Chapter 1

* 1. Exchange-traded markets

A derivatives exchange is a market where individuals trade standardized contracts that have been defined by the exchange.

Electronic Markets

Open outcry system

Electronic trading

* 1. Over-the-counter markets

It is a telephone- and computer- linked network of dealers. Trades are done over the phone and are usually between two financial institutions or between a financial institution and one of its clients (typically a treasurer or fund manager).

Market Size

* 1. Forward Contracts

It is an agreement to buy and sell an asset at a certain future time for a certain price. It can be contrasted with a spot contract, which is an agreement to buy and sell an asset today.

Payoffs from Forward Contracts

Forward Prices and Spot Prices

* 1. Futures Contracts

Like a forward contract, a futures contract is an agreement between two parties to buy or sell an asset at a certain time in the future for a certain price. Unlike forward contracts, futures contracts are normally traded on an exchange.

* 1. Options

Options are traded both on exchanges and in the over-the-counter market. There are two types of options. A call option gives the holder the right to buy the underlying asset by a certain date for a certain price. A put option gives the holder the right to sell the underlying asset by a certain date for a certain price.

* 1. Types of traders

Three broad categories of traders can be identified: hedgers, speculators, and arbitrageurs. Hedgers use derivatives to reduce the risk that they face from potential future movements in a market variable. Speculators use them to bet on the future direction of a market variable. Arbitrageurs take offsetting positions in two or more instruments to lock in a profit.

* 1. Hedgers
  2. Speculators
  3. Arbitrageurs
  4. Dangers