Key Risks Associated with Derivatives

Video Title: Section 4 Key Risks Associated with Derivatives

In the previous section, we introduced the application of derivatives, and now we will talk about the key risks involved in derivatives. They are (1) Counterparty Risk, (2) Investment Risk of the Underlying Asset, (3) Early Redemption & Potential Capital Loss Risk, (4) Liquidity Risk, (5) Interest Rate Risk, and (6) Leverage Risk. Let's talk about them one by one.

The first one is Counterpart Risk. Derivatives are issued by third parties, such as listed companies or financial institutions, which we usually refer to as "issuers". If these organizations encounter financial problems and this leads to a decrease in their credit rating, or if they collapse because of solvency problems, the derivatives' values will be affected and may even lose all value.

Another risk is the Investment Risk of Underlying Asset. As we mentioned in the first part of this training, derivatives' prices depend on the value of their underlying assets. Normally, fluctuations in the underlying assets' prices will affect derivatives' prices directly. This is the Investment Risk of the Underlying Asset.

The third risk is the Early Redemption & Potential Capital Loss Risk. Regardless of whether the investor chooses to redeem early, or the issuer has to terminate the products because of early redemption, these actions may cause the investor to lose money because they may receive an amount less than what they have invested. Therefore, you should pay attention to the early redemption provision, and consider if it would affect the amount you invest.

The fourth risk is the Liquidity Risk. Generally speaking, this risk is related to whether or not the derivatives can be easily sold and converted into cash. Before the expiry, some derivatives may be harder to sell and convert into cash. If it is not possible to sell them, you will have to wait until the derivatives expire before you can get your funds back. If you need to use these funds at any time, please pay special attention to this risk.

The fifth risk is the Interest Rate Risk. Any derivative will ultimately be exchanged for an "asset" and "money", or exchanged between two currencies. The fact is that "money" is necessarily linked to interest rates; Therefore, interest rate changes will definitely affect the values of derivative products.

Last is the Leverage Risk. Consider that a small movement in the stock market (or foreign exchange market) may exhibit more drastic change in a derivative's price. This is the Leverage Risk.

Can you remember the different kinds of key risks we talked about? Now let's make a quick summary. They are (1) Counterparty Risk, (2) Investment Risk of the Underlying Asset, (3) Early Redemption & Potential Capital Loss Risk, (4) Liquidity Risk, (5) Interest Rate Risk, and (6) Leverage Risk.

The above risks are common ones, and because of the rapid changes in the financial markets, when you trade derivatives, please make sure you are aware of the specific provisions and risks of each. We have now come to the end, and you hopefully have a better knowledge of derivatives and their risks. However, even if you fully understand the concepts mentioned in this training, it still does not mean you know everything about derivatives. Since derivatives have different kinds of characteristics, when you trade derivatives, ask your investment advisor for detailed information about the derivatives and the risks involved.

As the saying goes, the "The More You Know, The Better!"

Until next time, Goo-bye!

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