**Derivatives - B7309-001-20173**

**BIDDING SYLLABUS | FALL 2018**

**Warren 310**

**PROFESSOR MARK ZURACK**

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**REQUIRED COURSE MATERIAL**

Equity Derivatives: Corporate and Institutional Applications

*Neil C. Schofield, 2017*

Selected Readings are on electronic reserve and accessible through the Study.net (SN) and Library Reserves (LR) tabs in Canvas, and in PDF files under “Miscellaneous” in the Files tab in Canvas.

**REQUIRED PREREQUISITES**

Capital Markets and Investments

**CONNECTION WITH THE CORE**

This course builds on knowledge from the Capital Markets and Statistics courses (B8306). Specifically, statistical techniques are used to estimate parameters of option pricing models, data are used to develop scenarios for risk analysis; and are used to understand simulation output when pricing and hedging derivative securities.

**COURSE DESCRIPTION AND OBJECTIVES**

Successful investing requires more than just picking stocks and bonds given the wide array of products at a portfolio manager's disposal. Through a combination of lectures, guest speakers and a final project, this course is intended to provide firsthand experience on how products like Options, Futures, Swaps, ETFs, Structured Notes, and Convertible Bonds are structured, valued, and used by all types of investors globally.

The course is designed from both the perspective of a practitioner who has to account for the real costs of trading derivatives and how the derivative can improve the return and/or reduce the risk of his/her portfolio.

The course is broken into the following sections:

**Products** - The course starts with a discussion of ”Delta 1” Derivatives like Exchange Traded Funds, Futures, and Swaps. These products trade dollar for dollar with the underlying security. We then explore options based Equity, Fixed Income and Commodity products, like Options, Structured Notes, Credit Default Swaps, and Callable and Convertible Bonds.

**Strategies** – A component of this course will revolve around how investors use these products through the combination of class discussions, guest speakers and project work.

Toward the end of the course, we will try to identify future trends that may affect the market. We also look at historical events that shaped the markets.

**ASSIGNMENTS, EXAM AND FINAL PROJECT**

All assignments must be completed in writing with hard copies handed in before class. Some assignments will be Type A, some Type B.

For Type A assignments, each student must participate in a group discussion regarding the assignment before submission and review and if needed edit the final submission. **Collaboration across groups is not allowed.**

For Type B Assignments, each student should attempt to answer the questions on their own before collaborating with other students. Each student should hand in their own submission for Type B assignments.

**METHOD OF EVALUATION**

|  |  |
| --- | --- |
| Participation and Assignments | 40% |
| Take-Home Exam | 35% |
| Final Project | 25% |

An important component of Class Participation is attendance which will be tracked. I reserve the right to downgrade (including failing) any student who misses a significant number of classes, or does not complete all of the assignments. I will try to avoid cold calling, with the exception being case discussions. During class, please do not use laptops, tablet computers, and smartphones. Exceptions will be made with my prior approval.

For the Final Project, each group has the choice of working with an industry practitioner on a project they created or completing a case study I created. In either case, the Final Project will be presented to the class and every group member (without exceptions) must attend the presentation.

If you were a student in my Capital Markets class, please do not use any material from that course to help you complete the assignments for this course.

1. Course Introduction/Indices and Exchange Traded Funds (09/11)

After a quick overview of the class, we introduce the measurement of trading costs, a concept that will be used throughout the course. This is followed by a discussion of Indices, focusing on the ways they are constructed and traded. If there is time, I will introduce Exchange Traded Funds.

Readings:

* + - * Chapter 1, pp. 3-7
      * [MSCI: Developed, Emerging, Frontier Markets](https://www.msci.com/market-cap-weighted-indexes)

(<https://www.msci.com/market-cap-weighted-indexes>)

* + - * Not All Commodity Indexes Are Alike (PIMCO) (LR)

1. Exchange Traded Funds and Futures (09/18)

This class reviews products investors use to obtain broad market exposure, starting with Exchange Traded Funds. The class addresses how they are created, what forces impact the way they trade and how they compare to other index products. ETFs have expanded into new markets like Fixed Income, Commodities and Currencies, providing individual investors choices that have historically been only available to institutions.

After ETFs the class moves onto Futures, starting with Stock Index Futures. We review how the markets operate and how futures are valued, and compare the cost, return, and risk of futures vs. ETFs.

