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 in derivatives throughout the past two decades. 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

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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.

Stephen Chambers is a Senior Fellow of Finsia.