# CONTENTS

Preface vii  
Acknowledgements ix  
About the Author xi  
List of Figures xix  
List of Tables xxiii  
List of Boxes xxv  

### Chapter 1: Derivatives and the Wealth of Nations 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  

### PART I: FORWARDS 13

### Chapter 2: Showa Shell Sekiyu K.K. 15

- “Shell-Shocked By Shell Games”: The Showa Shell Debacle 15  
- Hedging Currency Risk at Oil Companies 16  
- The Mechanics of Hedging Dollar Exchange Rate Risk and Oil Price Risk 19
<table>
<thead>
<tr>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Was Showa Shell Hedging or Speculating?</td>
<td>21</td>
</tr>
<tr>
<td>Concealing Currency Losses</td>
<td>22</td>
</tr>
<tr>
<td>The Story Unfolds</td>
<td>23</td>
</tr>
<tr>
<td>Forecasting Exchange Rates: Treacherous at Best</td>
<td>23</td>
</tr>
<tr>
<td>The Moral of the Story</td>
<td>25</td>
</tr>
<tr>
<td>Chapter 3: Citibank’s Forex Losses</td>
<td>29</td>
</tr>
<tr>
<td>Currency Trading in the Tranquil Days of Bretton Woods</td>
<td>30</td>
</tr>
<tr>
<td>Gambling on Currencies with Forward Contracts</td>
<td>32</td>
</tr>
<tr>
<td>How Do Banks Keep a Lid on Their Foreign Exchange Trading Operations?</td>
<td>33</td>
</tr>
<tr>
<td>Speculating from a Commercial Bank’s Trading Desk: When Citibank</td>
<td>35</td>
</tr>
<tr>
<td>is Not Quite a Hedge Fund à La Georges Soros</td>
<td></td>
</tr>
<tr>
<td>Hasty and Costly Conclusion</td>
<td>38</td>
</tr>
<tr>
<td>The Moral of the Story</td>
<td>39</td>
</tr>
<tr>
<td>Chapter 4: Bank Negara Malaysia</td>
<td>41</td>
</tr>
<tr>
<td>What is Central Banking All About?</td>
<td>42</td>
</tr>
<tr>
<td>Bank Negara as a Macro-Hedge Fund</td>
<td>43</td>
</tr>
<tr>
<td>How Did Bank Negara Speculate?</td>
<td>44</td>
</tr>
<tr>
<td>Part II: Futures</td>
<td>47</td>
</tr>
<tr>
<td>Chapter 5: Amaranth Advisors LLC</td>
<td>49</td>
</tr>
<tr>
<td>The Rise and Fall of Amaranth Advisors LLC</td>
<td>50</td>
</tr>
<tr>
<td>Genesis of Natural Gas Derivatives</td>
<td>52</td>
</tr>
<tr>
<td>A Primer on Speculating in Natural Gas Derivatives</td>
<td>53</td>
</tr>
<tr>
<td>The Alchemy of Speculation Through Natural Gas Futures</td>
<td>58</td>
</tr>
<tr>
<td>The Story Unfolds: Amaranth Speculative Assault on Nymex</td>
<td>60</td>
</tr>
<tr>
<td>Risk Management at Amaranth</td>
<td>68</td>
</tr>
<tr>
<td>The Moral of the Story</td>
<td>70</td>
</tr>
<tr>
<td>Postscript</td>
<td>72</td>
</tr>
</tbody>
</table>
## Contents

**Chapter 6: Metallgesellschaft**  
The Metallgesellschaft Debacle  
The “Long and Short” of Hedging in the Oil Market  
Numerical Illustration of “Ebbs & Flows” Under a “Stack & Roll” Hedge  
If Only MGRM had been Allowed to Roll the Dice  
When a Hedge is a Gamble: Was MGRM Hedging or Speculating?  
MGRM as a Market Maker  
The Moral of the Story  
Bibliography  

**Chapter 7: Sumitomo**  
Was Sumitomo Manipulating Copper Prices?  
Alarm Bells  
Debacle  
Postscript  

**PART III: OPTIONS**  
**Chapter 8: Allied Lyons**  
A New Mission for Allied Lyons Treasury Department  
A Primer on Currency Options: Was Allied Lyons Hedging or Speculating?  
Selling Volatility: Allied-Lyons “Deadly Game”  
Alarm Bells are Ignored as the Story Unfolds  
The Moral of the Story  
Appendix: Pricing Currency Options  

**Chapter 9: Allied Irish Banks**  
Rusnak and Currency Trading at Allfirst  
Gambling on Currencies with Forward Contracts  
Arbitraging the Forward and Option Market: The International Put-Call Parity Theorem
The Art of Concealment
When Alarm Bells are Ignored
The Moral of the Story
Epilogue
Bibliography

Chapter 10: Barings
The Rise and Fall of the House of Barings
Rogue Trader
Arbitrage
From Harmless Arbitrage to Lethal Speculation
A Primer on How to Speculate with Options
Financing Margin Calls by Selling Volatility
Warning Bells
The Art of Concealment
The Moral of the Story: Leeson’s Seven Lessons
Epilogue
Bibliography

Chapter 11: Société Générale
The Making of a Rogue Trader
From Arbitrage to Directional Trades
Hasty Conclusion
When Alarm Bells are Ignored
The Art of Concealment
The Moral of the Story
Postscript
Bibliography
PART IV: SWAPS 197

Chapter 12: Procter & Gamble 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

Chapter 13: Gibson Greeting Cards 217

Chapter 14: Orange County 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

Chapter 15: Long-Term Capital Management 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

Chapter 16: AIG 275
Securitization and Credit Default Swaps 275
What are Credit Default Swaps (CDSs)? 278
A Stealth Hedge Fund at AIG 279
The Moral of the Story 281
Postscript 283

Chapter 17: JP Morgan Chase London Whale 285
The JP Morgan Chase Fortress 286
A Primer on Credit Default Swaps and Their Extended Family 288
The London Whale: The Story Unfolds 291
Hedge Funds Harpoon the London Whale 296
A Stealth Hedge Fund? 298
The Art of Concealment 300
The Moral of the Story 304
Postscript 306

Chapter 18: From Theory to Malpractice: Lessons Learned 309
Some First Principles 309
Policy Recommendations for Non-Financial Firms 310
Policy Recommendations for Financial Institutions 314
Policy Recommendations for Investors 320
Policy Recommendations for Regulators 322
Index 327