Derivatives – overview, types, advantages and disadvantages

Economics, Financial Markets

Introduction

In the present-day society, with the development ofglobalization, small companies are struggling to survive in a severeenvironment. Not only do they have to compete with large companies, but also are affected by the impact of fluctuating economic climates. Under this environment, they have no choice but to seize every chance to increase profits.

A feasible method is by using financial derivatives. These financial instruments, which are linked to a specific indicator, commodity or other financial instruments, can receive great rewards with only a small amount of investment. This essay first discusses four main financial derivatives: forwards, futures, options and swaps. Then analyze the pros and cons of financial derivative usage by small companies. Finally, suggestions are made for small companies to better take advantage of financial derivatives.

Definition of small business

“ A small business is a business that is privately owned and operated, with a small number of employees and relatively low volume of sales. Small businesses are normally privately owned corporations, partnerships or sole proprietor ships. “

In this article, the four main group of financial derivatives discussed are forward, futures, options and swaps. They are basically business contracts made either in the financial market or individually negotiated between parties. Forwards and Futures obligate one of the parties to buy and another to sell a specific asset at a specific price on a specific date, Options give one

party the right of selling or buying, not the obligation. Meanwhile, Swaps have obligations and rights set to exchange one security for another to alternate quality of issue, or investment objectives. In the research of (Kosik and Pontiff 2004)[3], among all the categories of derivatives, foreign exchange derivatives, interest rate derivatives and commodity price derivatives are the most frequently used derivative instruments by small firms.

Advantages

To start with, the most noticeable advantages for small companies of using financial derivatives are in the financial area. This includes predicting a future price trend, stabilizing costs and maximizing sales profits. When the company is concerned about the derivative market, the price of futures and options and commodity price derivatives can easily help it to predict the future price trend of its raw materials. Thus wise decisions on making instant large purchases or future purchases could be made. If the predictions prove correct, unnecessary expense on raw materials can be avoided. Another way small companies could take advantages is to stabilize their purchase costs. If the company enters into a commodity price forward contract, it could possibly stabilize its purchase costs. Since engaged in these derivative contracts, the company has accepted to buy a certain commodity at a special price, thus the purchase cost is fixed in contractual format. Or it could use foreign currency forwards and options to minimize the impact of exchange rate fluctuation in the same way. (Bodnar and Marston, 1988).[4] A third area a small company could benefit from utilizing financial derivates

is to maximize its profits. A foreign currency forward or option contract with its distributors, the company is able to sell its products with fixed sales income in domestic currency. As a result, no more price or exchange rate fluctuation could influence the company's sale revenue. There are three other advantages caused by derivative instruments. These are: increasing business reputation, expanding the company to enter thefinanceindustry, and training the management team to handle more complex finance problems. There is a further explanation that derivative instruments can increase business reputation. When a company fulfills all the obligations and duties that the derivative contract included, distributors may think it a creditable partner and shareholders may give more credit to their invested entity as well. The second advantage is that a small company can gain opportunities to enter the high level of financial markets for its frequently participation in the derivative market. It is beneficial for the future development of the company. Through earning large quantities of short-term return, the firm's volume could be increased and expansion into the financial markets could be realized (Gay and Nam, 1998).[5] Finally, the management team of a small enterprise could get plenty of experience in dealing with these advanced financial instruments. This could train them for better understanding of the whole economic trend, so they are better prepared for future financial work, benefiting the company in a fundamental way.

Disadvantages

Aside from all the possible advantages financial derivatives can bring for small companies, there are also corresponding disadvantages. Just as proper

managing can cut down on material costs and maximize sales figures and profits, if used inappropriately, derivative instruments may result in huge losses or even bankruptcy for small companies.

The most recognized disadvantage that financial derivatives could bring about isfinancial difficulty. In this situation, it is hard to professionally handle the derivatives instruments, the consequences would be terrible. One appropriate example to illustrate the huge financial losses caused by derivative use is that five to six small firms in India have engaged in a lawsuit with private-sector banks with some improper handling of the derivative product, causing ten million losses on derivative instruments.[6] In the second place, if the prediction is incorrect, a commodity price or foreign exchange future or forward contract will raise the purchase costs for small firms, for that this kind of derivatives sets the future amount due fixed whatever the future prices or exchange rate would be. In a similar situation, when arrangement is improper, interest rate derivatives will cause fund costs to rise. That is because the interest rate derivatives have set a limit to the funding costs. As a consequence, when the interest rate descends, funding costs are increased, leading to financial trouble for the small enterprise.

There have some other disadvantages come in other area except for finance. When companyfailureon derivative markets, shareholders, creditors and other relevant parties tend to be lose their confidence in the company’s performance, therefore, it will face a much worse financial position. Shareholders may start to sell their stocks, and creditors may ask for early

repayment of credit. Under these circumstances, the reputation of company may be seriously damaged. Another drawback is the management team of the company may feel frustrated about their poor operation on derivative instruments, thus losing morale for attempting another innovative financial instrument, which could possibly put the enterprise into a more difficult situation.

Suggestion

After analyzing the advantages and disadvantages of derivative instruments which are used for small enterprises, some suggestions for making full use of these instruments can be made. Taking two fundamental factors into consideration, they are the size of firm and the special characteristics. Forwards, futures and options are recommended for frequent use, whereas swaps should be carefully used. When investing in these financial instruments the level of risk involved the selection of the type of derivatives.

Conclusion

To sum up, from comparing the advantages and disadvantages of derivative investments, it clearly can be seen that certain type of derivatives, such as forwards and futures, when used properly can bring visible benefits for small firms. On the other hand, when inappropriately used, derivative instrument may result in huge losses and even bankruptcy. Thus, the conclusion is that small companies can take many advantages of financial derivatives as long as they pay sufficient attention to their investments.

Reference:

1. The International Monetary Fund.(2008) Financial Derivatives.

Available from: http://www. imf. org/external/np/sta/fd/index. htm

[Accessed on September 09, 2010]

2. Small business . Available from: http://en. wikipedia. org/wiki/Small_business

[Accessed on September 09, 2010]

3. Koski, J. and Pontiff, J. (2004). Wiley Interscience. How are derivatives used. Availablefrom: http://www3. interscience. wiley. com/journal/119065624/abstract? CRETRY= 1&SRETRY= 0.

[Accessed on September 10, 2010]

4. Bodnar, G. and Marston, R. (1998). The Wireless Center for International Financial Research. 1998 Survey of financial risk management by U. S. non-financial firms. Available from: http://finance. wharton. upenn. edu/weiss/survey98. pdf

[Accessed on September 09, 2010]

5. Gay, G. and Nam, J. (1998). The underinvestment problem and corporate derivatives use. Financial Management 27(4): 53-55

6. Reuters India. India Axis Bk: clients' notional derivative loss $169mln. http://uk. reuters.

com/article/rbssFinancialServicesAndRealEstateNews/idUKBOM14592320080421.[Accessed on September 09, 2010]

7. Pennings, J. and Garcia, P. (2004). Hedging behavior in small and medium-sized enterprises: The role of unobserved heterogeneity. Journal of Banking & Finance 28: 951-978.