

# CONTENTS

<i>Preface</i>	vii
<i>Acknowledgments</i>	ix
<i>About the Author</i>	xi
<i>List of Figures</i>	xix
<i>List of Tables</i>	xxiii
<i>List of Boxes</i>	xv
<b>Chapter 1: Derivatives and the Wealth of Nations</b>	1
What are Derivatives?	2
A Brief History of Derivatives	4
Derivatives and the Wealth of Nations	8
Organization of the Book	9
Bibliography	11
<b>PART I: FORWARDS</b>	13
<b>Chapter 2: Showa Shell Sekiyu K.K.</b>	15
Hedging Currency Risk at Oil Companies	16
The Mechanics of Hedging Dollar Exchange Rate Risk and Oil Price Risk	19
Was Showa Shell Hedging or Speculating?	21

Concealing Currency Losses	22
The Story Unfolds	22
Forecasting Exchange Rates: Treacherous at Best	23
The Moral of the Story	25
<b>Chapter 3: Citibank's Forex Losses</b>	29
Currency Trading in the Tranquil Days of Bretton Woods	30
Gambling on Currencies with Forward Contracts	32
How Do Banks Keep a Lid on Their Foreign Exchange Trading Operations	33
Speculating from a Commercial Bank's Trading Desk: When Citibank is Not Quite a Hedge Fund à La Georges Soros	35
Hasty and Costly Conclusion	38
The Moral of the Story	39
<b>Chapter 4: Bank Negara Malaysia</b>	41
What is Central Banking All About?	42
Bank Negara as a Macro-Hedge Fund	43
How Did Bank Negara Speculate?	44
<b>PART II: FUTURES</b>	47
<b>Chapter 5: Amaranth Advisors LLC</b>	49
The Rise and Fall of Amaranth Advisors LLC	50
Genesis of Natural Gas Derivatives	52
A Primer on Speculating in Natural Gas Derivatives	53
The Alchemy of Speculation Through Natural Gas Futures	58
The Story Unfolds: Amaranth Speculative Assault on Nymex	60
Risk Management at Amaranth	68
The Moral of the Story	70
Postscript	71

<b>Chapter 6: Metallgesellschaft</b>	73
The Metallgesellschaft Debacle	74
The “Long and Short” of Hedging in the Oil Market	77
Numerical Illustration of “Ebbs & Flows” Under a “Stack & Roll” Hedge	83
The “Message is in the Entrails”: Empirics of the Oil Market (1983–2002)	85
If Only MGRM Had Been Allowed to Roll the Dice	89
When a Hedge is a Gamble: Was MGRM Hedging or Speculating?	92
MGRM as a Market Maker	93
The Moral of the Story	94
Bibliography	96
<b>Chapter 7: Sumitomo</b>	97
Was Sumitomo Manipulating Copper Prices?	98
Alarm Bells	100
Debacle	101
Postscript	101
<b>PART III: OPTIONS</b>	103
<b>Chapter 8: Allied Lyons</b>	105
A New Mission for Allied Lyons Treasury Department	106
A Primer on Currency Options: Was Allied Lyons Hedging or Speculating?	109
Selling Volatility: Allied-Lyons “Deadly Game”	115
Alarm Bells are Ignored as the Story Unfolds	121
The Moral of the Story	122
Appendix: Pricing Currency Options	123
<b>Chapter 9: Allied Irish Banks</b>	125
Rusnak and Currency Trading at Allfirst	125
Gambling on Currencies with Forward Contracts	127
Arbitraging the Forward and Option Market: The International Put-Call Parity Theorem	129

The Art of Concealment	133
When Alarm Bells are Ignored	137
The Moral of the Story	139
Epilogue	140
Bibliography	140
<b>Chapter 10: Barings</b>	143
The Rise and Fall of the House of Barings	144
Rogue Trader	146
Arbitrage	148
From Harmless Arbitrage to Lethal Speculation	151
A Primer on How to Speculate with Options	156
Financing Margin Calls by Selling Volatility	161
Warning Bells	168
The Art of Concealment	169
The Moral of the Story: Leeson's Seven Lessons	174
Epilogue	177
Bibliography	177
<b>Chapter 11: Société Générale</b>	179
The Making of a Rogue Trader	179
From Arbitrage to Directional Trades	182
Hasty Conclusion	188
When Alarm Bells are Ignored	190
The Art of Concealment	192
The Moral of the Story	192
Postscript	195
Bibliography	196

<b>PART IV: SWAPS</b>	197
<b>Chapter 12: Procter &amp; Gamble</b>	199
How to Reduce Financing Costs with Levered Interest Rate Swaps	200
Embedded Options and Hidden Risks	206
Landmark Lawsuit	210
The Moral of the Story	213
Bibliography	214
<b>Chapter 13: Gibson Greeting Cards</b>	217
<b>Chapter 14: Orange County</b>	221
Municipal Finance in Orange County	222
A Primer on Fixed Income Securities	224
Anatomy of Orange County Asset Portfolio	227
OCIP as a Hedge Fund	232
Double Jeopardy: How Orange County Collapsed	236
Was Filing for Bankruptcy Warranted?	237
The Moral of the Story	239
Epilogue	242
Bibliography	244
<b>Chapter 15: Long-Term Capital Management</b>	245
What are Hedge Funds?	246
The Rise of Long-Term Capital Management	247
The Alchemy of Finance	249
Relative Value or Convergence Trades	252
The Central Bank of Volatility	257
Straying Away from the Master Plan	263
The Fall of LTCM	264
The Rescue of LTCM	267
The Moral of the Story	270

Epilogue	272
Bibliography	273
<b>Chapter 16: AIG</b>	275
Securitization and Credit Default Swaps	275
What are Credit Default Swaps (CDS)?	277
The Moral of the Story	279
<b>Chapter 17: From Theory to Malpractice: Lessons Learned</b>	281
Some First Principles	281
Policy Recommendations for Non-financial Firms	282
Policy Recommendations for Financial Institutions	286
Policy Recommendations for Investors	292
Policy Recommendations for Regulators	293
<i>Index</i>	297