

Derivatives—Session 1

Implementing Investment Strategies

Deeper Dive Webinar Series

June 22, 2015

2:00 – 3:15 pm ET

Panelists

- »» John P. Kavanaugh, Moderator
Independent Director
MFS Funds
- »» Philip Sindel
President
Olmstead Associates
- »» Payson Swaffield
Chief Income Investment Officer
Eaton Vance Management

Agenda

- » Overview of derivatives
- » Use of derivatives to implement portfolio strategies
 - » Managing risk
 - » Gaining exposure
- » Monitoring and oversight
 - » Adviser's monitoring
 - » Board reports

Derivatives Overview

Concept of a Derivative

“a derivative is a security so named because it ***derives*** its value from an underlying security or asset”

Common Derivatives: Futures

- » Represents an obligation to buy or sell
 - » Buy – “Long” future
 - » Sell – “Short” future
- » Regulated
 - » Commodity Futures Trade Commission (CFTC)
 - » National Futures Association (NFA)
 - » Exchanges
- » Leverage
 - » “it doesn’t take a lot to control a lot”
- » Forwards
 - » Negotiable, OTC traded version

Common Derivatives: Options

- » Right but not the obligation to buy or sell
 - » Right to buy – call option
 - » Right to sell – put option
- » Exchange traded and OTC traded (“exotics”)
- » Key terms
 - » Strike price
 - » Expiration date
 - » Underlying quantity
 - » Premium
- » Issuing an Option (Option Writing)
 - » Receives the premium
 - » Counterparty if exercised

Common Derivatives: Swaps

- » Negotiated exchange between investors
- » Key is what is being exchanged
 - » Fixed and variable interest rates
 - » Currencies at predefined exchange rates
- » Key terms
 - » Notional amount
 - » Length
 - » Reset dates
 - » Netted payments

Common Derivatives: Swaps

- » Major concerns
 - » Counterparty risk
 - » Unique terms
 - » Collateral management
- » Primary categories
 - » Credit default swap
 - » Currency swap
 - » Interest rate swap
 - » Total return swap

