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Does is matter which side of the trade you're on in a derivatives meltdown?

When the subjects of options and derivatives come up, even pundits will depart from their usual cheerleading and adopt an admonishing air of "don't try this home" to the armchair daytraders: "90% of all options expire worthless" they will say, wagging their fingers at the TV camera. The implication being that most amateur daytraders waste their money buying options that expire out of the money.

Which is probably true. But a large chunk of derivatives aren't bought by the amateurs, many of them are bought by the commercials, funds and institutions by way of hedging their positions and they actually want them to expire worthless.

I'm an amateur, but recently I found myself thinking through a strategy that has me buying options that I think will make me a lot of money in a crash, but all things being equal, I'm hoping they'll expire worthless two years out. If they do, it means the economy has more or less kept going, and if the economy keeps going it means my main business interests will probably hold up (unless I screw things up on my own).

If there is a crash, I think it'll be a big one, one that heralds the arrival of an undisputed, no-massaging it, full on recession. So I'm positioning for that (I think). If it happens I'm hoping to be well hedged and flush with enough cash to get across the tough times following it.

When non-professional hacks like me talk about the possibility of a crash, you can safely ignore it. I'm just one of many cranks who pound out a blog from underneath my tin-foil hat. But when central bankers talk about "Asset Repricing" you have to understand that central bankers talk in soft, non-threatening sounding euphemisms about the kinds of things us unsophisticated fringe contrarians are scared stiff about.

But lately I've been wondering about whether my derivatives holdings would hold up in a serious meltdown situation, even if I'm on the right side of the trade. The total size of derivatives positions worldwide is reputed to be something like an order of magnitude larger than the aggregate M3 money supply of the world. I can't remember where I read that but it means that all the derivatives contracts add up to literally "more than all the money in the world". (According to the BIS the notional value of all derivatives was 57 trillion dollars at the end of 2004, and since then, the amount of derivative contracts being floated has gone parabolic).

So let's do a simple thought experiment:

- let's say the total notional value of derivatives is 20X the aggregate M3 of the USD, CAD, Euro, Swiss Franc, the Pound and the Yen.

- then posit a first domino: somewhere something happens along the lines of an Asian Flu, LTCM, Financial 9/11, etc.

- for fun, add in a cascading failure that burns through the global financial system, let's say this wildfire sucks up only 10% of all the open derivatives (that would probably be a relatively "mild" derivatives meltdown)

- so derivatives totalling twice the aggregate money supply of the major currencies implode

- I am on the "right side" of the trade in all my positions (ha!)

The "sell" side of all the winning options would be on the hook for an amount of money equal to total M3. Do you think the people who sold those contracts are going to be able to pay out?

My guess is the "winning side" of all the derivatives contracts in a meltdown situation would be lucky come out of it with pennies on the dollar.

People who put their money into physical unencumbered assets like gold, silver and land would probably make out like bandits tho.

Just thinking out loud. This is not investment advice, remove cellophane before eating, etc.

Posted by Mark Jeftovic in Thinking out loud at 22:40

I am an 'unsophisticated' investor. Like you, I have mostly kept my excursions beyond stock trading to options trading, including LEAPS (I'm presuming that is what you are alluding to in your post). There are derivative critters out there that I readily admit I don't understand. How is it possible to have derivative investments that are worth many times what they are derived from and somehow expect everything to come to some sort of equilibrium in the event of a catastrophic meltdown? Like you, I have pondered that fact and have concluded that aside from the occasional forays into these relatively simple types of derivatives, count me out. The way I look at it is that in the event of a meltdown, there will be serious effort made by investment houses, banks, even the central banks, to keep things afloat as long as possible. To me, that means not being greedy. When things get crazy, get out while there are still funds to honour what is due to you, then sit back with a good single malt and a cigar and breathe easy.
Anonymous on Jan 30 2007, 09:41

I am not expert in how to profit from a depression.

As far as I know, the Great Depression lowered real estate prices in America. For example, according to http://www.realtor.org/vlibrary.nsf/pages/amf2006, in early 1934, U.S. Secretary of Commerce Daniel Roper, speaking to the Philadelphia Real Estate Board, said 1933 "recorded the greatest amount of liquidation in the history of real estate over any previous 12 months' period." He added that low real estate values and declining sales had weakened the building and construction industries. In summary of Roper, the values (in other words, the prices) of real estate declined in 1933. Many sources support the conclusion that real estate prices declined during the Great Depression, not just in 1933. By the way, real estate prices also dropped in East Asia during its 1997, severe recession. Buyers usually borrow most of the purchase price of real estate. During a depression, many potential buyers no longer qualify for loans. Furthermore, many potential buyers who qualify for loans during a depression become pessimistic about their economic future and therefore decide not to borrow. As a result, sellers of real estate during a depression often sell for what ordinarily would merely be a down payment. I think that this is an important reason why real estate prices seem to decline during depressions.

According to "Descent Into the Depths (1930)" by Dan Blatt, which is at http://www.futurecasts.com/Depression_descent-end-'30.html, silver had cost 65 cents per ounce in 1926, before the depression. The price declined sharply toward the end of 1930. It hit 30 cents at the end of 1930 and 26 1/2 cents on 7 February 1931. The price of silver crashed in May 1931, when the Chinese Reserve Bank stopped buying silver. In conclusion, the depression seems to have driven down the price of silver. I don't claim that it is common for the price of silver to decline during depressions.

As far as I know, the price of gold in America, and I guess elsewhere, rose during the Great Depression. I guess that buying gold (for example, bars of gold which weigh a kilo or a fraction of a kilo) before a depression, then selling the bars during a depression, is a good way to profit from a depression. Some jurisdictions do not allow people to own bars of gold.

I'm not in the gold business and I don't sell gold.
Anonymous on Apr 26 2007, 17:25

If you look at LTCM, they made a mistake, which was easy to see in hindsight. When you short a currency (the ruble), in a liquid market, you have... well, a short position.

When you short a currency in what becomes an illiquid market, you end up, in effect, going long on the underlying fundamental.

Derivatives work, and only work, when the underlying fundamental market itself is liquid.
Anonymous on May 27 2007, 00:18