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Does it 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.

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