Readings:

* + - * Chapter 1, pp. 16-19; Chapter 4, pp. 73-78; Chapter 9, pp. 273-276
      * ETFs for the Single Stock Manager: Correlations, Myths & Realities (Goldman Sachs) (PDF)
* [The Evolution and Success of Index Strategies in ETFs](http://www.cfapubs.org/doi/pdf/10.2469/faj.v72.n5.2) (Hill, Joanne M.) (<http://www.cfapubs.org/doi/pdf/10.2469/faj.v72.n5.2>)

1. Futures and Swap Markets (09/25)

After completing our discussion on futures, this class completes our discussion on indexation by introducing Equity Index Swaps. After completing Index Swaps, we discuss Equity Finance which is the business of lending money to investors and facilitating short sales, and describe how swaps on individual stocks are employed in that business.

Readings:

* + - * Chapter 1, pp. 10-14, 19-20; Chapter 4, pp. 81-83; Chapter 10, pp. 287-292
      * Making Alpha Portable (Bernstein, Peter L.) (PDF)
      * Mechanics of the Equity Lending Market (Fabozzi, Frank J.) (SN)

1. Options Introduction and Valuation (10/09)

With Delta 1 products completed, we move to Equity Options. We start with a discussion on how the market operates and liquidity is provided using the ISE case study as background. Please read the case and be prepared to discuss it.

We then move on to Valuation, a topic that can get fairly complex. Although options pricing cannot be explained without any formulas, I start by providing intuition on what drives pricing leaving out the higher mathematics.

Readings:

* + - * Chapter 1 pp. 20-23; Chapter 5, pp. 105-119
      * [The International Securities Exchange: New Ground in Options Markets](https://cb.hbsp.harvard.edu/cbmp/pl/67431448/67431458/4e4891f1623a972f63079251ff199aa6)

(<https://cb.hbsp.harvard.edu/cbmp/pl/67431448/67431458/4e4891f1623a972f63079251ff199aa6>)

Assignments:

Assignment (1) – Futures, ETFs, Swaps and ISE Questions (Type A)

1. Options Models/Practical Considerations in Pricing Options (10/16)

We start this class by reviewing the commonly used Options Models like the Binomial and Black-Scholes Models.

We then discuss how the cost of trading stock influences the price of an equity option and why the interest rate used to price a particular option depends on how the trader hedges that option.

In the index options market there are historical relationships between implied and historical volatility, implied volatility for options with different strike prices (skew) and terms (term structure), as well as stock versus index options (dispersion). Relying on historical data, this class discusses those relationships.

Readings:

* + - * Chapter 6 – pp. 139-172, pp. 190-196
      * Introduction to Binomial Trees (Hull, John) (SN)
      * Valuing Stock Options: The Black-Scholes Model (Hull, John) (SN)

Assignments:

Assignment (2) – Options Pricing Questions (Type B)

1. Fixed Income Derivatives/Commodity Derivatives (10/23)

For the next few classes we move away from Equities into Fixed Income and Commodities.

Jack Hattem from Blackrock provides an overview of Fixed Income Derivatives products and describes how Blackrock uses them.

Oliver Kinsey from Ballymena will then provide an overview of the Commodities Derivatives Market.

Guest Speakers: Jack Hattem, Blackrock  
 Oliver Kinsey, Ballymena Advisors LLC

Readings:

* + - * Commodity Investments: The Missing Piece of the Portfolio Puzzle? (Kang, Xiaowei)  
        (LR)
      * PIMCO, the Quiet Giant Among Commodity Investors: Kemp (Kemp, John) (LR)

Assignments:

Assignment (3) – Options Skew and Term Structure (Type B)

1. Credit Derivatives and Structured Notes (10/30)

Dominique Toublan will explore the inner workings of the Credit Derivatives Market.

Structured Notes are fixed income securities that combine bonds issued by an investment bank with options to provide equity exposure with different risk than conventional equities. During the second half of the class Cecilia Manzolillo and I review how structured notes are created, what factors determine their pricing and how they are used by institutional and individual investors.

Guest Speakers: Dominique Toublan, J.P. Morgan  
 Cecilia Manzolillo, Columbia Business School

Readings:

* + - * Chapter 12, pp. 347-350

1. Convertible Bonds and Exotic Options (11/13)

Exotic Equity Derivatives is the focus of the first half of this class, concentrating on Path Dependent Options and Correlation Options. Cecilia Manzolillo and I start by explaining each product and comparing its benefits and risks to more conventional derivatives. We end each class by discussing how investors use Exotic Equity Derivatives in their portfolios.

