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Derivatives in investing: Why they're not the bad guys

The use of derivatives has caused severe losses to many speculative investors who've guessed wrong about the next market move, which is why they've earned a bad reputation. But used in the correct way, derivatives have actually helped millions to protect their money. Here we explain what they are, how they work and why investors need them

What are derivatives?

Derivatives are financial instruments whose values are "derived" from underlying assets, like stocks or bonds (basically, any asset that can be valued). They usually take the form of a contract between two parties that is based on the parties' views of the future movements in the asset's price. They became popular in the 1970s, following the sharp increase in financial market volatility, to help investment managers and traders protect the value of their portfolios and manage (or "hedge") risk. However, they soon became tradeable in their own right as traders created new varieties and found more diverse applications for them. The more advanced types came with high risk, as some have unlimited downside and some involve leverage, which can potentially lead to losing huge sums of money. This is how derivatives in general have earned a reputation for being very risky.

Limiting the downside

When used for their original purpose of protection, derivatives can be very effective in helping limit the downside when markets fall. In South Africa, the use of derivatives by unit trusts is permitted, but strictly regulated by the Collective Investment Scheme Control Act (CISCA), which allows unit trust managers to use derivatives solely for protection, not speculation.

One of the most commonly used derivatives for protection is an equity put option, which is a contract that gives the owner the right to sell a specified number of underlying shares at a certain price, within a specific amount of time. At Prudential our use of equity derivatives is limited largely to put options. Much like an insurance policy that provides protection in adverse scenarios, derivatives do come at a cost, which we need to be mindful of.

As a simple example, if an equity fund manager believes that there is a very good likelihood that the share price of Naspers will fall in the near-term, but they don't want to sell their holdings outright, they can limit their potential losses by buying a put option to sell a certain amount of their Naspers holdings once they decline to a certain price within a specific timeframe. The manager may not want to sell the shares directly because they believe from their analysis that it is a sound longer-term holding, but may foresee a shorter-term decline (due to external market risks, or a temporary deterioration in the environment, perhaps).

So if a fund manager buys a put option to sell 1,000 Naspers shares at R100 per share and the share price falls to R80 within the specified time, the manager can then sell the shares at R100. The manager has therefore limited their losses and can then even decide if they want to purchase the shares back in the market at R80, for a R20 profit.

Fund managers can also protect their entire equity portfolio from losses by buying a put option on an equity index. So if they believe the South African equity market will lose ground over the short term (perhaps due to falling commodity prices, for example), they can buy a put option on the FTSE/JSE All Share Index or the Top 40 Index, for example.

It’s not uncommon for unit trusts to be able to hold derivatives nor is it necessarily a high-risk investment strategy. Instead, as with certain Prudential unit trusts, it merely allows the fund manager greater flexibility to protect investors against downside risk in uncertain market conditions.

For more information or if you have any questions please speak to your financial adviser. Alternatively, contact our Client Services Team on 0860 105 775 or email us at

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