Financial trades: Why didn't I think of that? - Were these the best financial trades ever carried out? (The Economist, Dec 16th 2004)

THE history buff is in no doubt: the greatest trade ever was the Louisiana purchase in 1803. It was certainly a splendid deal for America, which picked up a great whack of land between the Mississippi and the Rockies for a song. But was it a trade? More of a treaty with a sale-and-purchase agreement tacked on, actually, as was the snapping up of Alaska from the Russians some 60 years or so later. To qualify as a trade—at least for the purposes of this article—a deal must be a financial transaction designed and executed using financial instruments to profit from an insight into a market opportunity. In other words, it cannot be something that happened by accident or sheer luck. And it cannot be a deal—a breathtaking takeover, an audacious property punt or an early investment in Google. Any of these might be both clever and lucrative, but it would not be a trade.

Unfortunately, that rules out one of history's quirkiest exchanges. In parts of 15th-century Africa, salt was more precious, because scarcer, even than gold. Traders determined enough to transport salt a thousand or so miles from the north found they could exchange the white stuff for its equal weight in gold—surely one of the best deals ever, reckons Peter Bernstein, whose book on "The Power of Gold" includes this tale. True, but it was sheer luck combined with grim effort, not special financial skill, that brought wealth to those fortunate barterers. Nor were financial tools essential.

Also ruled out must be the group of middle-class women running a charity in Arbois, a small town in France, two centuries ago. In the autumn of 1807 they noticed that bad weather was threatening the grain harvest. Fearing that high prices during the winter would stop their distribution of food to the poor, they went to the local market and paid well above the prevailing price in order to lock in future supplies—an early example of futures trading. During the winter, prices indeed shot up. Had they been speculating, they would have made a fat profit. That was not their aim, though, and there is no evidence that they continued to trade.

No, to be among the greatest trades, there must be something of that special characteristic that makes observers wonder why they had failed to think of it themselves. The quality that elicits admiration may be just the simplicity of the idea; or it may be the sheer imagination that constructed a complex set of interactions designed to bring about a specific profitable outcome. Trades involving the modern mechanisms for trading commodities are certainly eligible to be called the greatest: some of the biggest, boldest and most secretive traders are to be found in the oil and metals markets. So, too, are deals involving derivatives, for they are more than mere mechanisms for executing trades, often using extra techniques to boost returns.

Soros sets a standard

Some trades are already well known, and deservedly so. George Soros became a household name after he made Britain's chancellor of the exchequer look an idiot by forcing the pound out of Europe's exchange-rate mechanism in 1992. Mr Soros is reckoned to have made a profit of $1 billion by borrowing heavily to bet that sterling would be devalued. That sets a testing benchmark against which to measure other candidates.

But plenty of traders have made tidy sums and had arguably brighter ideas. Often they wish to remain anonymous, either embarrassed by their success or, more likely, anxious to avoid the attentions of mendicants. A fine example is the young Morgan Stanley man who retired after the 1987 stockmarket crash. His insight was that the heady levels of the market were strikingly reminiscent of an earlier boom that had gone spectacularly bust in 1929.

He used his knowledge of the market to load up on put options (those that give the holder the right to sell) on the S&P 500 share index, and even persuaded his mother to buy some. The options were ridiculously cheap because no one thought they would ever be exercised, so far would the market have to fall for them to be valuable. Fall it did, and the trader had the nerve to wait for Black Monday—October 19th 1987—rather than cash in during the tremors of the previous week. Having sold his options for about 800 times what he had paid for them, he is said to have walked away with $13m and was last heard of living on a ranch in Montana.

That combination of pluck, tenacity and reserve is powerful. But $13m is small change for Mr Soros. Moreover, the winner of the biggest-trade title will get no prize for modesty. In fact, most traders are far from shy about their talents. Remember the Big Swinging Dicks made famous by Michael Lewis in his novel, “Liar's Poker”? One BSD merits such a mention. In the 1980s Andy Krieger was a star at Bankers Trust, an investment bank that later imploded. In his heyday there, Mr Krieger made hundreds of millions of trading profits, before resigning in 1998—to go, as it happens, to work for Mr Soros.

Putting the kiwi to flight

Mr Krieger is scarcely remembered these days except perhaps in one country, New Zealand. The trade for which he deserves mention involved the kiwi, as the New Zealand dollar is known in currency markets. And here is a measure of just how big a BSD Mr Krieger was. During 1987 he sold short (hoping to buy back more cheaply in future) more kiwis than the entire money supply of New Zealand. So huge were his bets against the currency that it is not really surprising that they succeeded, causing the kiwi to collapse. It is said, apocryphally, that New Zealand's finance minister telephoned Bankers Trust to complain and beg for mercy. In fact, the government was privately pleased, because the weaker currency gave a helpful push to the country's struggling exports.

