1/ Definition of Derivative

The term “derivative” refers to a type of financial contract whose value is dependent on an underlying asset, a group of assets, or a benchmark.

These contracts can be used to trade any number of assets and come with their own risks. Prices for derivatives derive from fluctuations in the prices of underlying assets. These financial securities are commonly used to access certain markets and may be traded to hedge against risk.

Key Takeaways

- Derivatives are financial contracts, set between two or more parties, that derive their value from an underlying asset, a group of assets, or a benchmark.
- A derivative can trade on an exchange or over the counter.
- Prices for derivatives derive from fluctuations in the prices of underlying assets.
- Derivatives are usually leveraged instruments, which increases their potential risks and rewards.

Understanding Derivatives

A derivative is a complex financial security that is set between two or more parties. Derivatives can take many forms, from stock and bond derivatives to economic indicator derivatives.

Traders may use derivatives to access specific markets and trade different assets. Typically, derivatives are considered a form of advanced investing. The most common underlying assets for derivatives are stocks, bonds, commodities, currencies, interest rates, and market indexes. Contract values depend on changes in the prices of the underlying asset—the primary instrument.

Derivatives can be used to hedge, speculate on the directional movement of an underlying asset, or leverage a position.

2/ Types of Derivatives

Derivatives today are based on a wide variety of underlying assets and have many uses, even exotic ones. For example, there are derivatives based on weather data, such as the amount of rain or the number of sunny days in a region.

- **Futures**

A futures contract, or simply futures, is an agreement between two parties for the purchase and delivery of an asset at an agreed-upon price at a future date. Futures are standardized contracts that trade on an exchange. Traders use futures to hedge their risk or speculate on the price of an underlying asset. The parties involved are obligated to fulfill a commitment to buy or sell the underlying asset.

- **Forwards**

Forward contracts, or forwards, are similar to futures, but they do not trade on an exchange. These contracts only trade over the counter. When a forward contract is created, the buyer and seller may customize the terms, size, and settlement process. As OTC products, forward contracts carry a greater degree of counterparty risk.

- **Swaps**

Swaps are another common type of derivatives, often used to exchange one kind of cash flow for another. For example, a trader might use an interest rate swap to switch from a variable interest rate loan to a fixed-interest-rate loan, or vice versa.

- **Options**

An options contract is similar to a futures contract in that it is an agreement between two parties to buy or sell an asset at a predetermined future date for a specific price. The key difference between options and futures is that with an option, the buyer is not obliged to exercise their agreement to buy or sell. It is an opportunity only, not an obligation, as futures are. As with futures, options may be used to hedge or speculate on the price of the underlying asset.