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"Innovate or die."
— Tom Peters

There is extreme danger in the market. The long list of reasons to hedge, insure and transfer risk are extremely compelling. This era of money printing and uncertainty has created all sorts of unknowns. This includes the risk of a painful market decline as much as missing a continued rally.

These dangerous times are opportune for businesses that thrive on hedging activity. The challenge is finding them. There are businesses that profit from hedging and risk transfer. They have existed for millennia yet require never ending innovation to be successful.

While news events and reasons to trade have constantly been with us, it is important to understand who the trading counterparties are and why they are trading.

The investing world can be divided between "price makers" and "price takers." The takers, which include bonafide hedgers, are in need of liquidity that comes at a price from the makers.

For example, farmers are takers who hedge and insure their crops for the same reasons they did thousands of years ago. Uncertainty caused by war, weather, fear, greed, government intervention or any uncertain event has never gone away. In addition to farmers, portfolio managers, miners, drillers, merchants, airliners and many more all transfer risk for the same reasons: to hedge and insure.

The price makers have been harvesting the same "edge," or demand for risk transfer, forever. They have been a profitable counterparty to these transactions but only by maintaining the steep requirements to monetize the edge. The fundamental reasons for the transaction have not changed but the products and the methods have. The common theme is the need to transfer risk from one party to another while evolving with the demands of the natural participants.

Today, hedgers might use VIX and S&P 500 options as insurance; years ago, it may have been maritime insurance or whale oil options. The products appear new but the fundamental reasons for the transaction are not.

While the edge has remained similar, the process to monetize this edge is constantly evolving and difficult to replicate.

The motives behind the first derivatives contracts in Mesopotamia are no different from those traded on exchanges today. However, imagine if a market-maker on the Chicago Merc attempted to use a team of scribes and clay tablets as a competitive edge – he would probably be arrested.

A quick trip down memory lane…

2000 B.C.

The first derivatives trades were between farmers and merchants. They agreed to terms carved on clay tablets. These forward contracts helped counterparties agree to a price before long trips to deliver the goods. Tablets that did not break were an edge.

1800s

The Chicago Board of Trade was the central point of liquidity for the biggest agricultural markets in America. Farmers shipped crops by boat and train. Privately negotiated futures contracts usually came with samples to assure buyers. Speedy transportation was an edge.

1970s -1980s

Options traded on an exchange in open outcry pits. The liquidity providers were in large part local market makers. You needed seats on the exchange and an entire team of runners, market makers, risk managers and operations personnel to be successful. Being tall and loud was an edge.

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1990s

Banks with teams of thousands of people became a primary source of liquidity providing. Standards were set for OTC trading through ISDA arrangements and credit lines. Having a big balance sheet and the ability to price complex risk were an edge.

2000s-Present

Electronic trading, along with a dozen new exchanges, created a surge of liquidity in the options market. Bid-offer spreads, reduced trading costs and electronic access becomes the norm. Automated systems to continuously price contracts provides an edge.

Lake Hill is a liquidity provider that monetizes the demand for risk transfer in index, metal, energy and agricultural options. A decade ago, this required an operating staff of almost 200 people just to trade 20 products. Success in these products required numerous human traders in each pit, coupled with human clerks, human brokers, and a host of related human decision makers.

Today, Lake Hill trades the same product mix with a just a handful of humans and powerful computers. The business requirement of hundreds of humans has been replaced with a few GPU enabled machines processing 15 teraflops of information on 10,000 cores distributed across a grid. That is 15 trillion floating point calculations a second. More than enough for our product mix. Not too long ago this would have required hundreds of servers taking up a whole warehouse of space. Years from now the requirements will evolve yet again. “Innovate or die.”

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