**Derivative securities**

Financial derivatives are so effective in reducing risk because they enable financial institutions to **hedge**; that is, engage in a financial transaction that reduces or eliminates risk. When a financial institution has bought an asset, it is said to have taken a **long position**, and this exposes the institution to risk if the returns on the asset are uncertain. On the other hand, if it has sold an asset that it has agreed to deliver to another party at a future date, it is said to have taken a **short position**, and this can also expose the institution to risk. Financial derivatives can be used to reduce risk by invoking the following basic principle of hedging: ***Hedging risk involves engaging in*** ***a financial transaction that offsets a long position by taking an additional short*** ***position, or offsets a short position by taking an additional long position***.

Equity-derivative securities are securities that have a claim on the common stock of a firm. This would include:

* **Options**

This refers to rights (but not obligation) to buy or sell common stock at a specified price for a stated period of time. The two kinds of option instruments are

(1) Warrants and

(2) Puts and calls.

*Warrants*

A warrant is an option issued by a corporation that gives the holder the right to acquire a firm’s common stock from the company at a specified price within a designated time period. The warrant does not constitute ownership of the stock, only the option to buy the stock.

*Puts and Calls*

A call option is similar to a warrant because it is an option to buy the common stock of a company within a certain period at a specified price called the striking price. A call option differs from a warrant because it is not issued by the company but by another investor who is willing to assume the other side of the transaction. Options also are typically valid for a shorter time period than warrants. The holder of a put option has the right to sell a given stock at a specified price during a designated time period. Puts are useful to investors who expect a stock price to decline during the specified period or to investors who own the stock and want protection from a price decline.

* **Forward and Futures Contracts**

Forward contracts are negotiated in the over-the-counter market. This means that forward contracts are agreements between two private parties—one of which is often a derivatives intermediary, such as a commercial or an investment bank—rather than traded through a formal security or commodity exchange. One advantage of this private arrangement is that the terms of the contract are completely flexible; they can be whatever any two mutually consenting counterparties agree to. Another desirable feature to many counterparties is that these arrangements may not require *collateral;* instead, the long and short positions sometimes trust each other to honor their respective commitments at Date *T.* This lack of collateral means that forward contracts involve *credit* (or *default*) *risk,* which is one reason why commercial banks are often market makers in these instruments.

One disadvantage of a forward contract is that it is quite often *illiquid,* meaning that it might be difficult or costly for a counterparty to exit the contract before it matures. Illiquidity is really a by-product of the contract’s flexibility because the more specifically tailored an agreement is to the needs of a particular individual, the less marketable it will be to someone else. Futures contractssolve this problem by standardizing the terms of the agreement (e.g., expiration date, identity and amount of the underlying asset) to the extent that it can be exchange traded. In contrast to the forward market, both parties in a futures contract trade through a centralized market, called a *futures exchange.* Although the standardization of contracts reduces the ability of the ultimate end users to select the most desirable terms, it does create contract *homogeneity,* whereby the counterparties can always *unwind* a previous commitment prior to expiration by simply trading their existing position back to the exchange at the prevailing market price.

**INVESTMENT COMPANIES AND MUTUAL FUNDS**

The investment alternatives described so far are individual securities that can be acquired from a government entity, a corporation, or another individual. However, rather than directly buying an individual stock or bond issued by one of these sources, you may choose to acquire these investments indirectly by buying shares in an investment company, also called a mutual fund, that owns a portfolio of individual stocks, bonds, or a combination of the two. Specifically, an investment company sells shares in itself and uses the proceeds of this sale to acquire bonds, stocks, or other investment instruments. As a result, an investor who acquires shares in an investment company is a partial owner of the investment company’s portfolio of stocks or bonds. We will distinguish investment companies by the types of investment instruments they acquire.

* **Money Market Funds**

Money market funds are investment companies that acquire high quality, short-term investments (referred to as money market instruments), such as T-bills, high grade commercial paper (public short-term loans) from various corporations, and large CDs from the major banks.

Individuals tend to use money market funds as alternatives to bank savings accounts because they are generally quite safe (although they are not insured, they typically limit their investments to high-quality, short-term investments), they provide yields above what is available on most savings accounts, and the funds are readily available.

* **Bond (Fixed Income Securities) Funds**

Bond funds generally invest in various long-term government, corporate, or municipal bonds. They differ by the type and quality of the bonds included in the portfolio as assessed by various rating services. Specifically, the bond funds range from those that invest only in risk-free government bonds and high-grade corporate bonds to those that concentrate in lower rated corporate or municipal bonds, called high-yield bonds or junk bonds. The expected rate of return from various bond funds will differ, with the low-risk government bond funds paying the lowest returns and the high-yield bond funds expected to pay the highest returns.

* **Common Stock (Equity) Funds**

Numerous common stock funds invest to achieve stated investment objectives, which can include aggressive growth, income, precious metal investments, and international stocks. Such funds offer smaller investors the benefits of diversification and professional management.

* **Balanced Funds**

Balanced funds invest in a combination of bonds and stocks of various sorts depending on their stated objectives.

* **Index Funds**

Index funds are mutual funds created to equal the performance of a market index like the NSE 20 or the ASE. Such funds appeal to passive investors who want to simply experience returns equal to some market index either because they do not want to try to “beat the market” or they believe in efficient markets and do not think it is possible to do better than the market in the long run.

**REAL ESTATE**

Like commodities, most investors view real estate as an interesting and profitable investment alternative but believe that it is only available to a small group of experts with a lot of capital to invest. In reality, some feasible real estate investments require no detailed expertise or large capital commitments. Below are some low-capital alternatives.

* **Real Estate Investment Trusts (REITS)**

A real estate investment trust is an investment fund designed to invest in various real estate properties. It is similar to a stock or bond mutual fund, except that the money provided by the investors is invested in property and buildings rather than in stocks and bonds.

* **Direct Real Estate Investment**

The most common type of direct real estate investment is the purchase of a home, which is the largest investment most people ever make.

* **Raw Land**

Another direct real estate investment is the purchase of raw land with the intention of selling it in the future at a profit. During the time you own the land, you have negative cash flows caused by property maintenance, and taxes. An obvious risk is the possible difficulty of selling it for an uncertain price. Raw land generally has low liquidity compared to most stocks and bonds.

* **Land Development**

Land development can involve buying raw land, dividing it into individual lots, and building houses on it. Alternatively, buying land and building a shopping mall would also be considered land development. This is a feasible form of investment but requires a substantial commitment of capital, time, and expertise. Although the risks can be high because of the commitment of time and capital, the rates of return from a successful housing or commercial development can be significant.