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Headline: Derivatives find more favour with investors

Derivatives find more favour with investors

Low capital required, flexibility make these instruments appealing to savvy individuals

Melissa Tan

Derivatives used to be a no-go area for retail investors and with good reason, given their complexity, but the tide is turning fast with trading volumes soaring.

The Singapore Exchange's derivatives trading business has continued to grow steadily over the past few months, with daily trading volumes up 8 per cent last month from July.

One attraction of derivatives is that little capital is required.

For as little as $200, depending on the instrument, investors can take a position of as much as $10,000, said Mr Justin Harper, market strategist at contracts-for-difference provider IG.

Many people investing in derivatives or products that contain them tend to be more sophisticated investors, such as high net worth individuals or family offices which manage the wealth of rich families.

But with greater public awareness of the potential gains, more retail investors are attracted as well.

Mr Goh Nai De, 25, an undergraduate at Singapore Management University, said he was introduced to derivatives in late 2007 by his retiree uncle.

Since then, he has made a "comfortable" five-figure sum trading them, he said.

Another reason derivatives and related products are becoming popular boils down to one word – flexibility.

Derivatives allow investors to make bets and profit even if the market goes down, notes Ms Grace Chan, director of sales and marketing at Phillip Futures.

In contrast, an investor who buys stocks profits only when the price rises.

The investment environment is growing increasingly complex as financial institutions introduce new products that aim to give investors more room to manoeuvre when times are tight.

"In instances where valuations have been more depressed, the (market's) volatility often allows us to introduce products which provide clients both upside and some downside protection," said Ms Tan Su Shan, managing director and group head of wealth management at DBS Bank.

But to avoid taking on risks they are unaware of, investors need to read the fine print.

Read fine print, be mindful of risks

Derivatives

A derivative is a type of product whose value is derived from, or depends on, an underlying financial asset such as stocks, bonds, currencies, commodities or indexes like the Straits Times Index.

Common derivatives include options and futures.

Investors in Singapore tend to go for index futures, though commodity futures are gaining ground.

"There is a preference from customers for derivatives linked to Asian broad market indices or Singapore blue chips," says Ms Radhika Bangaru, director for investments at Citibank Singapore.

Ms Chan added that commodities futures for crude oil, copper, gold and soya beans are also becoming more popular.

Structured products

These combine both assets and derivatives. The derivative is used to link the structured product's return to the performance of the underlying asset.

For example, if you buy a structured note whose return is linked to the Straits Times Index (STI), the value of the structured note will vary depending on the STI's level.

The more popular structured products here include equity-linked notes and dual currency deposits, which DBS' Ms Tan described as the "bread-and-butter business for the vast majority of private and priority banks across client segments".

Risks

Though the prospect of higher returns may seem tempting, investors expose themselves to the credit risk of the issuer, market risk and general investment risks.

Derivatives also carry what is called counterparty risk – this is the danger that the other party in the transaction fails to carry out its side of the bargain.

Another risk comes from using margins. Derivative products like futures require the investor to place an initial amount of cash with a broker at the start of the contract. This cash is called the margin.

The broker may occasionally ask the investor to put up additional margin, known as a margin call, if the derivative's market value drops.

Depending on how many margin calls there are and the performance of the derivative, the investor could end up losing more than the initial investment amount.

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BETTING ON STRUCTURED WARRANTS

Structured warrants may sound arcane to many undergraduates, but not Mr Lu Yang, 23.

The third-year accountancy and business student at the Nanyang Technological University's Nanyang Business School has been trading in structured warrants since early last year.

He is also enrolled in a derivatives securities course at university.

He told The Sunday Times that his interest in this instrument was sparked after he joined an online warrants trading simulation contest organised by Macquarie Singapore, a warrants issuer here.

Mr Lu said he buys structured warrants on Hong Kong's Hang Seng Index, issued by Macquarie. These warrants are denominated in Singapore dollars.

"I want to bet on the short-term movements but don't want to be exposed to the Hong Kong dollar," he said.

He added that he chose warrants over exchange-traded funds because he was more familiar with the former.