Derivatives Trading

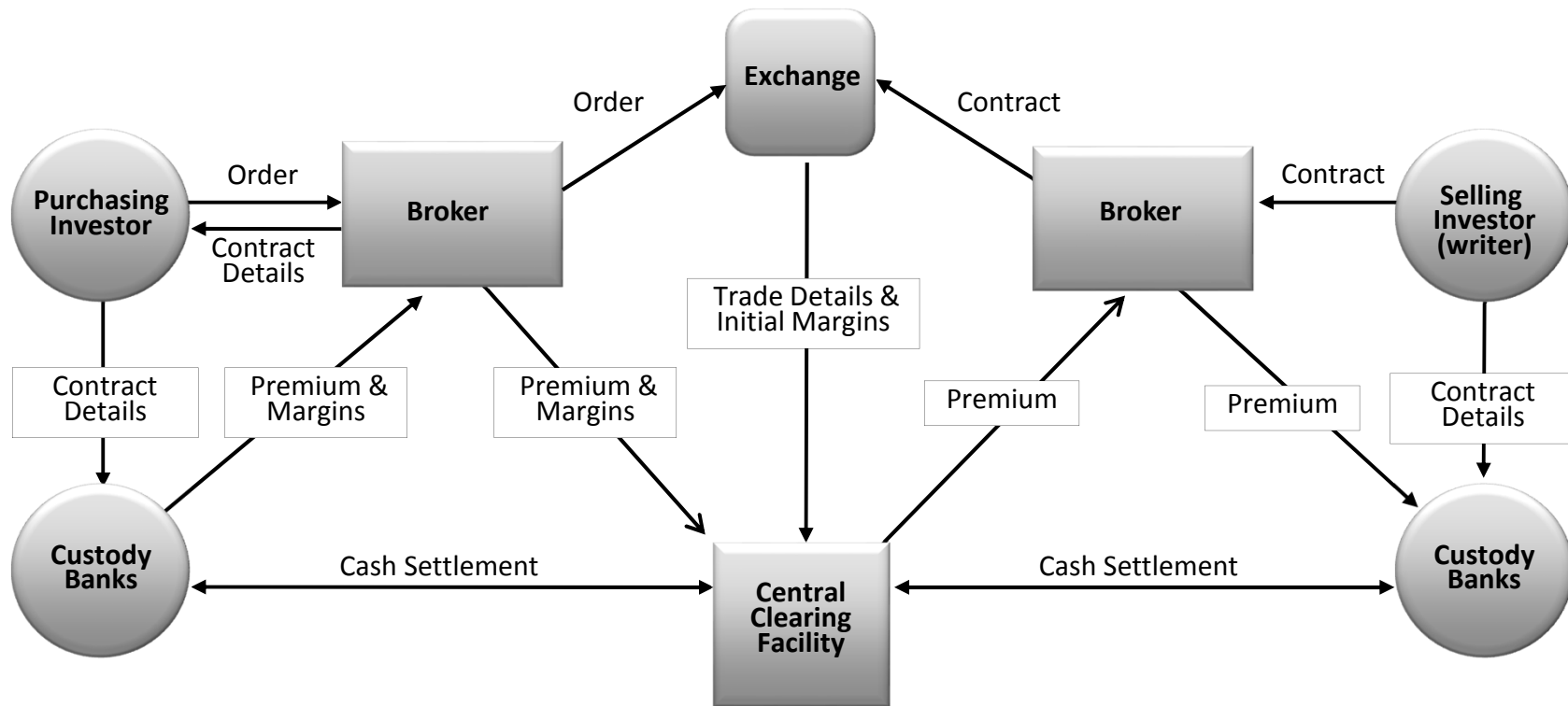
» Exchange Traded

- » Standardized terms
- » Minimal counterparty risk through clearing
- » High transparency through exchange (auction) process
- » Standardized, automated settlement process