During the second half of the class I will review Convertible Bonds, securities which combine Equity and Credit Derivatives.

Guest Speaker: Cecelia Manzolillo, Columbia Business School

Readings:

* + - * Chapter 7, pp. 203-206; Chapter 10, pp. 247-267
      * [Convertible Securities](https://cb.hbsp.harvard.edu/cbmp/pl/67431448/67431460/ec5e10cce1ab20a9994413dfa4f3bcc2)

(<https://cb.hbsp.harvard.edu/cbmp/pl/67431448/67431460/ec5e10cce1ab20a9994413dfa4f3bcc2>)

Assignments:

Assignment (4) – Structured Notes (Type B)

**Exam Handed Out**

1. Options Strategies for Active Managers and Pension Funds (11/20)

In this class we will discuss how Active Asset Managers tie their knowledge of the underlying company to develop options strategies on individual stocks. We go into mathematical detail on the most popular Equity Options strategies, writing covered calls and puts.

Pension Funds use Index Options and Interest Rates Futures and Options to control the risk of both their Assets and Liabilities. We next explore the strategies they follow and how to arrive at an appropriate hedge.

Readings:

* + - * Tutorial on Using Options in Active Strategies (Tsu, Maria E.) (PDF)
      * Covered Call Strategies: One Fact and Eight Myths (Israelov, Roni) (LR)

**Exam Due**

1. Volatility Derivatives/Tax Considerations in Trading Derivatives (11/27)

This class begins with a presentation by Rocky Fishman from Goldman Sachs, who will share current research he has done on strategies using the VIX.

Before using derivatives taxable investors need to be well versed in tax issues related to their overall strategy. In this class we cover the tax laws most relevant to Equity Derivatives transactions and introduce strategies to enhance After-Tax returns.

Guest Speaker: Rocky Fishman, Goldman Sachs

Readings:

* + - * Chapter 10, pp. 293-294; Chapter 14, pp. 426-436

Assignments:

Assignment (5) – Convertible Bonds/Stock Options Strategies (Type A)

1. Learning From History (12/04)

To better understand the impact Derivatives has on the Capital Markets it is useful to understand history. In this class we discuss situations in history where Futures and Options were misused. Prior to 2008, two stand out, Portfolio Insurance and the 1987 crash and Long-Term Capital Management.

Starting in 2008, three events come to mind, AIG in 2008, the Flash Crash of 2010, the ETF Mini-Crash on August 24, 2015, and what happened with VIX Derivatives in early February of this year. We end the class with a discussion of current regulatory initiatives.

Readings:

* + - * Bank of Volatility (Lowenstein, Roger) (SN)
      * The Demons of ’87 (Bookstaber, Richard M.) (PDF)
      * [Leland O’Brien Rubenstein](https://cb.hbsp.harvard.edu/cbmp/pl/67431448/67431464/d7ad8101e4ee9f4d1d66d910690bd9df)

(<https://cb.hbsp.harvard.edu/cbmp/pl/67431448/67431464/d7ad8101e4ee9f4d1d66d910690bd9df>)

* + - * Long-Term Capital Management, L.P. (A, C, D)

<https://cb.hbsp.harvard.edu/cbmp/pl/67431448/67431450/d6f2b82d67443f22565931ff0231dd46>

<https://cb.hbsp.harvard.edu/cbmp/pl/67431448/67431454/ef413c35c0fca580fabee48d98c5d6fa>

<https://cb.hbsp.harvard.edu/cbmp/pl/67431448/67431462/aefe47d31492dce26cea34a8dc716eee>

* [Findings Regarding the Market Events of May 6, 2010](http://www.cftc.gov/idc/groups/public/@otherif/documents/ifdocs/staff-findings050610.pdf) (CFTC & SEC), Executive Summary only, pp. 1-8 (<http://www.cftc.gov/idc/groups/public/@otherif/documents/ifdocs/staff-findings050610.pdf>)
  + - * Enhancing Our Equity Market Structure (White, Mary Jo) (LR)
      * From Free Lunch to Black Hole: Credit Default Swaps at AIG (PDF)

Assignments:

Assignment (6) – LOR/LTCM A16/Flash Crash /VIX Questions (Type A)

1. Final Project (12/11)

To end the course each group will present their final project to the entire class. If they are available, each practitioner/advisor will also speak to the class, providing an overview of their business and how it relates to the project their group completed.