



# 73rd CFA Institute Annual Conference

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23 May 2013

## The Use, Misuse, and Abuse of Derivatives

By [Bud Haslett, CFA](#)



The dark side of derivatives is well known: Speculation and excessive risk can yield staggering losses. But not so well understood are the proper ways to use derivatives. Sell-side firms, such as financial institutions that sell derivatives to buy-side clients, identify a need and tailor a solution that is aligned with a client's interest. That is the proper way to create a derivatives hedge,

Bruno Dupire, Bloomberg's Head of Quantitative Research, told delegates at the 66th CFA Institute Annual Conference in Singapore. In his talk, Dupire provided much-needed guidance on how to extract value and avoid pain from the intricacies of the derivatives market.

"Good derivatives products represent an economic exchange that should benefit both parties and address economic exposures while optimally redistributing the risk between buyer and seller," he said. That ideal, of course, was something that was all too infrequent during much of the pre-crisis derivatives trading.

Diff... those on the buy side and the sell side complicate the outcomes. They hope to minimize these uncertainties by hedging a portion of their exposures with derivatives. A sell-side institution's risk exposure comes from selling derivatives to the client and the subsequent exposure to changes in the derivatives' prices due to market forces. These changes are commonly measured by the "Greeks," which indicate the derivatives' exposure and sensitivities to various risk factors, such as movement in market prices or changes in volatility levels. This inherent difference between views on risk exposures often leads to conflicting interests in derivatives transactions.

Does this differing view on risk permanently relegate derivatives to the "dark side"?

No, argued Dupire, who believes that by properly aligning a product to a need or a view — and having the proper tools to make informed decisions — both parties can benefit from the economic exchange and risk can be successfully redistributed between buyer and seller. A change in culture that stresses client solutions that satisfy specific client needs can shine light on the darkness that permeated derivatives trading in the past and provide new opportunities for the future.

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