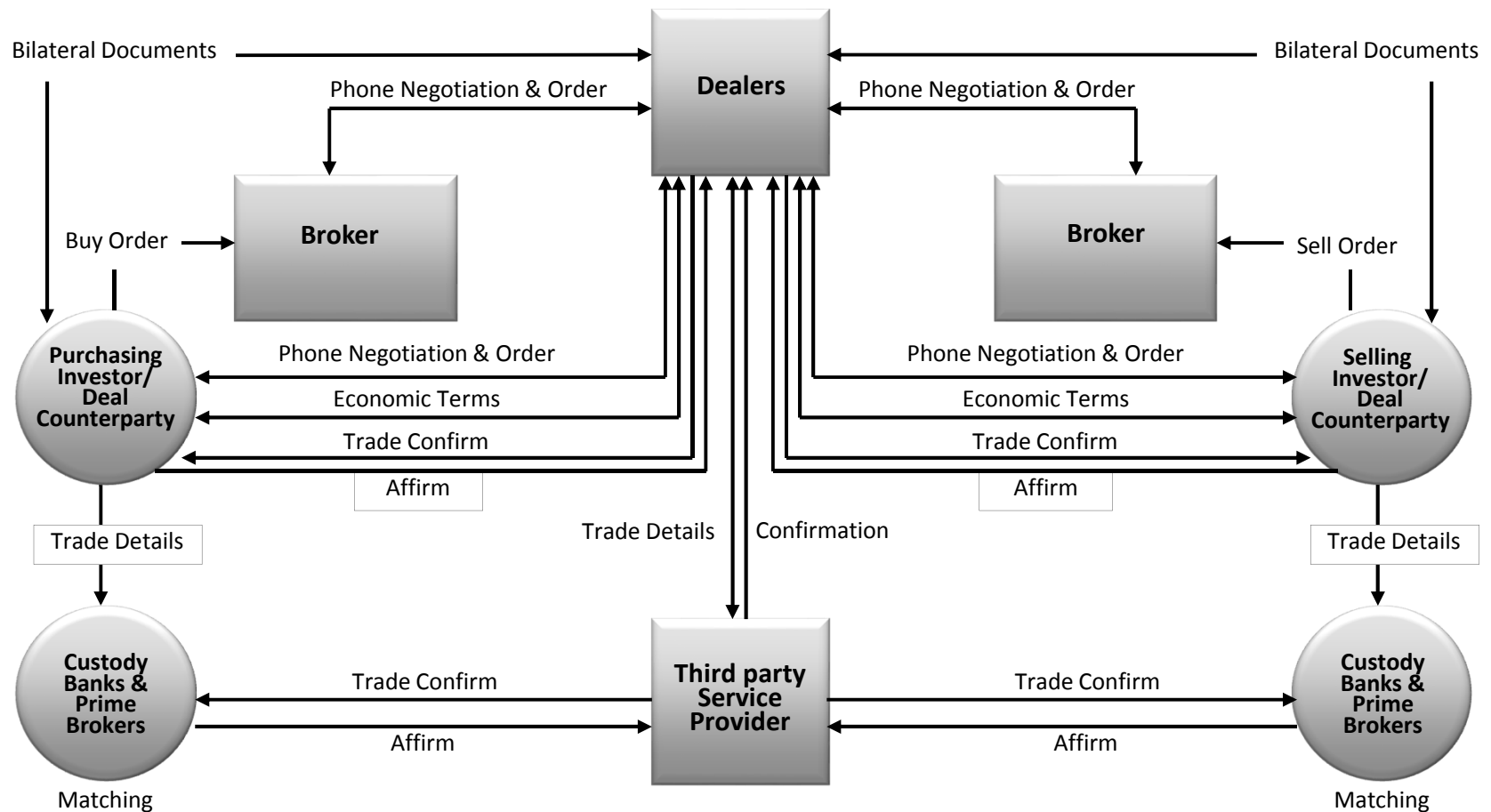
» OTC Traded

- » Negotiated deals
- » High counterparty risk
- » Lower transparency due to negotiated process
- » People and paper settlement process

Derivatives Trading: Exchange Traded



Derivatives Trading: OTC Traded



Use of Derivatives in Portfolios

Using Derivatives to Manage Risk

- » Hedge duration risk
- » Hedge currency risk
- » Hedge credit risk
- » Manage liquidity risk
- » Achieve overall risk target
- » Enhance income and reduce risk in equity strategies

Using Derivatives to Gain Exposure

- » Alternative way to gain exposure to desired risk
- » More efficient way to gain exposure
- » Only way to gain exposure
- » Arbitrage opportunity between cash security and derivative
- » Provide asymmetric payoffs; using options and credit default swaps
- » Gain economic leverage
- » Sell volatility

Monitoring and Oversight

- » Adviser's monitoring and internal reporting
- » Board reports
 - » Education
 - » Regular reports
 - » Attribution – performance and risk

Questions?

Appendix A: Panelist Biographies

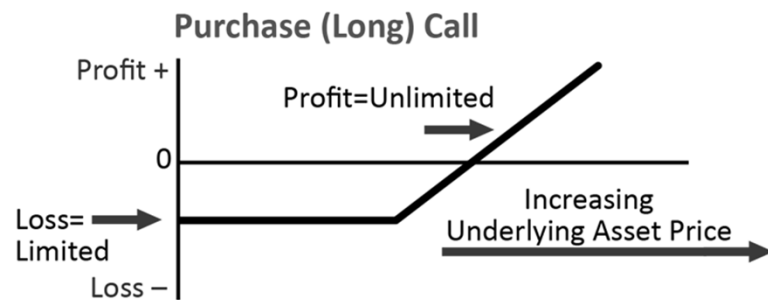
John P. Kavanaugh is an Independent Trustee of the MFS Funds. For over twenty years, he was an investment analyst, portfolio manager and corporate vice president with The Hanover Insurance Group, Inc. (formerly, Allmerica Financial Corp.). For his last decade at Hanover, he was vice president and chief investment officer of its insurance companies where he led an in-house investment management team as well as had oversight of the selection and performance monitoring of multiple investment sub-advisors to the company's mutual funds. From 2002 to 2006, he served as chairman of the board, president and trustee of Allmerica Investment Trust, Allmerica Securities Trust and Opus Investment Trust. John is a Chartered Financial Analyst. He holds an AB degree from Harvard College and an MBA from Harvard Business School.

