2 Market Basics - Overview

The Market Basics Chapters provide a short review of some of the more important core concepts for trading and risk management, and is a quasi glossary for some key definitions. Much of this has been deliberately written in oversimplified terms. For many readers, this Chapter will be a simple review, but please read it nonetheless; it contains important definitions and terminology used in the entire TG2 Series of books. Or, just read it to be entertained by the anecdotal stories and connections to "reality impact".

There are 4 parts to the Market Basics section:

Chapter 2 Market Basics - Overview (this Chapter): provides a pedestrian approach to some of the most important core definitions and a review of crucial concepts such as mandates, supply/demand, market participants and their risk/return needs, arbitrage/fair value, risk/return, and links these with judicious use of reality impact.

Chapter 3 Market Basics – The Trading Cycle, Trading Discipline: introduces the most basic concepts required for managing a trading business including the trading cycle, rudimentary performance measurement and management of (trade) policy.

Chapter 4 Market Basics - Risk Management & Position Keeping: takes the first steps towards defining the different types of risks a trading operation may face, and provides the linkages to methods for measuring/managing these risk where possible, as well as dealing with risks which do not lend themselves too well to traditional risk management/position keeping methods.

Chapter 5 Market Basics - A Few Easy but Important (mini) Cases and Questions: introductory question and cases intended to illustrate the concepts in this Chapter, and to test/drive-home the most crucial points using real world examples and considerations.

2.1 Some Basics of Finance, Trading, and Business in the Real World

Throughout the entire TG2 Series there are certain basic market "idioms" that are considered absolutely crucial. Each of these items should be considered pretty much every time there is a trading/risk management analysis/issue. This Section reviews the 7 most important of such principals:

I. **Mandates and "how we make our money":** from this follows everything else.

II. **Cash is “KING”:** don’t get lost in the fancy *mumbo jumbo*; follow the money.

III. **Supply/demand is “KING”:** because this is what determines the price now.

IV. **Economic Need of the Participants**: the needs of the participants determine the dynamics of the market place, and the manner in which money is made, and risks taken.

V. **Fair Value, Arbitrage, and Forward Prices:** prices can be calculated reliably, and risk can be managed with reasonable reliability, in an arbitrage-free environment … but does this apply to you? If it does not, then be sure to make the appropriate adjustment to valuation/risk and profit/compensation.

VI. **Risk/Return:** high risk requires higher return, but remember there is “no risk” in an arbitrage-free environment[5], so if the mandate requires/permits taking risk to make profits, then be sure that you can accurately measure and manage the risks, and most importantly that you (technically the share holders) are fairly compensated for taking those risks. Notably, all sales, trading, and risk problems are variations of accurately assessing the holding period risk-adjusted P&L or returns, and this notion is tied closely with a technique called (Optimal) Profit-at-Risk (PaR) analysis.

VII. **Reality Impact:** liquidity, transactions costs, event risk, and many other factors will always succeed in messing up the best-laid plans.

2.1.1 Business Mandate, and Overview of Strategies & Tools for Profit & Risk

How does a trading operation make its money? This issue must be decided in advance by the owners of the capital (or by senior management[6]). The definition of how the operation is to make its money is the business mandate. It is subjective. However, once a clear set of policy rules are established, then the business may be implemented. Thereafter, many aspects of implementing/managing the business will be “mechanical” (i.e. objective as opposed to subjective).

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[5] Remember that “risk” has different meanings in different contexts.

[6] In principal, all activities are supposed to support the wishes and best interest of the shareholders. However, in practice this is not always so. Human nature, and the shortcomings of many compensation/bonusing schemes, can ensure a self-serving component in the decision making process. These books will highlight such as appropriate, though will not attempt to provide a deep study of “Agency Theory”.