

The Wharton School
Financial Derivatives (206/717)

Mr Krishna Ramaswamy
Spring 2013

Financial Derivatives

FNCE [717]-001 MW 10:30am Room JMHHXXX

FNCE [206]-001 MW 1:30pm Room JMHHYYY

FNCE [206]-002 TTh 1:30pm Room JMHHZZZ

(Room Numbers are To Be Announced!)

1 Course Description

The phenomenal growth in the global markets for exchange-traded Options and Futures contracts on financial assets (foreign exchange, fixed income and equity securities, and stock indices) and on commodities has been accompanied by the growth in Over-the-Counter markets for swaps, related options, credit derivatives, and other structured products. The exchange-traded products are traded by individuals and institutional investors, but the structured products are tailored to institutions. These *derivative securities* are used to meet a variety of objectives. For example, the markets in options on stock indices and in futures contracts on Treasury securities allow managers to control the risk of their portfolios and alter the distribution of the returns on their portfolios. And options and futures contracts on interest rates, currencies and commodities permit corporate treasurers to manage risk. These markets also permit individuals and hedge funds to speculate on price movements and relative price relationships among assets and commodities.

Most features of the “newer” financial contracts are almost always equivalent to bundled portfolios of options, futures and their underlying securities. A solid grasp of options and futures helps us to understand and deconstruct these (more complex) objects with relative ease. While the techniques for the valuation of options and futures might at first glance appear advanced and difficult, they are easily and conceptually digestible. And in the process of learning these valuation techniques we uncover many practical aspects of the use of options and futures.

The purpose of this course is to provide the student with the necessary skills to value and to employ options, futures, and related financial contracts. In order to provide a useful treatment of these topics in an environment that is changing rather rapidly, it is necessary to stress the fundamentals and to study some important applications. The topics to be covered are

- Futures Markets & Their Applications, including the pricing and use of futures contracts on stock indices, on commodities, and Treasury instruments;
- Options Markets & Their Applications, covering the valuation and use of options, including a discussion of the empirical evidence and dynamic asset allocation strategies;
- Swaps, Complex Derivatives, Structured Securities including several cases, and the use (and misuse) of derivatives in the context corporate applications.

I expect that slightly less than a third of the course will be devoted to futures, a third of the course to options, and the remainder to more complex derivatives and applications — however, many applications are included in the coverage of options and futures markets, the final part of the course employs several cases.

Four individual homework assignments, two midterms, and a (concept-testing, multiple-choice) final exam (described fully below) help determine the student's grade.

Pre-requisites: Basic knowledge of statistics from the core course is expected. You should have had Core finance; but if you're willing to put in the hours to learn the relevant ideas of risk and return and the minimum understanding of institutional arrangements necessary to follow the class, you can enroll in the course without my permission.

Auditors must talk to me at the end of the first lecture.

2 Office Hours

Office: 3259 SHDH; 'phone 898-6206.

Office Hours: My *posted* hours are on

Mondays	3:00 to 4pm
Thursdays	11am to Noon

Please note that I keep *Open Office Hours*, which means no appointment is needed: I'm almost always there (I may have stepped out but only for 5 mins) at the times given above.

I also have an *open door policy* on Fridays from 11am on, except for the lunch hour (12 to 1pm) but it's wise to call (215 898 6206) to check if I am in, just before you intend to come by.

Dial-a-Question: Call (215) 898 6206 or e-mail me at krishna@wharton.upenn.edu for answers to brief questions: I might be able to save you the trip to my office.

Weekly TA Office Hours: I have TAs for this course who will hold Office Hours in the cubicles in the Finance Department (2400 SHDH). Their hours will be posted as soon as their class schedules are fixed. Their times may change: if they do you'll be notified in my weekly memo emailed to you.

