What investors should know about derivatives

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Derivatives do not, on their own, have value. They, by definition, derive their value from the price of another asset, whether that be the level of the equity market or the value of a currency, for example. So, derivatives can be helpful tools in modifying the risk profile of a portfolio, but in my view, cannot be the basis of an investment portfolio. So for us, we always build a bond portfolio first and we may use derivatives on the edges to help true up our risk exposure so that we don't have too much risk in any one particular area. But derivatives should not be the basis of a bond portfolio.

Investors should be aware of the derivatives and the latitude with derivatives that their manager may have. Derivatives may or may not present a lot of risk to a portfolio but investors ought to know where their risk is coming from and if there is additional risk hidden in their portfolio via derivatives.

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Investing in derivatives is a specialized activity that involves special risks that subject the portfolio to significant loss potential, including when used as leverage, and may result in greater fluctuation in portfolio value.

There are risks associated with fixed-income investments, including credit risk, interest rate risk, and prepayment and extension risk. In general, bond prices rise when interest rates fall and vice versa. This effect is usually more pronounced for longer term securities.

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