WORDS THAT LAST

"No nation was ever ruined by trade."

Benjamin Franklin (1706 to 1790), American statesman and philosopher

DERIVATIVES safest tools around

By Peter Harmsen
THE CHINA POST

In the local financial community, there is a d-word. What it stands for can potentially mean enormous advantages to Taiwan companies. But the companies shun it, this d-word. It's derivatives.

According to current conventional wisdom, derivatives trading is a sport for people who have grown tired of bungee jumping or sky diving.

However, derivatives trading could also be characterized as the potential favorite activity for people who wouldn't board a ship without slipping into a life ring first.

In short, derivatives are the riskiest of tools and the safest of tools. It all depends on how they are perceived — as devices to avert risk, i.e. hedging, or as vehicles to make money, i.e. gambling.

Speaking at a recent conference on finance and banking held in Taipei, Joseph Wong, executive chairman of the Australian company CCK Treasury Systems, tried to dispel some of the myths surrounding derivatives.

"The good thing about derivatives is that you can use them for hedging. The bad thing about them is that you can abuse them. But of course, you can abuse anything," he said.

Basically, a derivative is an agreement to sell or buy a certain amount of a commodity — for instance a foreign currency — at a certain price at a certain point of time in the future.

In other words, there's ideally a lot of certainty involved in this kind of deal. It infuses much-hungered-for predictability into an otherwise unpredictable world.

Accordingly, Taipei-based John Isacs, managing director of the consulting company Intelink, sees derivatives as basically sound tools:

"The idea is to diversify investments, to find a certain area in the portfolio where the risk is, and then hedge the risk by means of derivatives," John Isacs says.

"By means of a small investment, a much larger investment can be secured. It's a very safe, a very good way to manage risk in your portfolio," he explains.

But there is one big don't, says John Isacs:

"You are not supposed to gamble."

Neither are you supposed to stay completely out of the market if being inside can help bring about advantages.

However, between these two options — being outside and being inside — some Taiwan companies opt for the former. And those opting for the latter don't necessarily do it the right way.

This isn't optimal, either for the entire market or for the individual companies: The derivatives market, if properly understood and properly operated, would be a perfect solution for many Taiwan companies, argues Ralph Liu, managing director at the Singapore-based company Advanced Risk Management Solutions.

"For instance, if an electronics company has input into its production from Japan, it will have to pay in yen. This will make yen its liability currency. If the yen goes up, the company will have to pay more in terms of its home currency," Liu says.

"On the other hand, if the company exports to the United States, the exposure will be in U.S. dollar, and the risk will be depreciation of that currency," he adds.

This risk of future fluctuation could be averted by hedging, agreeing to buy yen and sell greenback at a fixed price at a certain time in the future.

These good reasons for entering into derivatives, and staying there in a smart way have already persuaded many Taiwan companies. But some still hesitate.

Observers mention several reasons, including government regulations and lack of training among local company executives and financial managers.

But perhaps the prime explanation is the bad reputation enjoyed by derivatives. And why is that?

A derivative is about buying or selling a commodity at a fixed prices in the future. Of course, the price may be the same as the real cash-market price at that point in the future — but most likely it is not, and this will involve a win for one part, and a loss for the other.

The derivative may, of course, be traded long before this final deal is due. Actually, it may be traded many times. This is where the quick buck is to be made — and lost.

This is why the derivatives market is sometimes seen as the equivalent of Las Vegas in the world of blips and beeps and fluorescent data screens making up today's financial world.

"The problem is, people say, 'Wow, this is a great way to make money,' but if a too large part of the portfolio is made up of derivatives, a lot of money can be lost," says John Isacs.

"The upside can be tremendous, but the downside can be, too," he adds.

Given these conditions, observers agree that Taiwan companies should be in the derivatives trade, but should take care while getting there.

There is a task here for the governments of Asia, including that of the ROC, says Singapore-based Ralph Liu.

"In my opinion, a healthy derivative exchange should be established. As a matter of fact, all exchange-listed derivatives are healthy," says Liu.

If Asian governments don't act, investors may go abroad, says Ralph Liu.

"The analogy is with your teenage daughter. Do you want her to go out and meet someone in a park, or do you want her to take him home and watch TV in the living room," he says.

But there is a danger, too, if the governments in the region become too eager in attracting investors and liberalize their markets too much, argues Liu.

"The governments have to open up their markets leniently. Otherwise, they will attract all the bad apples," he says, referring to the let's-make-a-million-bucks-right-now type of trader.

TWO OF A KIND

According to Ralph Liu, managing director at the company Advanced Risk Management Solutions there are two kinds of derivatives:

First, those traded at stock exchanges. Very transparent, very standardized.

Secondly, those traded Over The Counter (OTC), i.e. not linked to trade at a specific exchange. Very flexible, very customized, and very dangerous.

"Most problems are with OTC derivatives," says Ralph Liu.

BAD FOR YOUR HEART?

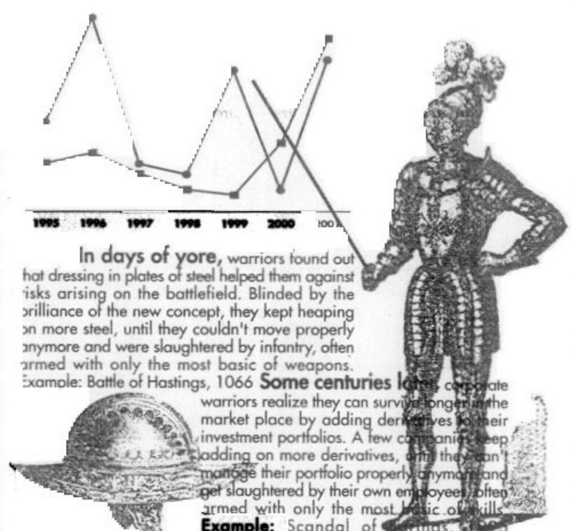
"Derivatives are like cholesterol.

Many people believe that all cholesterol is bad for you.

But that's not true.

Some is actually good for you,"

says Ralph Liu



—A. S. Imagen, The China Post