Contents

Preface			vii		
About t	About the Author				
Part]	I Int	roduction	1		
Part 1	II T	raded Assets and Liabilities	5		
Chapte	er 1 F	Primary Assets	9		
1.1	Marke	t Types	9		
1.2	Asset	Types	10		
	1.2.1	Physical Commodities	10		
	1.2.2	Financial Securities	11		
1.3	Buying	g on Margin	15		
1.4	Short	Selling	16		
1.5	Asset	Risks	16		
Chapte	er 2 D	Derivatives	19		
2.1	The Fe	our Basic Derivatives	19		
	2.1.1	Forwards	20		
	2.1.2	Futures	20		
	2.1.3	European Puts	21		
	2.1.4	European Calls	21		
2.2	Notab	le Derivatives	22		
	2.2.1	Repurchase Agreements (Repos)	22		
	2.2.2	Swaps	23		
	2.2.3	Swaptions	25		

	 2.2.4 Bonds with Embedded Options	26 26 27
Part	III Modeling Risks	29
Chapt	er 3 Market Risk (Equities, FX, Commodities)	35
3.1	Set up	35
3.2	Results	40
3.3	Pricing	42
3.4	Synthetic Construction	43
3.5	Bubbles	44
Chapt	er 4 Market Risk (Interest Rates)	47
4.1	Set up	47
4.2	Results	49
4.3	Pricing	50
4.4	Synthetic Construction	51
4.5	Bubbles	51
Chapte	er 5 Credit Risk	53
5.1	Set up	53
5.2	Results	56
5.3	Pricing	56
5.4	Synthetic Construction	57
5.5	Bubbles	58
Chapte	er 6 Liquidity Risk	59
6.1	Temporary Quantity Impact on the Price	59
	6.1.1 Set up	60
	6.1.2 Results	64
	6.1.3 Pricing and Synthetic Construction	64
6.2	Permanent Quantity Impact on the Price	66
	6.2.1 Market Manipulation	66
	6.2.2 Pricing and Hedging Derivatives	67
	6.2.3 Conclusion	68
Chapte	er 7 Operational Risk	69
7.1	Management and Accounting Controls	69
7.2	Risk Management	69

	Contents							xiii
-	er 8 Trading Constraints							71
8.1	Set up							71
8.2	Results							74
8.3	Pricing and Synthetic Construction							75 76
8.4	Bubbles	• •	•••	•	•	•	•	76
Part 1	IV Optimizing Risk							77
Chapte	er 9 Individuals							81
9.1	Set up							81
9.2	Objective				•			81
	9.2.1 The Expected Utility Hypothesis				•			82
	9.2.2 Risk Aversion							83
	9.2.3 The Risk Management Problem			•	•		•	84
9.3	Solution							84
	9.3.1 Finding Arbitrage Opportunities							85
	9.3.2 Risk Optimized Portfolios							86
9.4	Complications	• •	•••	•	•	•	•	87
Chapte	er 10 Firms							89
10.1	Set up			•	•	•	•	89
10.2	Objective			•	•	•	•	89
	Solution							90
10.4	Complications			•	•	•	•	91
Chapte	er 11 Banks							93
11.1	Set up							93
11.2	Objective				•		•	93
	11.2.1 Regulatory Risk Measures				•			94
	11.2.2 The Constrained Optimization Problem			•	•		•	95
11.3	Solution							96
11.4	Complications	• •		•	•	•	•	97
Part `	V Managing Risks							99
	er 12 Diversification							103
12.1	The Basic Idea	• •			•			103
	Portfolio Risk Minimization							104
12.3	Conclusion	•			•			105

