous Interest

$$F(0, T) = (S_0 e^{-r^* T}) e^{r^* T}$$

2-17. Value of Forward Contract on Currency Based on Discrete Interest

$$V_t(0, T) = \frac{S_t}{(1 + r)^{T-t}} - \frac{F(0, T)}{(1 + r)^{T-t}}$$

2-18. Value of Forward Contract on Currency Based on Continuous Interest

$$V_t(0, T) = (S_t e^{-r^*(T-t)}) - F(0, T) e^{-r^*(T-t)}$$

CHAPTER 3: Futures Markets and Contracts

3-1. Futures Price at Expiration

$$f_T(T) = S_T$$

3-2. Value of Futures Contract at Initiation Date

$$v_0(T) = 0$$

3-3. Value of Futures Contract During Its Life

$$v_{t+}(T) = f_t(T) - f_{t-1}(T) \text{ an instant before the account is marked to market}$$

$$v_{t-}(T) = 0 \text{ as soon as the account is marked to market}$$

3-4. Futures Price When Underlying Has No Costs, Benefits, or Cash Flows

$$f_0(T) = S_0(1 + r)^T$$

3-5. Futures Price When Underlying Has Storage Costs

$$f_0(T) = S_0(1 + r)^T + \text{FV}(\text{SC}, 0, T)$$

3-6. Futures Price When Underlying Generates Positive Cash Flows

$$f_0(T) = S_0(1 + r)^T - \text{FV}(\text{CF}, 0, T)$$

3-7. Futures Price When Underlying Generates Costs Minus Benefits

$$f_0(T) = S_0(1 + r)^T + \text{FV}(\text{CB}, 0, T)$$

3-8. Treasury Bill Futures Price

$$f_0(h) = B_0(h + m)[1 + r_0(h)]^{h/365}$$

3-9. Implied Repo Rate for Treasury Bill Futures

$$r_0(h)^* = \left[\frac{f_0(h)^*}{B_0(h+m)} \right]^{365/h} - 1$$

3-10. Discount Rate Implied by Treasury Bill Futures Price

$$r_0^{df}(h) = [1 - f_0(h)] \left(\frac{360}{m} \right)$$

3-11. Treasury Note and Bond Futures Price

$$f_0(T) = B_0^c(T+Y)[1 + r_0(T)]^T - FV(CI,0,T)$$

3-12. Treasury Note and Bond Futures Price Based on Conversion Factor

$$f_0(T) = \frac{B_0^c(T+Y)[1 + r_0(T)]^T - FV(CI,0,T)}{CF(T)}$$

3-13. Stock Index Futures Price Based on Compound Value of Dividends

$$f_0(T) = S_0(1+r)^T - FV(D,0,T)$$

3-14. Stock Index Futures Price Based on Present Value of Dividends

$$f_0(T) = [S_0 - PV(D,0,T)](1+r)^T$$

3-15. Stock Index Futures Price Based on Discrete Dividend Yield: Variation 1

$$f_0(T) = \left(\frac{S_0}{(1+\delta)^T} \right) (1+r)^T$$

3-16. Stock Index Futures Price Based on Discrete Dividend Yield: Variation 2

$$f_0(T) = S_0(1-\delta^*)(1+r)^T$$

3-17. Stock Index Futures Price Based on Continuous Dividends

$$f_0(T) = (S_0 e^{-\delta^* T}) e^{r^* T}$$

3-18. Currency Futures Price Based on Discrete Interest

$$f_0(T) = \left(\frac{S_0}{(1+r^*)^T} \right) (1+r)^T$$

3-19. Currency Futures Price Based on Continuous Interest

$$f_0(T) = (S_0 e^{-r^* T}) e^{r^* T}$$

CHAPTER 4: Option Markets and Contracts

4-1. Payoff of Interest Rate Call

$$(\text{Notional Principal}) \text{Max}(0, \text{Underlying rate at expiration} - \text{Exercise rate}) \left(\frac{\text{Days in underlying rate}}{360} \right)$$

4-2. Payoff of Interest Rate Put

$$(\text{Notional Principal}) \text{Max}(0, \text{Exercise rate} - \text{Underlying rate at expiration}) \left(\frac{\text{Days in underlying rate}}{360} \right)$$

