

A dissertation on derivatives

There are few topics in the world of finance capable of arousing the sort of controversy, suspicion, misunderstanding or outright hysteria that derivatives do.

STEPHEN CHAMBERS reports.

Traders, Guns & Money

by Satyajit Das
(FT Prentice Hall, 2006)

Over their comparatively short life, derivatives have been likened to “financial weapons of mass destruction” and have been at the centre of several high-profile financial disasters, including the collapse of Barings Bank and more recently the failure of US hedge fund Amaranth whose US\$6 billion loss came as a result of leveraged positions taken in natural gas futures.

While the reputation of derivatives has no doubt suffered as a result of these and other so-called “derivatives disasters” there is little to suggest that investor’s appetite for these products is waning.

Indeed recent figures from the Bank for International Settlements (BIS) show that the level of notional exposure in OTC derivatives has reached a staggering \$US285 trillion.

A similar story exists at the major derivatives exchanges where trading volumes are at record levels and where mergers between securities and derivatives exchanges (such as those of the Sydney Futures Exchange and the Australian Stock Exchange) are serving to cement the place of derivatives as mainstays of the financial markets.

It is against this backdrop of controversy, contradiction and growth that Satyajit Das has released his own personal perspective on the derivatives industry – *Traders, Guns & Money*.

During a career in the financial

markets that has spanned some 25 years, Das has been at the derivatives coalface as both a “buy-side” and “sell-side” practitioner. He is also the author of a number of highly acclaimed reference books on derivatives and as such, is uniquely placed to comment on the role that derivatives have within the global finance industry and how they have served to transform the way in which risk is priced, traded and managed.

Unlike his other published works, which by necessity have been rich in their depth and mathematical complexity, *Traders, Guns & Money* offers a far more accessible insight into the workings of the derivatives industry.

Indeed as Das points out the book has been written for two distinct audiences: the first being those currently employed

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in banking and finance who, as Das modestly claims, will find the book a “wry and entertaining read” and the second being those who simply want an introduction to the “weird and wonderful world” of derivatives.

Through a clever combination of humour, street smarts and more than a dash of cynicism, Das gives *Traders, Guns & Money* a page-turning quality more reminiscent of a John Grisham novel than a dissertation on derivatives.

Through his narrative, Das brings the reader directly into the world of

derivatives and into the day-to-day lives, motivations and conflicts faced by market players such as traders, analysts, sales people and fund managers.

In doing so, Das offers a very human perspective on a subject that is more often than not dealt with in an abstract and detached manner. Indeed in some ways, the story that *Traders, Guns & Money* tells is less about the derivative instruments themselves and more about the human frailties that allow the leverage and complexity of derivatives to be used and misused in ways well beyond their core function as tools for risk management.

While there are many excellent chapters that demystify and explain the mechanics of structured derivatives (the topic on credit derivatives is particularly insightful), the real appeal of *Traders, Guns & Money* is that it is less about the minutia of derivatives pricing and trading and more about how investment banks, money managers and other participants continually “push the envelope” to create ever more sophisticated and for some at least, ever more profitable, financial products.

From vanilla interest rate swaps, hybrids, inverse floaters, collateralised loan obligations and the numerous products in between, Das chronicles the innovations that have taken place in derivatives throughout the past two decades.

At the same time, he also reveals that at least some of this innovation has been fuelled by motives that could be considered as less than honourable, such as the desire to circumvent equity ownership laws, avoid tax or to transfer unwanted risks to counterparties that

Portfolio management and investment strategy

Two new books cover some of the same topics but as **M. SCOTT DONALD** reports, the results are mixed.

invariably lack the sophistication to understand the risks they are inheriting.

While *Traders, Guns & Money* is generally informative and good humoured, occasionally one cannot help but despair at Das's seemingly bleak view of the derivatives industry and ask why he has chosen to stay within a field he so often pillories for its greed and dishonesty.

In one memorable section, Das recounts a time early in his career when he was given the task of showing new trainees around his bank's dealing room. Here Das writes how he described that salespeople were those that "lie to clients", traders were those that "lie to risk-managers", risk managers were those that "lie to management" and clients were those that are "lying mainly to themselves".

Stories of this kind are littered throughout *Traders, Guns & Money* and there is no literally no-one within the financial industry that escapes Das's ire. His refrain that "lies – both beautiful and true – are still the currency of trading" says much about his attitude towards the financial markets.

Despite its occasional grimness, there is no doubt that *Traders, Guns & Money* is a fascinating and compelling insight into the world of derivatives. Unlike other texts on the subject that are often dry or simply incomprehensible, Das has managed to use his considerable, wit, intelligence and experience to produce a book that will no doubt provoke many more spirited debates and discussions on the mysterious world of derivatives. **J**

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Pioneering Portfolio Management

by David F. Swensen
(Free Press, 2000)

Multi-Asset Class Investment Strategy

by Guy Fraser-Sampson
(John Wiley and Sons, 2006)

Disillusioned by equity market volatility and uninspired by the hard work of grinding returns out of fixed income markets, many investors have turned in the past five years to alternative assets.

For many, their inspiration is David Swensen and his team at the Yale Endowment; their guidebook, *Pioneering Portfolio Management*. Swensen's work in creating a peerless investment track record and then documenting some of the principles and beliefs behind that achievement deserve praise. He makes both seem easy.

Pioneering Portfolio Management reads like a modern Benjamin Graham. There are no clever tricks, no sure-fire, get-rich-quick strategies. Instead there are solid, common-sense prescriptions illustrated with well-chosen examples and careful language. His readers soon realise what they are in for. The scene is set by the opening chapters, one on the history of Yale endowment, the other on the nature of an endowment's financial objectives.

This is no mere window-dressing. Swensen is making an important point

– these things matter. Again and again his illustrative examples highlight the importance of understanding what and where things came from in order to recognise their true import. And if you don't understand what you are trying to achieve and why, "risk management" becomes mere cant.

For all his reputation as a "prophet" (not his words) of the virtues of alternative assets, Swensen nevertheless dutifully covers modern finance theory and traditional asset classes thoughtfully. Markowitz, Tobin and Sharpe share the lectern with Keynes, Schumpeter and Shiller, the iconoclasts.

Investment in alternative assets is presented in the same measured, common-sense way. His clear-sightedness also untangles many of the conflicts and dysfunctions in institutional investing, whether they are fee-charging practices, soft dollars or decision-making sclerosis.

If *Pioneering Investment Management* has a short-suit it is in his treatment of the international arena. That's easy to identify from Australia, where a global perspective comes naturally from the reality to see beyond the limits of a market accounting for perhaps 2% of the world's investment opportunities. His examples outside the US are fewer and less compelling than US-sourced examples and his treatment of currency risk is cursory. Perhaps that gives him something to work on for a second edition.

Multi-Asset Class Strategy covers some of the same ground as *Pioneering* ▶