Contents

107

	Risk Reduction	107
	13.1.1 Portfolio Insurance	107
	13.1.2 Floating Rate Loans	108
13.2	Cost of Carry	108
	Put Call Parity	109
	Coupon Bonds	110
	13.4.1 Default-free	110
	13.4.2 Risky	112
13.5	Inverse Floaters	112
	Interest Rate Swaps	113
Chapte	er 14 Dynamic Hedging	115
	Set up	115
	Complete Markets	116
	14.2.1 Taylor Series Expansion	117
	14.2.2 Delta $\left(\frac{\partial C}{\partial S}\right)$ Hedging	118
	14.2.3 Gamma $\left(\frac{\partial^2 C}{\partial S^2}\right)$ Hedging \ldots	119
	14.2.4 Vega $\left(\frac{\partial C}{\partial \sigma}\right)$ Hedging	120
14.3	Incomplete Markets \ldots	123
	14.3.1 Super- and Sub-Replication	124
	14.3.2 Valuation and Hedging	124
	0.0	
Part '	VI Case Studies 1	
Tate	VI Case Studies	1.17
		127
Chapte	er 15 Penn Square Bank (1982)	133
-		
15.1	Summary	133
15.1	Summary The Trading Strategy	133 133
15.1	Summary	133 133 135
15.1	Summary	133 133 135 135
15.1	Summary	133 133 135 135 135 136
15.1	SummarySummaryThe Trading Strategy15.2.115.2.1Oil and Gas Partnerships15.2.2Oil and Gas Mortgage Loans15.2.3Market Risk15.2.4Credit Risk15.2.5Liquidity Risk	133 133 135 135 136 136 137
15.1	SummarySummaryThe Trading Strategy15.2.115.2.1Oil and Gas Partnerships15.2.2Oil and Gas Mortgage Loans15.2.3Market Risk15.2.4Credit Risk15.2.5Liquidity Risk	133 133 135 135 136 137 137
15.1 15.2	SummarySummaryThe Trading Strategy15.2.115.2.1Oil and Gas Partnerships15.2.2Oil and Gas Mortgage Loans15.2.3Market Risk15.2.4Credit Risk15.2.5Liquidity Risk15.2.6Operational Risk	133 133 135 135 136 137 137 138
15.1 15.2 15.3	SummarySummaryThe Trading Strategy	133 133 135 135 136 137 137 137 138 138
15.1 15.2 15.3 Chapte	Summary	133 133 135 135 136 137 137 138 138 138 139
15.1 15.2 15.3 Chapte 16.1	Summary The Trading Strategy 15.2.1 Oil and Gas Partnerships 15.2.2 Oil and Gas Mortgage Loans 15.2.3 Market Risk 15.2.4 Credit Risk 15.2.5 Liquidity Risk 15.2.6 Operational Risk Conclusion The Trading Strategy	133 133 135 135 136 137 137 138 138 138 139 141
15.1 15.2 15.3 Chapte 16.1	Summary The Trading Strategy 15.2.1 Oil and Gas Partnerships 15.2.2 Oil and Gas Mortgage Loans 15.2.3 Market Risk 15.2.4 Credit Risk 15.2.5 Liquidity Risk 15.2.6 Operational Risk Conclusion Conclusion The Trading Strategy The Trading Strategy	133 133 135 135 136 137 137 138 138 138 139 141 141

xiv

Chapter 13 Static Hedging

Contents

	Lorano Larganano, como e	$\frac{144}{145}$
16.3	F	$145 \\ 145$
10.0		110
Chapte	er 17 Orange County (1994)	147
17.1	Summary	147
17.2	The Trading Strategy	149
	17.2.1 Long-term Coupon Bonds	149
	17.2.2 Inverse Floaters	150
	17.2.3 Leveraging via Reverse Repurchase Agreements	150
	17.2.4 Market Risk	152
		152
	17.2.6 Liquidity Risk	152
		152
17.3	•	153
Chapte	er 18 Barings Bank (1995)	155
		155
18.2	The Trading Strategy	156
	3 3	156
	18.2.2 Option Straddles	158
		159
	18.2.4 Credit Risk	159
		159
		160
18.3		160
Chapte	er 19 Long Term Capital Management (1998)	161
-		161
		162
		163
	,	163
		164
		165
		165
		165
		165
19.3		165

xv

Contents

Chapter 20 The Credit Crisis (2007)	167
20.1 Summary	167
20.1.1 The Ponzi Scheme	167
20.1.2 The Collapse	169
20.2 The Trading Strategy	169
20.2.1 Buying ABS and CDOs	169
20.2.2 Buying CDS	170
20.2.3 Selling CDS	171
20.3 Conclusion	171
Chapter 21 Washington Mutual (2008)	173
21.1 Summary	173
21.2 The Trading Strategy	175
21.2.1 Option ARMs	175
21.2.2 Market Risk \ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots	176
21.2.3 Credit Risk	176
21.2.4 Liquidity Risk	176
21.2.5 Operational Risk	176
21.3 Conclusion	176
Bibliography	179
Index	185

xvi