

February 29, 2008

**Economic Indicators
Canada**

	Dec. 2006	Jan. 2008	
GDP ⁽¹⁾	2.8	2.7 ⁽²⁾	↓
CPI ⁽¹⁾	1.6	2.2	↑
Unemployment	6.1	5.8	↓

United States

	Dec. 2006	Jan. 2008	
GDP ⁽¹⁾	2.9	2.2 ⁽³⁾	↓
CPI ⁽¹⁾	3.2	4.3	↑
Unemployment	4.5	4.9	↑

(1) Year-over-year % variation
(2) November 2007 (3) December 2007

Sources: Statistics Canada, U.S. Dept. of Commerce, U.S. Dept. of Labor Statistics.

Equity Indices

% Change	2008 in local currency	2008 In C\$	
S&P/TSX	-1.5	-1.5	↓
S&P500	-7.6	-7.0	↓
Russell 2000	-8.7	-8.1	↓
Nikkei	-9.1	-5.3	↓
S&P 350	-11.1	-9.1	↓
Europe			↓

A Few Facts About Derivative Products—Part 2

In the first part of this article, we noted that many organizations have been hit with large losses due to derivative-product disasters. We reviewed some of the basic characteristics of derivative products and highlighted that large corporations and governments make significant use of them. For individuals, vehicles such as principal-protected notes involve derivative products to a large extent. Investors should be sure to understand the risks before investing in vehicles that involve derivative products. We will now see a few more of their characteristics and discuss some of their uses and misuses.

- 1. They require little cash investment:** Unlike using stocks and bonds, derivatives allow institutions to implement leveraged positions without having to borrow money. In fact, taking a derivative position requires very little cash investment. For example, buying \$100,000 in Canadian dollar *futures* requires less than \$10,000 as an initial investment. Since the investor is not buying Canadian dollars per se, but rather a promise to buy them at a later date, his disbursement only serves the purpose of protecting the seller of the *futures* against the risk that the investor may default on his commitment. The *Société Générale's* rogue trader, *Jérôme Kerviel*, had reportedly accumulated \$55 billion in positions—something he may never have done if he'd had to write a cheque for the full amount. **Huge losses with derivatives often involve some kind of overuse of leverage.**
- 2. Investors can buy or sell short with equal ease:** Short selling (selling something that the investor doesn't even own) an underlying asset with derivative products is easy because it involves little cash investment. **Traders tend to "accumulate" derivative positions:** whenever they want to close a position, they take a new one that hedges the "old" position rather than buying it back. This is why banks have huge aggregate derivative positions. **A vast majority of these positions can be attributed to "hedging," which is a sound risk-management practice.**
- 3. "Counterparty risk":** Over-the-counter derivatives are traded directly between two entities rather than through an exchange. This type of transaction involves *counterparty risk: the risk that the counterparty to the transaction will fail to deliver on its commitment.* Losses related to this risk can be severe. CIBC announced yesterday that it will take a \$2.3 billion writedown charge following the collapse of bond insurer *ACA Financial Guaranty Corp.* ACA had sold a type of derivative product called "credit default swap" to CIBC. This was a commitment that if certain bonds held by CIBC defaulted, ACA would cover the loss. When the bonds actually went into default, ACA was not able to deliver on its promise.

This article illustrates that derivative products are very powerful. In our view, derivatives are used properly in the vast majority of situations. However, abusive leverage, poor risk-management procedures, and excessive counterparty risk can lead their users to extreme losses.

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