Warrants make up around a tenth of his portfolio, worth around $10,000.

The rest consists of Singapore-listed stocks, which he said he typically holds for about a month.

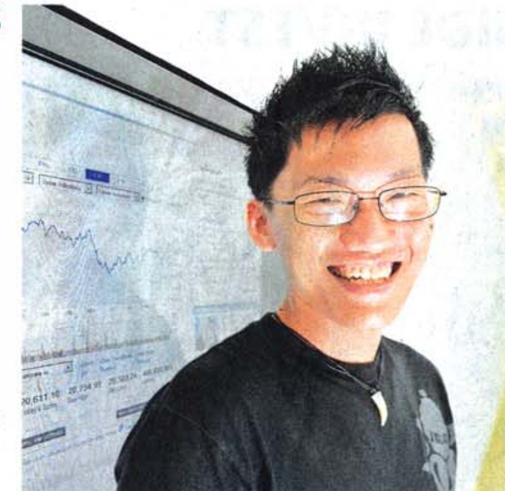

PHOTO: LIM YAOHUI FOR THE SUNDAY TIMES

Mr Lu buys structured warrants on Hong Kong's Hang Seng Index, issued by Macquarie.

'OPTIONS PROVIDE FLEXIBILITY'

Options may not be traded much in Singapore markets but they are Mr Jason Lee's instrument of choice, in more ways than one.

"Options provide flexibility," said the 24-year-old account manager at social events marketing firm Ares Marketing.

Mr Lee told The Sunday Times that he usually sells equity call options to collect premiums and hedge against a downward movement in the underlying shares.

"I prefer options to CFDs (contracts for difference) or warrants because they are more regulated and have a more standard pricing model... so I feel safer," he added.

An equity call option gives the holder the right to buy the underlying stock from the seller of the option at a predetermined price. The cost of the option is called the "premium".

Investors usually buy call options on stocks if they are bullish. Those who sell call options are usually bearish.

About half Mr Lee's portfolio is in US equity options. The other half goes to US stocks such as shipping company DryShips.

But Mr Lee said that he had closed off his options positions recently since the market correction that he had been expecting did not occur.

ST PHOTO: CAROLINE CHIA

Account manager Jason Lee says he usually sells equity call options to collect premiums and as a hedge.

KNOW THE PRODUCTS

Options: There are two types of options – call and put.

A call option on an asset like a share gives the buyer the right to buy the stock at a predetermined price, called the strike price.

A put option on the stock gives the buyer the right to sell the stock at the strike price.

The buyer can choose to exercise that right up until the option's expiry date.

Take an investor who thinks a stock trading at $3 will shoot up to $5 in the short term but does not want to pay $3,000 to buy 1,000 shares.

He could buy a call option on the stock with a strike price of $4. If the stock rises above $4, the investor profits.

Futures: These allow investors to lock in a certain price today for an asset that will be delivered some time in the future. Assets range from commodities such as crude oil to a market index such as the Straits Times Index.

However, in practice, retail investors usually exit the contract before they get sent bushels of grain, for example.

Dual currency deposit: Dual currency deposits, also known as dual currency investments, let investors bet on a currency pair by depositing money with a bank.

The investor deposits money with a bank in a base currency, the Singdollar, for example, and chooses an alternate currency, such as the greenback. The investor and bank then agree on a strike exchange rate for the currency pair for the put option.

The bank can choose to pay back the investor in the alternate currency at the agreed strike rate when the deposit matures.

This means the investment in Singdollars may be converted into US dollars if the greenback is weaker, at the bank's discretion.

Equity-linked notes: An equity-linked note is a debt instrument where, instead of a fixed payment upon maturity, the final payout depends on the performance of an stock or basket of stocks. The payout could be in cash or in shares valued at a predetermined price.

Structured warrants: A structured warrant is a type of option issued by a third-party financial institution.

There are call and put warrants. They are issued on the stock of an unrelated company, a basket of stocks or an index.

Structured warrants differ from an ordinary, company-issued warrant on a stock. If an investor exercises a warrant, the company issues new shares in the market.

But with structured warrants, no share dilution occurs upon exercise.

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