3 Department of Notifications

1. *Weekly Memos.* I send an e-mail late every Thursday night to give guidance on: what we covered that week, what to read for the following week, as well as sample problems, Answers to Frequently Asked Questions regarding the homework assignments, Practice Problems, Reminders and such. These e-mails will have a subject heading that usually begins with "FINDERIVS!!" Please read them carefully.
2. *Canvas:* I make pretty extensive use of it. All handouts (other than the cases and readings available from StudyNet), Sample Problem Sets and Exams, Examples I worked out in class, even Weekly Memos and other class-related material are posted here.
3. *E-Mails:* When sending me e-mail, please use krishna@wharton.upenn.edu and do avoid hitting the *Reply to All* button to a general e-mail that I have sent to all students, for obvious reasons.

You should be on the class e-mail list-server very shortly after you register. If you drop the course, please send me an e-mail so you can be dropped from the list and shielded from the dreadful stuff I send your former classmates: that may take a few days, so please be patient!

4. *Non-Whartonites*: **If you're not from Wharton**, then please do let me know your e-mail address so I can get you on the list-server asap.
5. *Seating Plan* : After the first class, stay in the seat you choose for the remainder of the semester. And you must plant your name-cards on your desk.

4 Text

Required Text: Hull, Options, Futures and Other Derivatives, 8th ed. I will refer to this as **Hull** henceforward. *The required text is a less-expensive version customised by Pearson and available in soft-cover from the bookstore – it contains the chapters that I will use. The publishers have also made available the web-based computer software and other learning aids to those who buy the cheaper customised text.*

Everyone should have access either to this subset or to the full hardcover book. If you're a finance major, you should consider buying the book, but this is not required.

Hull's text is comprehensive but not particularly well-written; it lacks intuitive explanations to concepts and techniques at important places. However, it is up-to-date, and it does cover all the topics we need, in almost the same sequence. There are chapter-ending problems some of which I'll encourage you to attempt. A big drawback is that it is a bit short on empirical evidence and important institutional material, so I will provide supplementary readings and class coverage. We'll cover the material in the first 18 or so chapters, and some material in later chapters.

The rest of the book has a treatment of Fixed Income and Credit Derivatives. I leave this coverage to the Fixed Income Course, but I will touch on the topic of Credit Derivatives.

CoursePack: StudyNet Halfway through the course (just before Spring Break) I will make available on Study Net the cases and other copyrighted material that are required reading assignments in the remainder of the semester.

Here are some other books:

1. Cox, John C and Mark Rubinstein, *Options Markets*, Prentice-Hall, 1985. This is an excellent book, around which the treatment of options in this course was originally designed. *A well-thumbed copy belongs on every finance major's bookshelf.* It doesn't have chapter-ending problems. But it does have the most useful treatment of the basic ideas of finance — corporate finance, even — that you will find *anywhere*. If you find a remaindered or used copy, buy it (see www.bookfinder.com) for yourself and a copy for a friend.
2. Siegel, Daniel R and Diane F Siegel, *Futures Markets*, The Dryden Press, 1990. I have placed several copies on Lippincott reserve, and interested students can come by my office to borrow a copy. Very dated but an excellent book which I would recommend to anyone who goes into the futures business. My notes will draw on some material from this book.

Here is a selection from the many books that combine reporting with commentary, and provide illustrative, humorous but sometimes sadly accurate examples from the world of derivatives and recent events: the list is in no special order.

1. Michael Lewis, *The Big Short*. Norton, 2010. A must read!
2. Cohan, William D, *House of Cards*, Doubleday, 2009. On Bear Stearns. A ripping yarn.

3. Sorkin, Andrew R, *Too Big To Fail*, Viking, 2009. A sobering read.
4. Chew, Lilian, *Managing Derivatives Risks*, Wiley, 1996. A practitioner-oriented book. Well written but perhaps best read after you've finished this course.
5. Das, Satyajit, *Traders, Guns and Money*, Financial Times/Prentice Hall, 2006. Lighter but very relevant fare.
6. Epstein, Richard, *The Theory of Gambling and Statistical Logic*, Academic Press, 1977. Feel it's all gambling and speculation and connected to Vegas, and want a complete, fun and strongly analytical treatment of every game of chance? See this one.

5 Course Requirements

The course grade will be based on

1. Four homework assignments to be done individually, no discussion among any of you, the work you submit must be entirely your own. Solutions will be posted after their due date; each will be graded for timely submission and completeness of effort for 3 points each.

