Monday, January 29. 2007

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

Friday, January 26. 2007

I don't get the new "New Economy" (2.0)

Back in 1999 I was walking around in a mental fog because I was coming off of a multi-year bender and had recently stopped drinking, smoking and,uh, other related recreational vices. At the time I was worried I was going to die from boredom (turned out not to be the case at all. My life has been more exciting and fulfilling since I cleaned up than I ever could have imagined, but that's another story...)

So I decided to start daytrading. I took out a $1,000 cash advance on my VISA card and opened an E-trade account. By March 2000, it was worth over $9,000 and I thought Warren Buffet was a pussy. I keep that E-Trade account open to this day as a reminder. It's worth $200 now.

Anyway, at the time I remember walking around the warehouse district where my office was thinking about "the new economy". I just couldn't wrap my head around it. A lot of the companies trading on the stock market weren't making any money. A lot of the start-ups getting funded had no prospects of revenues. "Aha" I thought. "I guess what it's about now, is the stock price and investment flow". Companies didn't make money by selling stuff at a profit, I realized, they made money by raising it in the capital markets!

It was one of the many moments I stood on the precipice of a major epiphany, had I thought it through properly I probably could have done well, but once again, I missed the point. My mind couldn't make the critical leap to where it needed to get in order to profit handsomely ("Aha! We're in the middle of a bubble! START SHORTING STUFF") and knuckled under to the flawed, murky newspeak "I guess that's how things work now. This is a new paradigm for wealth building. The old rules don't apply at this new, permanently high plateau of the New Economy", and I went along with it. Silly me.

Well lightning does strike twice. Here we are and the DOW is reaching new highs daily while insider selling outpaced insider buying 55 to 1 last month (this ratio has been higher than 30 to 1 for over two years). The new Kook-aid (that was a typo for Kool-aid but I think I'll leave it), is "Web 2.0".

Companies like Slide.com are getting third round VC fundings of $20 Million and they are (as Michael Arrington politely calls it) "pre-revenue". It was interesting to find out about this shortly after yesterday's post about "remorasites". Slide is a remora to MySpace, and all it takes is one move from MySpace and Slide will get shafted for all that precious "mindshare".

Nowadays my biggest mental handicap is that I haven't had a decent night's sleep since becoming a parent nearly 11 months ago. But I don't need to be fully rested to realize we are in BUBBLE 2.0, echo bubble overdrive baby. Insiders are selling up a frenzy, most of the stock market's gains can be explained by inflation, no-revenue companies are getting close to 100 million dollar valuations and some VC's seem STUPIDER than MONKEYS.

Bearing in mind the old adage "The graveyards of Wall St. are littered with the bones of those who were too early", methinks it is a fine time to start thinking seriously about getting short, or at least well hedged.

Either that or it's time to learn ajax and start an aggregator with widgets that are tagable from social networks.

On mobiles.

Via RSS.

Can I have 20 million dollars now?

Posted by Mark Jeftovic in Venture Crapital at 15:51

Thursday, January 25. 2007

The problem with remora websites

In the biological world, remora's attach themselves to larger organisms such as sharks or whales and they "benefit by using the host as transport and protection and also feeds on materials dropped by the host".

I've coined the term "remorasites" to refer to the crop of websites that spring up around any big internet whale and derive their value entirely from servicing that website. The plethora of MySpace profile builders, AOL Instant Message Icon sites, Youtube scrapers all fit this category.
The sites could be further segmented into those that add value to the user experience of the host site, or those that simply extract value from it (leeching).

Examples of the former would be third-party AWS toolkits, which would enable people to easily build third-party websites that can hook into the Amazon product base. Examples of the latter would be the "Video Code" sites that had a heyday about a year ago (all they did was rip html for music videos code from Yahoo)

Building remorasites is a dicey proposition. The value-add ones can rely almost entirely on the existance of "blind-spots" in the host website's awareness or marketing niche. They see a value and then devote the time and energy to adding value, fulfilling a need. Clickbank for the longest time didn't have a "search" function for it's product base. A whole host of third-party sites emerged providing clickbank-malls which basically layered a search on top. Now clickbank has a product search. I haven't seen a "clickbank mall" around in awhile. I'm sure they are still around, but a change in the architecture of the host site can sure change things for the remorasites.

I've been bitten by this one myself. Shortly after building FeedBay as a way of playing with the Ebay Developer Tools I began to notice that little [RSS] icon at the bottom of Ebay categories. I'd been obsoleted!

People still do use FeedBay, but from here on in it's a straight case of residual crumbs: anybody looking for customized Ebay RSS Feeds finds FeedBay first, they use it, otherwise, they use the built-in Ebay feeds.

Over the last few weeks I got burned again. When I launched FeedBay, I got a few emails from people asking if they could generate RSS feeds using their own affiliate codes. Now there's a value added service I thought to myself, and promptly forgot about it while I went out and became a daddy, bought my company, moved houses, in short, lived my life until I revisited the FeedBay idea.

A week ago at night after the baby went down, I started coding in the ability for other people to generate feeds with their own affiliate codes. I finished it last night, typed "Ebay Rss" into google and realized I've been scooped again.
Ebay already allows affiliates to generate RSS feeds with their own affiliate codes.

So there were a few lessons I learned here:

If you see a value-add niche for a remorasite, MOVE FAST, the blind spot in the host won't last forever. If you have momentum when it ends, you have a chance to hold your own against the overwhelming advantages the host website has. If you are really lucky, part of their blindspot may be have been exposed by your site and to rectify their oversight, maybe they'll just buy yours. Who knows.

People will still use remorasites for functionality available directly from the host if they don't know the host offers that functionality. This then comes down to things like SEO and marketing.

There will always be ways the small operator can stay viable by doing it better, faster, simpler. When I look at the Ebay Affiliate RSS feed a number of value adds still come to mind: Adding in-depth tracking and reporting features, monitoring active RSS subcriptions from the major aggregators. There are still many possibilities to make FeedBay viable, but I'd hafta move on `em pretty quick (see #1). My Copious Spare Time isn't what it used to be.

The major issue about remorasites is that the entire ecology of your website is defined by an external entity in the host website. Whether the relationship is friendly (value added, encouraged via API's and toolkits) or hostile (leech sites) greatly impacts the longterm sustainability of the project. But either way, you are still subject to the whims of the host.

You could wake up tomorrow and your entire business case is moot, obsolete or facing new competition from the host itself.

Posted by Mark Jeftovic in Living off the net at 15:06