Durbin, Michael – All About Derivates

McGraw-Hill, 2011, [Finance] Grade 

If you want an accessible way of starting to learn about derivates this is it. Michael Durbin has written an easy going text, free from jargon and without too many equations. The equations needed are still there, if not in the text then at least in the appendixes. The text is basic but still relatively complete. When not writing books (in addition to this one he's the author of *All About High-Frequency Trading*) Durbin works as a financial technology consultant helping firms develop derivates trading systems and he also teaches classes on derivatives at Duke University and University of Chapel Hill.

This is not a book for the reader who is able to take a quick glance at an equation and instinctively understand its construction; instead the text is for those of us that benefit from a text-based, chronologically structured description of derivates contracts. As this is very much myself, I found the book to be extremely useful.

After an introduction one chapter is spent each on what forwards, futures, swaps, options and credit derivates are. When this level of basic understanding is set Durbin goes back and dedicates a new set of chapters to the pricing of all the above types of contracts. The longest chapter is, not surprisingly, that on the pricing options that starts off with a binomial pricing model and then goes on to explain the Black-Scholes model. Even though this is a book for the relative novice, the various theoretical short cuts in the Black-Scholes framework are dealt with and it becomes clear that there is a reason why it's called "a model". Durbin also gives an excellent run through of the so called Greeks. There are on top of these a few chapters covering risk management with derivates, hedging and, slightly more apart, the role that derivates played in the 2008 financial crisis.

You have to give Durbin high marks for his teaching skills. It takes a very deep understanding of something to give a simple, and still correct, explanation of it. Even I almost cannot help but understanding the pricing of options, the construction of swaps and the differences between credit derivates (performance guarantees) and ordinary derivates (price guarantees). As a side note, I appreciate that the explanations of certain concepts are repeated in the text. It gives a more seamless reading experience. For example, it is not always the case that the reader when getting to the end of a book remembers or can find an explanation that is made at the very beginning. As it is a text presenting "the easy way to get started", the reader will not find material on derivatives markets, various trading strategies etc.

With the backdrop of the financial crisis and Warren Buffett's statement of "financial weapons of mass destruction" Durbin ends the book with a chapter on whether derivates are any good to start with. His answer is defiantly affirmative "*Derivates exist because so does financial uncertainty. […] Derivates quantify uncertainty thereby letting us put exposures into reasonably tangible packages that can be measured, managed, priced and – most important – traded. That's their power.*"

Even so he doesn't shy away from the role that credit derivates played as instruments canalizing the hysteria of the US housing bubble. Derivates were hardly the causes of the events but they in part served as a facilitator. Credit derivates like Credit Default Swaps are basically securitized insurance on someone being able to pay off their loan. That someone doesn't have to be the same person as the one buying the insurance. And if there is a person buying the insurance there must be someone who's selling it and he's basically speculating that the loan will not be repaid. These long and short positions in insurance-like scenarios, especially in their synthetic forms, serve fundamentally different functions than traditional derivates. With sufficient regulatory oversight at least the latter serve their purpose.

Mats Larsson, May 24, 2013