Weight, 12%

2. **Two mid-terms exam** — the first on **TUESDAY FEB 19**, and the second on **WEDNESDAY APRIL 10**, both closed-book and closed notes (you may bring a single sheet of $8\frac{1}{2} \times 11$ " paper with one side left blank) — each for two hours, from 6 to 8pm.

Total Weight, 60%

3. **One final exam** — on a lapidary date and time fixed by the University Registrar and not by me — very basic set of questions on all the material, some true false and the rest multiple choice, a few involving minimal use of simple arithmetic; designed so that you can calmly review your material and solidify your understanding. It is NOT an optional exam for undergrads!

Weight 26%

4. **MBAs ONLY: PLEASE NOTE!!!** I will compute your course grade a full week before the date of the final exam and e-mail it to each of you individually – if you're satisfied with that grade you can elect to skip the final exam. This "option" is not available to undergraduates.

6 Mark Your Calendars

Please mark the following important dates into your schedule for the term: these dates are lapidary *i.e.*, *written in stone!*

Date	Event	Remarks
1. Jan 24	HW 1	By 4:30pm in 2400 SHDH
2. Feb 07	HW 2	By 4:30pm in 2400 SHDH
3. Feb 19	<i>Mid-Term 1</i> , 6-8pm, RoomTBA	Closed Book, Closed Notes
SPRING	BREAK	Mar 1-10
4. Mar 21	HW 3	By 4:30pm in 2400 SHDH
5. Apr 10	<i>Mid-Term 2</i> , 6-8pm	Closed Book, Closed Notes
6. Apr 22	HW 4	By 4:30pm in 2400 SHDH
7. May XX	<i>Final Exam</i> , 6-8pm	Closed Book & Notes

All exam-related absences must now receive **prior approval** from the Grad Division for MBAs; or from the UG advisors and me, for UGs.

Please Note: All requests for regrades — even discussions of the grading — should be directed to me at most a week after the graded item is returned, in my Office Hours, and *never* to my TAs.

7 Review Sessions for Doubt-Clearing

Weekly review sessions are so sparsely attended that I've decided that the TA and I will hold them *only just prior* to the mid-terms and the final. So please use our office hours and call me with any questions you have. The TAs and I will hold Office Hours throughout each week, so you should have ample opportunities for doubt-clearing. (Their office hours will be posted on the web cafe and in your weekly e-mail!) And we will help you work through problems posted (with solutions) in the web-cafe.

8 Readings & Lectures

In my weekly e-mails I will indicate what you need to read before and after the lectures, and the practice problems you should work out.

In my lectures, I approach each topic as a (proto)typical decision, then proceed to indicate how the firms involved engage themselves in organising a solution, perhaps one that requires existing markets and intermediaries such as brokers and financial institutions. That way, you learn every facet of the derivatives business, and understand how many of these markets (for example, the swaps market) develops. This method of instruction is very much like the case method, but it excludes the surplus of unnecessary readings around a case and concentrates on the essential bits — after I finish each topic the formulas will effectively have been derived, it is decidedly more efficient! When it is necessary to bring in some concepts in finance that you may have seen earlier, I do it quickly; and I work out an additional example or two. The topics covered throughout the semester have a thread running through them, so when you're forced to miss coverage along the way it is best to catch up as soon as you can.

You should read the assigned material from the Text with a view to grasping the concepts being discussed, and make every attempt to follow the mathematical treatment; while I do not test on the math and no derivations are done even in class, it will help you in connecting with my lectures. My Weekly Memo will direct you to do the readings and work at some problems. In general, it is best to skim the text once *before* you see the material in the lecture, and afterwards review the material and the text carefully and try the problems. See!

I'll upload to CANVAS the *Weekly Lecture Notes* (these I project in class); it is very important that you bring a copy to class. I also make available *Notes to these Lectures & Practice Problems*. And occasionally I will distribute additional handouts in class. If you miss a lecture, then

1. the *quickest* way to get any in-class hand-out is to get it from a colleague and xerox it; or
2. to look for that handout, whose date will appear in its file-name, in the web-Café. Whenever possible, I will create a PDF version that you can double-click on and print.