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Title: SLUGGISH WALL STREET IS RUSHING INTO 'DERIVATIVES'
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Abstract: With its traditional businesses on the skids, Wall Street is rushing headlong into the esoteric world of derivatives, which are customized securities designed to act a certain way when an underlying security, index or commodity moves in price.

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NEW YORK -- With its traditional businesses on the skids, Wall Street is rushing headlong into the esoteric world of derivatives.

Derivatives are not exactly stocks, not exactly bonds. They are customized securities designed to act a certain way when an underlying security, index or commodity moves in price.

Some derivatives, such as convertible bonds and currency swaps, have been around for years. But in their newest, most sophisticated forms, derivatives are tailor-made options that allow investors to play in several different markets at once without the hassle of passing through exchanges and incurring trading costs.

Derivatives may involve anything from international stocks and bonds to currencies, and oil, gold and other commodities. Earlier this year, investors rang up profits of 400% in a few months by buying Nikkei put warrants, a derivative product that allowed them to bet on a decline in the then-highflying Japanese stock market.

Using derivatives 'is different -- it's unique and it's better' than the traditional approach to investing, says Benjamin Weston, managing director at Credit Suisse Financial Products, the derivative-product subsidiary of Credit Suisse. 'It's the wave of the future,' he says.

It also is very profitable for the big commercial banks and brokerage firms that create and make markets in these investments. The most sophisticated products, such as 'exotic multi-exposure synthetics,' can produce returns on the money a Wall Street firm has at risk 'in the multiple hundreds of percent,' says Ramesh Menon, vice president, global proprietary trading, at County NatWest Ltd., an investment banking subsidiary of National Westminster Bank.

But such returns also come with some big risks. These investments are considered synthetic because the investor doesn't own a security at all. Often, all the derivatives represent is a private agreement between a broker and a customer, involving hundreds of millions of dollars and promises to pay months or years down the road, no matter what happens in the markets.

In effect, the whole derivative market is based on the market makers' ability to pass off their inventory risks to dozens of different parties, converting market risk to credit risk in the process. The worry is that one day, some number of parties in this complex web of obligations will fail, leaving the other players in the lurch.

'These things are traded as if there's no worry about people discharging their obligations,' says William F. Sharpe, Nobel laureate in economics and chairman of the investment advisory firm that bears his name. 'But there are three or four parties linked behind each product, and they bridge different tax and regulatory systems across countries.'

Derivative players can take a bath if they bet wrong. While the Nikkei warrants made big profits for investors when the Japanese stock market tanked early this year, they produced big losses for Japanese insurance companies and others who took the other side of these trades. (Most brokerage firms that sold the warrants, meanwhile, profited in their role as middlemen.)

Risks or no risks, derivatives are becoming a mainstream business for Wall Street, particularly at a time when traditional businesses, such as trading, underwriting and investment banking, are looking anemic.

'Synthetics are a big growth area, for sure,' says Martin Leibowitz, chairman of the research policy committee at Salomon Brothers Inc. 'Investors see respectable people they know are using them. It's becoming a credentialized product.'

Among the things investors like about derivatives is that they offer a versatile way to hedge investments. Because of their vast risk-management potential, enthusiasts say, derivatives will be for the loss-conscious 1990s what leverage and takeovers were for the go-go 1980s.

How do derivatives work? Last week, for example, Loyd Johnson, a portfolio manager at Advanced Investment Management, was anxious about a $100 million exposure his firm had to a single, thinly traded stock.

The first thing he considered was to hedge with the stock's listed options on the Chicago Board Options Exchange. But those were too scarce to satisfy his hedging needs. Finally, a Wall Street securities firm created over-the-counter options that suited his needs, matching the traded options' prices exactly.

The trade was far from riskless for the brokerage firm, however, which then was left to hedge its own exposure on the open market or through direct trades with clients. Meanwhile, Advanced Investment is counting on the dealer's ability to meet its promise when the customized options expire.

For derivative buyers, 'Ultimately, the stumbling block is the credit risk,' says Michael Granito, managing director at J.P. Morgan Investment Management. 'The only certainty you have that you'll actually get that [promised] return is the credit of the guy who sold it to you.'

Meanwhile, regulators have a tough time keeping tabs on the derivative market, because it spans securities, commodities and foreign-exchange markets across the globe, and involves not only securities firms, but banks, too. The rapid evolution and opaque, over-the-counter nature of derivative products make it almost impossible to gauge the real risks.

'We haven't been asleep at the switch,' says E. Gerald Corrigan, president of the Federal Reserve Bank of New York and a powerful market regulator. 'But getting your arms around these things can be extremely difficult.'

The banks and brokerage firms that make markets in derivatives express concern about less sophisticated, less wellheeled competitors coming into the business.

'If everyone were a triple-A credit, I wouldn't be so worried,' says James Healy, a Credit Suisse Financial managing director. 'But if something goes wrong, the whole business gets a black eye, and it's too valuable for everyone to get a black eye.'

The leading market makers insist they rigorously hedge their inventory of these products, so that they aren't vulnerable to market swings. 'We have put structures in place that we think alleviate these problems,' says Richard Stuckee, director of Salomon Brothers' hedge group.

For example, when a firm sells an option to one customer, it looks for another party on whom it can lay off its own risk. This was the case with most of the Nikkei put warrants sold to investors last winter by Salomon

Brothers, Bankers Trust Co., Goldman, Sachs & Co., and PaineWebber Group Inc. In addition, market makers may use collateral, such as bank letters of credit, to back the derivatives they sell.

Aside from hedging, derivatives also offer investors a way to venture into unfamiliar foreign markets at a lower cost -- and often lower risk -- than in using the conventional route.

'This is tantamount to dealing in asset exposures, rather than the assets themselves,' Salomon's Mr. Leibowitz says. 'When you're talking about assets that are costly to hold or trade -- where the . . . expenses are very high because of custodial, currency conversion and other costs -- this is a very attractive way to go.'