Philip Sindel is President of Olmstead Associates, Inc. and has provided consulting and training services to the securities industry for over 30 years and has been with the firm soon after it was founded in 1994. Phil has provided strategic consulting services on projects that span the front to the back office at clients such as Federated Investors, Mass Financial Services, Putnam Investments, Omgeo, Columbia Management and the State of Georgia. Phil is also a key participant in Olmstead Associates' training services both as an instructor and class developer. These classes have been delivered both as public seminars in Boston, New York, Chicago and San Francisco and on site at clients such as State Street, DuPont Capital Management, Babson Capital Management, Bank of America, OPERS, Interactive Data and other major industry firms. Prior to joining Olmstead Associates, Inc., Phil had experience in the securities industry working at Aetna Life and Casualty, Mass Mutual and as an independent consultant. Phil also worked for the White House as Manager of Information Systems for the Executive Office of the President.

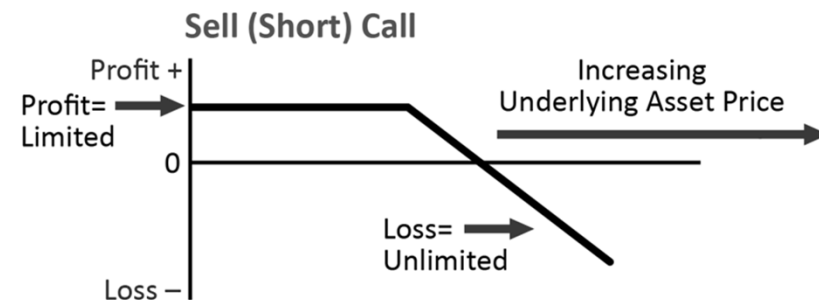
Appendix A: Panelist Biographies

Payson Swaffield is a vice president and chief income investment officer of Eaton Vance Corp. He is responsible for all income disciplines at Eaton Vance, including investment-grade and high-yield bonds, floating-rate loans, global fixed income, municipal bonds and customized solutions for institutional and retail accounts. He joined Eaton Vance in 1990. Payson began his career in the investment management industry in 1978. Before joining Eaton Vance, he held positions in valuation and corporate finance with Conning & Company, State Street Bank, Duff & Phelps, Inc. and in commercial lending with Northern Trust. Payson earned a B.A. from Middlebury College and an MBA from the University of Chicago Booth School of Business. He served on the Board of the LSTA (Loan Syndications and Trading Association) from 2001-2008 and currently serves as an overseer of the Museum of Science in Boston.

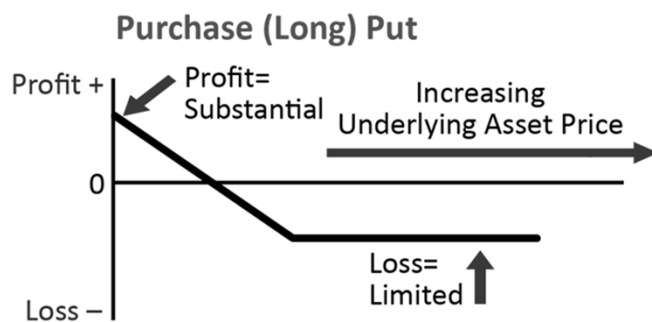
Appendix B: Options Payoff Diagrams



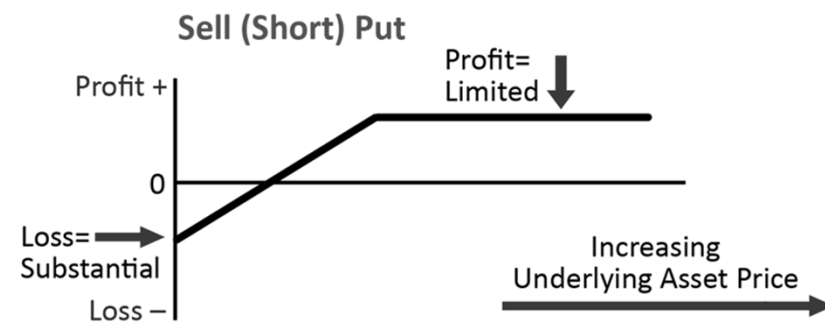
Participate in upside of asset price increase; limit downside exposure to option premium.



Receive option premium as additional portfolio return, in exchange for possible loss if asset price rises above option strike price.



Earn return if asset price falls; limit downside exposure to option premium.



Receive option premium as additional portfolio return, in exchange for possible loss if asset price decreases below option strike price.

Source: Chicago Board Options Exchange

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