

The Wharton School
Financial Derivatives (206)

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Financial Derivatives

FNCE 206-001 TuThu 1:30pm JMHH 245

1 Course Description

The global markets for exchange-traded Options and Futures contracts on financial securities (foreign exchange, fixed income and equity securities, and stock indices) and on commodities has been accompanied by equally phenomenal and much more profitable growth in Over-the-Counter (OTC) markets for swaps, related options, credit derivatives, structured products, and by the process of securitisation. Exchange-traded products are traded by individuals and institutional investors; but most OTC derivatives are traded between corporates, financial institutions, hedge funds, and sovereigns. 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 money 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. In many instances the derivatives offer a convenient way in which users can lower their transactions costs relative to a more cumbersome, perhaps dynamic, alternative strategy in the underlying assets.

Many features of common financial contracts are equivalent to bundled, perhaps temporally-adjusted portfolios of bonds, futures, options and their underlying securities. A solid grasp of options and futures helps us to understand and deconstruct more complex arrangements 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.

My objective in this course is to provide students with the intuition and the necessary skills to value financial derivatives and to use them. In order to provide a useful treatment of these topics in an environment that is changing rapidly, it is necessary to stress the fundamentals and to study some important applications. I will focus – in the applications – on the following markets: equity and especially equity index markets, crude oil derivatives, and some fixed income applications.¹ The final part of the course employs cases. We may have one guest lecture.

Three individual homework assignments, two in-class midterms, and a concept-testing, multiple-choice final exam help determine your 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 – just talk to me at the end of the first class. **Auditors must talk to me at the end of the first lecture.**

¹Note that this will avoid overlap in applications involving interest rate and credit risk modeling, and currency hedging – these are properly the province of other electives.

2 Office Hours

Office: 3259 SHDH; 'phone (215) 898-6206.

Office Hours: My *posted* hours are on

MONDAYS	1:30 to 3pm
Fridays	11am to Noon

When I have to move my office hours I will always indicate an alternative time in an email I broadcast via Canvas!

NB:: I try to keep an open door policy on Fridays from 1:30 to approx 3pm for those whose class schedules clash with my posted hours; but it's wise to call (215 898 6206) to fix a time, and to avoid wasting your time if I have other obligations that day.

Quick Questions: E-mail me at krishna@upenn.edu for brief answers to simple questions: I might be able to save you the trip to my office.

Weekly TA Office Hours: Vimell Yuvarajah is the TA for this course and will hold Office Hours in the cubicles in the Finance Department (2400 SHDH). His hours will be posted on CANVAS as soon as class schedules are fixed. Our times may change: if they do you'll be notified either in my weekly email or on Canvas. Prior to each exam I will hold a general review session, possibly Mon/Wed evening 5-7pm.

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. Please read them carefully, and delete them at your peril!
2. *Canvas:* I make 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@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 course's 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 – best to send me an email – so I can get you on the list-server asap and enable access to Canvas..
5. *Seating Plan :* After the first class, please stay in the seat you choose for the remainder of the semester. And you must plant your Wharton-provided name-cards on your desk.

4 Text

Recommended: McGraw-Hill: Hull, Fundamentals of Futures, Options and Derivatives. I refer to this as **TEXT** henceforward. It is available from the bookstore. Its coverage mirrors what we do and serves as

background.

Required: CoursePack: StudyNet I will make available on Study Net copyrighted material that are required reading assignments in the second half of the semester. The cases that we discuss towards the end of the course will be accessible here.

I will place Supplementary Notes, Sample Exams, articles and other (uncopyrighted) readings on Canvas.

Here is a very desirable book that every finance major should own, I have placed it on Lippincott Reserve:

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, intuitive 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 buy a copy to endear yourself to a friend.

And here's a selection from the many books that combine reporting on financial derivatives 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. **Three homework assignments (Problem Sets)** to be done individually, no discussion among any of you, the work you submit must be entirely your own. Of course, you can drop by the TAs' or my hours to ask Qs. Solutions for the first two will be posted after their due dates; each will be graded for timely submission and completeness of effort. But here is an important point to keep in mind:

The first problem set deals with Futures and applications, the second with Options and applications.

Important Note: I will begin posting on Canvas the first two Problem Sets in PRELIMINARY VERSION as soon as I start teaching the related topic; as the classes progress, I will update and add problems to the preliminary version; and then, a week before the Prob Set is due I will make the version FINAL. This way, you can slowly work at the problem sets and avoid the crush before the due date. The two problem sets are worth 5 points each.

