Alternative Investments
Derivatives, Commodities, Hedge Funds

Derivatives

Once a lowly step-child of the investment industry, derivatives have taken on new meaning as more and more creative investment products have been packaged. They are securities created by Dealers or Financial Institutions to meet certain market needs. The popular ETFs and I-Shares are derivatives, as are options and futures. Some of the more common types encountered are:

Options

Options are rights to buy or sell a certain amount of stock at a specified price at a specified time in the future. Investors may write (sell) options or buy them. The theory is that the company stock price will have moved favorably in the future so that the investor can profit.

Puts and Calls

A put is the right (and obligation) to sell a stock at a price in the future. The investor who purchases a put will hope the stock price will go down, so that it is sold for more than the price of the stock.

A call is the right to purchase a stock at a price in the future. The investor who purchases a call hopes the price will go up, so that it is higher than the stipulated price in the option. In both cases, the investors will have made a profit.

Buying and Selling options

There are various option exchanges, which are supervised by the Options Clearing Corporation (OCC) which supervises, lists and guarantees performance on option contracts. They are only sold through Brokerage Firms.

In and Out of the Money

An option, which has value currently is said to be In The Money. For instance, a call with the security selling for more that the strike price, and a put with the security selling for less than the strike price are examples of In The Money Options. An Out-of-the-Money Option is currently priced unfavorably to the investor (NOTE: It may change, prior to the expiration date).

Strike Price and Expiration Date

Strike price is the price at which the security would be bought or sold at the end of the term of the option. The expiration date is the end of the term of the option

Intrinsic Value and Time Value

The intrinsic value is the amount by which the option is In The Money. The time value is the total amount of the option when due.

Commodities

Commodities are hard goods such as grain, oil, currencies, ore, timber, minerals, etc. They are generally, but not always, purchased in the Futures Market, in which contracts for purchase and sale at a time in the future are sold.

Futures

Futures specify a forward date of delivery or receipt of an amount of a tangible product. Futures are often used as a hedge against price changes, and as speculation vehicles. You can but and sell futures on currency, commodities and markets, among others. Note: the futures markets are very sophisticated to trade.

Alternative Investments And Strategies

Managed Futures

Managed Futures offer a money manager specializing in Futures which purchases and sells contracts for the client with discretion. Managed Futures are often used as a diversification tool, offsetting stocks, bonds and traditional securities.

Real Estate Investment Trusts (REITS)

REITS are packages of properties, or a fund of such packages (Such as shopping centers, commercial developments, etc.) which pay a relatively high rate of interest. They are often limited partnerships, and have tax considerations, which may or may not be favorable

American Depositary Receipts

ADRs are domestic securities tied to foreign stocks and sold on US exchanges in dollar denominated forms. They offer investors a convenient and understandable way to invest in foreign companies. Although dollar denominated, they still bear the currency risk of the home country as they are "Mirror " securities.

Direct Investments/Private Placements

A Private Placement is a security sold to a limited number of qualified investors, and may have any of the investment vehicles discussed in this section as the underlying securities. Partners are limited as to their liability in the venture, and the placement will be managed by a general partner who takes more risk, but is paid a management fee, as well as their share. Many Hedge Funds operate as Private Placements. Direct Investments are sold as limited partnerships and pass through income and tax losses directly to investors. They are seldom used today.

Hedge Funds

Hedge Funds are (Currently) unregulated investments managed by a hedge fund manager. Unlike traditional Managed Accounts, the investor does not know what the Manager is buying, selling, shorting or optioning. They are offered as direct private placements or as Fund of Funds, which is a package of several hedge funds collectively offered by a specialist While Hedge Funds directly have minimums of $1 Million or more. Fund of Funds offer accounts for as low as $25,000. While not for everybody, they can be good diversification strategies.

Since Hedged Strategies of any kind are highly risky, they require a great deal of expertise and experience to maintain as part of a portfolio; for this reason, detailed discussion of Hedge Funds, and of other similar strategies generally referred to as "Alternative Investments", will be largely reserved for the intermediate and advanced sections of this educational course and instructional program.