To put Mr Krieger's effrontery into context, he was just one trader in a veritable sea of them on Wall Street, in London and elsewhere. In a sense, he took on his entire industry and won. But some context is important. Mr Krieger was on to options early, and he soon realised that the youngish options market was inefficient, not least in its failure to ensure that options prices were a fair reflection of prices on the underlying cash markets. Much of his success came from his readiness to make maximum use of that inefficiency by placing huge bets.

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It would be impossible to repeat his feats today. One reason is that banks are far warier and no one is usually accorded the almost limitless freedoms Mr Krieger enjoyed. When big trades are done, they are often seen afterwards as failures of risk management. Another reason why the world will probably not see another Mr Krieger is that today's markets are much more efficient: the excess returns that he scooped up are no longer on the table, and only if new markets emerge will there be fresh sources of profit for pioneers. Indeed, a feature of modern financial markets is that they are tending to become more efficient, and that has made great trades harder than ever to concoct. That is one reason why those that do occur get big rewards.

Most great trades are done in secret by highly paid traders working for investment banks, hedge funds and so on. Rarely does this institutional activity cross paths with the world of retail finance. But for inventiveness in linking the two activities, one trade clearly stands out.

It originated in 1992 when the Italian government changed its previously lax rules on withholding tax for Eurobonds. At that time some specialist teams in London and other big financial centres did nothing but seek out tax arbitrages: by buying this bond here and moving it there, it was often possible to avoid taxes at the point of purchase and thereby earn extra returns. Exploiting Italy's rules had been one of the neatest such wheezes, so when it was thwarted several of the tax teams found themselves wondering what to do next.

Among them was Ludovico Filotti, who worked for Barings. In 1993 Mr Filotti was on holiday in Italy. Reading the local newspaper, something caught his eye. An advertisement was encouraging companies to buy bonds issued by Italy's Post Office. These bonds were postal savings bonds, rather like Britain's national savings certificates, and carried the guarantee of the Italian state. Mr Filotti was curious: normally such bonds would only be for retail investors, so he wondered on what terms companies could invest. Back in Britain, he sent his Italian father the equivalent of £100 and asked him to nip down to a post office to buy a bond certificate so that he could study the small print on the bond.

What he found was encouraging. The postal bonds were “zero coupon”, that is, unlike most bonds, which pay annual interest instalments, they would pay nothing until they matured, so investors would have to wait a set period before pocketing their returns and recovering their original investment. The bonds promised a return of three times the initial investment after 12 years—a rate equivalent to 9.6% a year.

Back at his bank, Mr Filotti explained his discovery to a colleague, John Hunter, who realised that this highly attractive rate would be even more so if the equally juicy rates on Italian-government bonds were to fall. That would open a spread between Italy's ordinary borrowings and the postal bonds, just the kind of “arbitrage” opportunity traders love. But the most remarkable feature of the offer was that there was no upper limit on how much could be invested. Nor were there disadvantageous tax obligations for foreigners.

In fact, the arbitrage quickly disappeared when Italy's interest rates rose rather than fell. The trading idea sat on a shelf. But, towards the end of 1995, Italy's economy began its path towards convergence with those of the other countries hoping to join the euro. That meant its interest rates began to fall. And, in the summer of 1996, they started to fall dramatically. Suddenly, the Post Office trade was on. Mr Hunter persuaded his new employer, a big Japanese bank, to buy $50m of the postal bonds.

At this stage, his trade became one of the greatest ever. It also became amusing. Mr Filotti, who had also gone to work at the same Japanese bank, flew to Italy and, escorted by police, carried a banker's draft for the equivalent of $50m into a post office. Queuing up alongside pensioners claiming their modest weekly infusion, he exchanged the draft for a savings bond. Soon the certificate was safely lodged in London. With no limit on the amounts that could be invested, a huge and profitable arbitrage was there for the taking.

Readers who are not financial experts need not worry about exactly how banks can exploit such trades, while the experts will understand that the bonds offered both option and swap opportunities to lock in big profits. Around the time of the trade, there was also large and unusual activity in the market for swaptions (options on swaps).

