

How To Minimize Risk With Derivatives

Derivatives have come under scrutiny in recent times, owing to the use of hedging instruments by companies for financial mismanagement. The misuse of derivatives has put many companies in the legal line of fire. The popular notion that derivatives caused the downfall of companies like Enron, is however, not true. The derivatives by themselves are not damaging. It is their misuse that can cause trouble for businesses.

What are Derivatives?

Derivatives are financial arrangements by which your company earns profits based on the functioning of an underlying asset.

If used properly, derivatives can store up your company's defense against many economic problems.

Advantages of Derivatives

1. Flexibility

Derivatives can be used with respect to commodity price, interest, exchange rates, and equity price. They can be used in many ways.

2. Risk Reduction

Derivatives can protect your business from huge losses. In fact, derivatives allow you to cut down on non-essential risks.

3. Stable Economy

Derivatives have a stabilizing effect on the economy by reducing the number of businesses that go under due to volatile market forces.

Disadvantages of Derivatives

If derivatives are misused, they can boomerang on the company.

1. Credit Risk

While derivatives cut down on the risks caused by a fluctuating market, they increase credit risk. Even after minimizing the credit risk through collaterals, you still face some risk from credit protection agencies.

2. Crimes

Derivatives have a high potential for misuse. They have been the caused the downfall of many companies that used trade malpractices and fraud.

3. Interest Rates

Wrong forecasts can result in losses amounting to millions of dollars for large companies. They can wipe out small businesses. You need to accurately forecast the long term and short term interest rates. This is something that many businesses cannot do.

Minimizing Risks with Derivatives

So how do you minimize the above-mentioned risks with derivatives? Here are some suggestions.

1. Future Exchanges

Arrange the derivatives through future exchanges. You may need to put in a lot of work here. You must keep track of all adjustments in the market worth of the underlying asset.

2. Asset and Liability Driven Transactions

The transactions should be driven by asset and liability management. You should not speculate based on future forecasts.

3. Derivative Policy

A good derivative policy focuses more on cost management and less on forecasting. It should aim for cutting down expenses and costs.

Additional Help

While dabbling in derivatives is risky if you choose to speculate, derivatives can be an important tool for financial structuring and cost management if you use them correctly. If you do not know how to start investing in derivatives, you can consult a small business advisor or financial consultant.

Remember, if you do go for derivatives, always play by the book and never try anything illegal.

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