4-3. Value at Expiration (Payoff) of European and American Calls

$$c_T = \text{Max}(0, S_T - X)$$

$$C_T = \text{Max}(0, S_T - X)$$

4-4. Value at Expiration (Payoff) of European and American Puts

$$p_T = \text{Max}(0, X - S_T)$$

$$P_T = \text{Max}(0, X - S_T)$$

4-5. Minimum Values of European and American Calls and Puts

$$c_0 \geq 0, C_0 \geq 0$$

$$p_0 \geq 0, P_0 \geq 0$$

4-6. Maximum Values of European and American Calls

$$c_0 \leq S_0, C_0 \leq S_0$$

4-7. Maximum Values of European and American Puts

$$p_0 \leq X/(1+r)^T, P_0 \leq X$$

4-8. Lower Bounds (Intrinsic Values) of American Calls and Puts

$$C_0 \geq \text{Max}(0, S_0 - X)$$

$$P_0 \geq \text{Max}(0, X - S_0)$$

4-9. Lower Bounds of European and American Calls

$$c_0 \geq \text{Max}[0, S_0 - X/(1+r)^T]$$

$$C_0 \geq \text{Max}[0, S_0 - X/(1+r)^T]$$

4-10. Lower Bounds of European and American Puts

$$p_0 \geq \text{Max}[0, X/(1+r)^T - S_0]$$

$$P_0 \geq \text{Max}(0, X - S_0)$$

4-11. Relationship Between Prices of Calls of Different Expirations

$$c_0(T_2) \geq c_0(T_1)$$

$$C_0(T_2) \geq C_0(T_1)$$

4-12. Relationship Between Prices of Puts of Different Expirations

$p_0(T_2)$ can be either greater or less than $p_0(T_1)$

$$P_0(T_2) \geq P_0(T_1)$$

4-13. Put-Call Parity for European Options

$$c_0 + X/(1+r)^T = p_0 + S_0$$

4-14. Relationship Between American and European Call and Put Prices

$$C_0 \geq c_0$$

$$P_0 \geq p_0$$

4-15. Hedge Ratio for Binomial Model

$$n = \frac{c^+ - c^-}{S^+ - S^-}$$

4-16. European Call Prices in One-Period Binomial Model

$$c = \frac{\pi c^+ + (1 - \pi)c^-}{1 + r}$$

4-17. Risk-Neutral (Binomial) Probability

$$\pi = \frac{1 + r - d}{u - d}$$

4-18. European Call Prices at Time 1 in Two-Period Binomial Model

$$c^+ = \frac{\pi c^{++} + (1 - \pi)c^{+-}}{1 + r}$$

4-19. European Call Prices at Time 2 in Two-Period Binomial Model

$$c^- = \frac{\pi c^{-+} + (1 - \pi)c^{--}}{1 + r}$$

4-20. Hedge Ratios for Two-Period Binomial Model

$$n = \frac{c^+ - c^-}{S^+ - S^-}$$

$$n^+ = \frac{c^{++} - c^{+-}}{S^{++} - S^{+-}}$$

$$n^- = \frac{c^{-+} - c^{--}}{S^{-+} - S^{--}}$$

4-21. Black-Scholes-Merton Model for Calls and Puts

$$c = S_0 N(d_1) - Xe^{-rT} N(d_2)$$

$$p = Xe^{-rT} [1 - N(d_2)] - S_0 [1 - N(d_1)]$$

4-22. d_1 and d_2 in Black-Scholes-Merton Model

$$d_1 = \frac{\ln(S_0/X) + [r + (\sigma^2/2)]T}{\sigma\sqrt{T}}$$

$$d_2 = d_1 - \sigma\sqrt{T}$$

4-23. Option Delta

$$\text{Delta} = \frac{\text{Change in option price}}{\text{Change in underlying price}}$$

4-24. Payoffs of Options on Futures

$$c_T = \text{Max}[0, f_T(T) - X]$$

$$p_T = \text{Max}[0, X - f_T(T)]$$

4-25. Minimum and Maximum Prices of European and American Options on Futures

$$0 \leq c_0 \leq f_0(T)$$

$$0 \leq C_0 \leq f_0(T)$$

$$0 \leq p_0 \leq X/(1 + r)^T$$

$$0 \leq P_0 \leq X$$

4-26. Lower Bounds of European Options on Futures

$$c_0 \geq \text{Max}\{0, [f_0(T) - X]/(1 + r)^T\}$$

$$p_0 \geq \text{Max}\{0, [X - f_0(T)]/(1 + r)^T\}$$

4-27. Lower Bounds (Intrinsic Values) of American Options on Futures

$$C_0 \geq \text{Max}\{0, f_0(T) - X\}$$

$$P_0 \geq \text{Max}\{0, X - f_0(T)\}$$

4-28. Put-Call Parity for Options on Forward Contracts

$$c_0 + [X - F(0, T)]/(1 + r)^T = p_0$$

CHAPTER 5: Swap Markets and Contracts

5-1. Fixed Rate on Interest Rate Swap

$$FS(0, n, m) = \frac{1.0 - B_0(h_n)}{\sum_{j=1}^n B_0(h_j)}$$

5-2. Market Value of Equity Swap During Its Life

$$\left(\frac{S_t}{S_0}\right) - B_t(h_n) - FS(0, n, m) \sum_{j=1}^n B_t(h_j)$$

5-3. Payoff of Payer Swaption

$$\text{Max}[0, FS(0, n, m) - x] \sum_{j=1}^n B_0(h_j)$$

5-4. Payoff of Receiver Swaption

$$\text{Max}[0, x - FS(0, n, m)] \sum_{j=1}^n B_0(h_j)$$

CHAPTER 6: Risk Management Applications of Forward and Futures Strategies

6-1. Sensitivity of Futures Price to Yield Change

$$\Delta f = -\text{MDUR}_f \Delta y_f$$

6-2. Sensitivity of Bond Yield to Implied Yield on Bond Futures

$$\Delta y_B = \beta_y \Delta y_f$$

6-3. Hedge Ratio for Bond Futures

$$N_f = -(\text{MDUR}_B / \text{MDUR}_f)(B/f)\beta_y$$

6-4. Number of Bond Futures to Adjust Duration

$$N_f = \left(\frac{\text{MDUR}_T - \text{MDUR}_B}{\text{MDUR}_f}\right) \left(\frac{B}{f}\right) \beta_y$$

6-5. Number of Stock Index Futures to Adjust Beta

$$N_f = \left(\frac{\beta_T - \beta_S}{\beta_f}\right) \left(\frac{S}{f}\right)$$

6-6. Number of Stock Index Futures to Create Synthetic Index Fund

$$N_f^* = \frac{V(1+r)^T}{qf} \quad (\text{rounded to an integer})$$

6-7. Effective Amount Invested in Synthetic Index Fund Using Futures

$$V^* = \frac{N_f^* qf}{(1+r)^T}$$

6-8. Effective Amount of Stock Converted to Cash Using Futures

$$V^* = \frac{-N_f^* qf}{(1+r)^T}$$



ANALYSIS OF DERIVATIVES FOR THE CFA[®] PROGRAM

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