Investing 101: Derivatives

### Description

Derivates are, hands down, the riskiest investment vehicle on the market. Its value is derived from an underlying asset such as a bond, stock, or commodity. Derivates are extremely volatile, which is why only experienced investors should put money in derivatives.



Derivatives can trade on an exchange or over the counter (OTC). It can be used for speculation purposes or to hedge risks. Derivatives include options, future, rights, and warrants, just to list a few.

## All about derivatives

There are many types of derivatives, but the most popular one is an option. Options come in the form of calls and puts. As the name suggests, options give the buyer the right but not the obligation to exercise the call or put. Calls give the buyer the right to buy a security at a certain price on a certain date. Contrary to this are puts, which give buyers the right to sell a security at a certain price on a certain date.

If options were used to speculate, the option buyer would first determine which direction they expect the stock to move and by how much. They would then purchase a call for less than the anticipated price (which means they can sell at gain) or purchase a put for more than the anticipated price (which also means they can sell at a gain).

If options were used to minimize risk, the investor could purchase shares of a company and hedge this risk by buying a put on the stock. If the price of the stock increases, the investor will let the put expire and sell the stocks for a gain. If the price of the stock decreases, then the investor would exercise the put option, which gives them the right to sell at a predetermined price. This limits the losses.

The investor could also short a stock while buying call options. Shorting the stock occurs when the investor borrows shares from another party and sells it with the obligation of buying it back at a later date.

If the price decreases, then the investor can buy the shares back at a lower price and return it to the party they borrowed it from while letting the call option expire. If the price increases, the investor can exercise the call option, which gives them the ability to buy the shares at a fixed price, which minimizes their losses.

## An example

One of the more popular options to purchase are those of **Canopy Growth**. The options market is the most active for stocks that are widely traded.

On a list of options for Canopy Growth, there are several columns that include the strike price, last, bid, ask, and volume. The strike price is the agreed upon price, which the buyer has the right to sell (put) or to buy (call). The last column represents the last price that the option was traded for.

The bid price represents the highest price that people are willing to pay, and the ask price represents the lowest price people are willing to sell. The difference between the two is the bid-ask spread.

The volume column details the number of options that were traded on a specific day. Options are typically traded in lots of 100, which means one option gives you the right to buy or sell 100 shares of the stock at an agreed upon price.



## Bottom line

Derivatives are a beneficial financial instrument for hedging risk but are extremely difficult to understand. Thus, if you are interested in investing in derivatives, be sure to do thorough research beforehand, as there is an opportunity to lose a lot of money.

For those of you wondering how to use derivatives to hedge risk, I would recommend talking to your financial advisor to see how they can go about helping you protect your portfolio.

Overall, derivatives are good granted you know how to use it.

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