Mr Hunter, however, was unable to persuade his conservative masters to go further. No matter: he sold the idea for the trade, first to a single rival bank, then to several others. This set off a mad rush to buy the bonds before the opportunity disappeared. Bankers flew in droves to Italy, jostling to be in front of each other in the queue. In double-quick time UBS bought over $1 billion-worth of the bonds. CSFB bought the most, but, according to *International Financing Review*, a trade magazine, later gave back its profits when the Italian government threatened to withhold lucrative mandates for privatisations. Nomura made the biggest single purchase, plonking down $1.1 billion on the counter of a bemused clerk, who duly filled out a certificate for more than a trillion lire.

Of course, it could not last. After $3.6 billion of the bonds had been issued in the space of a few days, the Italian government suddenly put a ceiling on the amount that could be bought and made threats to the banks' future fee income. Too bad. Mr Hunter, however, is now the chief executive of Brains, a specialist broker that tries to make money by selling clever ideas to other traders.

Bubble, bubble, short and double

However, an even better contender for the title must be the trade conceived by Sir John Templeton to profit from the 1990s internet bubble. A renowned investor, Sir John will be remembered for many trades, not least the one in 1939 in which he bought shares in 104 almost worthless, and in some cases already bankrupt, New York stockbrokers. Hitler had just invaded Poland, and the young Mr Templeton correctly foresaw that abundant surpluses of goods and commodities would soon become scarcities, leading to a strong recovery of financial-asset prices. Within three years he had turned a profit on 100 of the 104 purchases.

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Sixty years later, long experience suggested to Sir John that technology and internet shares were an especially inflated part of a huge bubble. The problem was to construct an investment strategy that could exploit this. His solution was ingenious, so much so that it wins the “Wish I'd thought of that” prize by a mile.

For every flotation there is a “lock-up” period during which insiders at the company are forbidden to sell any of their shares. Sir John reasoned that, in a bubble market, these insiders would generally be keen to sell once they could. After all, this was their only way of getting a lot of money out of their venture if it was unlikely to mature into a profitable long-term business and, as insiders, they ought to know better than anyone that few of their companies were likely to stay the course. So he systematically sold their shares short just before the end of the lock-up. That meant he could buy the shares back more cheaply if they fell in price, as he reckoned they would.

Sir John acted with great discipline. First, he decided to sell only those shares that were trading at more than three times their original price. Then he set precise points at which he would take profits if prices fell—and he would ruthlessly cut his losses if a particular share held up unexpectedly. In the end he made 84 separate transactions, each for $2.2m. The results were spectacular. Sir John made a return of almost 50% on his $185m bet. On some positions, he made profits of more than 90%.

Not bad, but still pretty piffling by Mr Soros's standards. To outdo his $1 billion coup, consider a scheme whose returns have been so great they are unmeasurable. Fittingly, as the winner of the “greatest trade” title, it requires only brief description. In 1996 and 1997 Italy (yes, again) was desperate to reduce its public-sector deficit so that the country would qualify for entry into the euro. One unintended boost came from the sale of the postal bonds described above—bizarrely, because they matured after the euro deadline, they were not counted as current debt. But the stroke of genius by officials in Italy's finance ministry was to enter into a secret trade that simultaneously brought in cash, took some debt off the books and deferred the repayment of the cash and the debt until after the euro deadline had been successfully reached.

Many economists were amazed when Italy defied expectations to qualify for the euro. And its admission into the system has been worth an incalculable fortune. It has brought huge savings via systematically lower interest rates and greater economic efficiency. Had Italy not qualified, its economy might have crumbled. Certainly, its public-sector finances would be in dire straits.

The trade itself was fairly simple, though complicated enough to ensure that it came to light only in late 2001, when Gustavo Piga, an economics professor, stumbled across it while studying public-debt policies. Essentially, Italy used a swap to defer interest payments on an issue of $1.7 billion of yen-denominated bonds that it had made in 1995, at the same time taking an up-front payment for the swap that was later repaid with interest. Thus was Italy able to make it into the euro, merely at the price of a big repayment on the swap in 1998.

Think of the various elements of the trade. It was bold and risky. It relied on secrecy. It was brilliantly conceived to solve a specific, and apparently insurmountable, problem. It was executed with great skill. And, for a fee, it gave Italy the opportunity to be part of the euro system, with its incalculable rewards. Part of its appeal is that the profits came not from the counterparty on the trade itself, but from the economic consequences of the trade.

Of course, it was also thoroughly dodgy—had it been done by a company, the management would probably be in prison for cooking the books—though the Italians have always maintained that it exploited weak rules, rather than broke strong ones.

But there is no need to be churlish. This was, after all, the greatest trade ever. *Bravissimo!*