The **third problem set, 9 points** is a capstone that brings the ideas from the first two to a more synthetic, case-like exercise. It's also to be done individually and is worth 9 points.

Total Weight, 19%

2. **Two mid-terms exam, IN CLASS** — the first on *THURSDAY 15 FEB* and the second on *TUESDAY APRIL 10* both closed-book and closed notes. *I will supply a formula sheet the week before the exam;* the same formula sheet will be available in the exam-book.

Total Weight, 50%

3. **One final exam** — book closed notes and the formula sheet supplied by me – on a lapidary date and time tentatively fixed **Wednesday 2 May, 6-8pm** by the University Registrar and not by me — a very basic set of questions on all (i.e. it's a cumulative test) the course material, some true-false questions and the rest multiple choice, a few involving minimal use of simple arithmetic.

The final is NOT an optional exam!

Weight, 25%

4. **Class Participation.** I will call on you to participate in answering my non-stressful questions, based on readings assigned; I will try to rotate randomly and buttonhole 6-7 students in each class.

Weight, 4%

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. 6 FEB	HW 1	By 4:30pm
2. 15 FEB	<i>Mid-Term 1, In Class</i>	Closed Book, Closed Notes
3. 27 MAR	HW 2	By 4:30pm
4. 10 APR	<i>Mid-Term 2, In Class</i>	Closed Book, Closed Notes
5. 24 APR	HW 3	By 4:30pm
7. 2 MAY	<i>Final Exam, 6-8pm</i>	Closed Book & Notes

All exam-related absences must now receive **prior approval** from the UG advisors and me, for UGs. The exams are in-class; there's no make-up date for midterms and the make-up for the Final will be held in the Fall 2018 semester. **NB**

Please Note: All requests for regrades — **even discussions of the grading** — should be directed to me **NB** at most a week after the graded item is returned, in my Office Hours, and *never discussed with 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 Canvas and in your weekly e-mail!) And we will help you work through problems posted (with solutions) on Canvas.

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 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. Whenever possible, these handouts will also be uploaded to Canvas. 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, on Canvas. Whenever possible, I will create a PDF version that you can double-click on and print.

9 Topic Sequence

The following is tentative – it is only by attending class (or by following along with a colleague's or Canvas's help) that you will know precisely where I am. I try never to skip part of a topic, but I may leave some material for you to read from the text. Each week, my Thursday e-mail will direct you to readings in the text or in Canvas – for which you will be responsible.

For approximately the first third of the course (~ 8 lecs) I will concentrate on *FORWARDS, FUTURES & SWAPS, with applications*; For the second third of the course (~ 9 lecs) we'll study *OPTIONS, with applications*, mainly on equities and equity indexes; and the final third (~ 9 lecs) will be devoted to *CASES & APPLICATIONS*, including product design, exotic options, credit products, and so on. In the first two-thirds of the course we lay the foundations – and please note that in that process we will include a large number of examples and applications! The final third is really special applications and derivative structures, mostly done with cases.

Topic	Description	Remarks
1.	INTRODUCTION	Syllabus & IntroLec Notes
2.	Forward & Futures Markets	Lec Notes, Text, and RDGS
3.	Forwards & Futures Pricing	Lec Notes, Text
4.	Commodity Futures	Lec Notes, Text
5.	Hedging w Applications	Lec Notes, Text, RDGS
6.	Swaps	Lec Notes, Text, RDGS
7.	Incldg Equity Swaps	Lec Notes, Rdgs
8.	Options Markets	Lec Notes
9.	Payoffs for Basic Strategies	Lec Notes
10.	No Arbitrage Pricing	Lec Notes, Text
11.	Optimal Exercise of Options	Lec Notes, Text
12.	Valuation by Replication	Lec Notes, Text
13.	Multiperiod Binomial Pricing	Lec Notes, Text
14.	Zoom to Black Scholes	Lec Notes, Text, RDGS
15.	Empirical Evidence	Lec Notes, RDGS
16.	Alternatives to Black Scholes	Lec Notes, Text, RDGS
17.	Cases, Applications including Credit Products, Securitisation, Product Design & Exotic Options Guest Speaker(s)	Course Pack from Repro TBD

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