

JuiceNotesTM

Derivatives

CFA Level 1
2026

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Derivatives

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Derivative Instrument and Derivative Market Features

FinTree Fruit 1: DERIVATIVE FEATURES

Definition:

A derivative is a security that derives its value from the performance of underlying asset.

A derivative does not directly pass through the returns of the underlying but transforms the performance of the underlying.

Under derivative contract, Buyer = LONG and Seller = SHORT.

- **Standalone Derivative-** This derivative contract is a derivative on a stock or bond.
- **Embedded Derivative-** It is a derivative within an underlying, such as a callable, puttable, or convertible bond.
- ✓ **Exchange-Traded derivatives-** These are standardized and backed by a clearing house. Eg. Options and Futures
- **Over-the-counter-derivatives-** These are traded by dealers in a market with no central location. OTC markets are unregulated and each contract is with a counterparty. This may expose the owner to default risk. Eg. Forwards, Swaps and Options.

Features of Derivative Contract

- More liquid
- Can sell short
- Small cash outlay
- Lower transaction costs
- Tool for portfolio diversification

FinTree Fruit 2: DERIVATIVE UNDERLYINGS

Underlying Category	Examples	Derivative Types	Purpose/Use
Equities	Individual stocks, stock indices	Options, forwards, futures, swaps	Speculation, hedging, compensation (stock options)
Fixed-Income	Bonds, interest rates	Options, forwards, futures, swaps	Hedging interest rate exposure, portfolio duration
Currencies	Foreign exchange rates	Options, forwards, futures, swaps	Hedging currency risk, speculation on exchange rates
Commodities	Soft and hard commodities	Futures, options, swaps	Hedging price risk, exposure to commodity markets
Credit	Issuer default risk, credit indices	Credit default swaps (CDS)	Managing default risk, changing portfolio exposure
Other	Weather, cryptocurrencies, longevity	Various derivatives	Managing risks specific to weather, crypto, longevity

- **Equity Swaps:** Exchange returns between stock indices or an index and an interest rate.
- **Interest Rate Swaps:** Convert fixed to floating interest rates.
- **Commodities:** Soft (e.g., cattle, corn) and hard (e.g., oil, metals).

FinTree Fruit 3 : DERIVATIVE MARKETS

Aspect	OTC Derivatives	Exchange-Traded Derivatives (ETD)	Central Clearing
Nature	Informal/formal organizations	Formal exchanges	Mandated clearing post-2008 crisis
Participants	End users, dealers, market makers	Market makers, risk takers, participants	Central Counterparty (CCP)
Customization	Highly flexible, tailored contracts	Standardized contracts	Maintains OTC flexibility with CCP
Transparency	Less transparent, limited disclosure	More transparent, full transaction information	Enhanced transparency to regulators
Liquidity	May be less liquid	Generally more liquid	Aims to enhance liquidity with CCP
Counterparty Risk	Higher due to customization	Lower due to standardization	Credit risk transferred to CCP
Settlement	Typically bilateral	Efficient clearing and settlement processes	CCP manages clearing, reduces risk
Regulatory Response	Increased focus on risk and transparency	Regulatory mandate for central clearing	Systemic risks, enhance risk management

Central Clearing Process

Trade occurs on SEF:

EXECUTION

SEF shares trade details with CCP:

SUBMISSION

CCP replaces original contract:

NOVATION