

Derivatives

In finance, derivative refers to a class of securities that are based on and derive their value from other investments and, many times, other securities. The sometimes hopelessly complex features of some derivatives have turned them into excellent vehicles for fraud or at least unscrupulous behavior. Consequently, “derivatives” has become a dirty word.

Despite their bad reputation, derivatives have played an instrumental role in keeping our financial markets and economy running efficiently. The principle of a derivative is (and will always be) an integral part of our modern financial world; and it is useful and even imperative to understand at least the basics of a derivative.

Probably the most important features of derivatives to understand are the following. First, the only real way to value a derivative is to first value the asset on which it is written. Only if you do this, can you make an accurate assessment of the derivative of interest.

Second, a stock is, essentially, a derivative on the value of the company. The only way to truly value a stock is to first value the company on which the stock is written.