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Risk is never destroyed, it only moves

Derivatives, market making, hedge funds and corporate treasury look like four separate careers. They are four seats around the same trade, and seeing the whole chain makes you better in any one seat.

THE IDEA

Finance moves two things: capital and risk. Moving capital is the easy part. Moving risk is the job, and every role in the industry is a different answer to one question: who wants this risk, who does not, and what does it cost to move it between them?

A roundtable with graduating finance seniors in FIN 4443, Financial Policy, run for two sections. Four student teams each prepared one area: structured products and derivatives, trading and market making, the buy side and hedge funds, and corporate finance and treasury. I moderated, pulled the teams into each other's topics, and gave the practitioner's view. My own path crosses all four seats: structuring and market making at BNP Paribas, three years at Citadel, and now head of treasury at Ava Labs.

Moving money is easy; moving risk is the job

When a hedge fund buys a billion dollars of Treasuries from a bank, the capital moves in seconds: bonds one way, cash the other. The real question is where the interest rate risk went. Risk is never created or destroyed. It moves from people who do not want it (an airline, a manufacturer) to people who do (a hedge fund), and a chain of specialists earns a living packaging, pricing and passing it along.

Derivatives slice risk; structured products repackage it

A **swap** exchanges two streams of cash flows, most often fixed for floating: one leg pays, say, 4% a year for five years, the other pays SOFR, the benchmark that replaced LIBOR in 2023. A company with fixed-rate bonds but floating-rate income swaps its debt to floating so both sides move together. A hedge fund that expects rates to rise pays fixed on the same swap. Same instrument, opposite motives.

That is why derivatives exist. Stocks and bonds hand you risk in fixed bundles; derivatives let you cut out the one slice you want to keep or give away. An airline hedges fuel because its business is flying people, not betting on crude. A hedge fund trades the same contract because it wants the risk, often against something else: oil against gasoline, or oil against airline stocks.

Securitization repackages risk, and it was my first job on Wall Street (structuring CLOs, collateralized loan obligations). A bank that has written 10,000 auto loans wants the risk off its books and the cash back to lend again, but no investor will diligence 10,000 tiny loans. So the bank sells them into a **special purpose vehicle**, a separate entity that holds the loans and issues notes against them, isolated from the

bank's own credit. Every dollar collected pays class A first, then class B, then class C: the **waterfall**. Rating agencies model the pool, and the class paid first can earn AAA. Insurers, regulated on ratings and hungry for yield, are natural buyers.

Why would a AAA note pay more than a Treasury? **Liquidity**: you can sell \$100 million of Treasuries in minutes, not \$100 million of a CLO tranche. And **complexity**: the rating comes from a model, not the full faith and credit of the US government. As of early 2026, new AAA CLO notes priced at about 1.2 to 1.3 percentage points over SOFR.

Market makers sell immediacy, not opinions

A market maker quotes a bid and an ask on anything from stocks to gold. Behind them are two estimates: fair value, and a spread that pays for holding whatever the client leaves behind. What sets the spread is **liquidity**, not volatility. Bitcoin and the S&P 500 are volatile but trade in huge size, so spreads are tight. A house is the opposite.

Say a hedge fund buys \$1 billion of 10-year Treasuries from you. You are now short \$1 billion of bonds, a rate position you never wanted. Bonds trade over the counter, so there is no exchange to buy them back on. You have three ways out: **find the other side** (your salespeople call insurers, asset managers and treasurers looking for sellers), **move your quotes** (raise your bid so sellers come to you), or **hedge with a derivative** (receive fixed on a swap, which gains when rates fall, exactly when your short loses).

The job is to clip the spread and stay flat, so the ideal P&L is a line sloping gently up. My best days in that seat were when two clients wanted exactly opposite trades and I stood in the middle. More and more of this is machines: single stocks are now almost entirely computers quoting computers.

The buy side is paid to take risk

The sell side earns fees (spreads, structuring, lending) and tries to take as little risk as it can. The buy side is paid to take risk and earn **alpha**, the return above what the market (**beta**) gives you for nothing, judged per unit of risk with measures like the Sharpe ratio.

WORKED EXAMPLE

What “2 and 20” costs. You invest \$1,000 and the fund makes 20%. The management fee is 2% of \$1,000 = \$20; the performance fee is 20% of the \$200 profit = \$40. Total: \$60, or 6% of your money. A **high-water mark** stops you paying twice for the same gain: if the fund falls to \$1,100 and climbs back to \$1,200, the recovery earns no performance fee. Some funds also set a **hurdle** (say 5%) they must beat first.

Investors pay because the pitch is **uncorrelated return**, and diversification is the only free lunch in finance. That pitch has rarely been easier to sell: in 2025 stocks, bonds and gold all rose together, and after the April 2025 tariff announcements stocks and Treasuries fell together. When everything trades as one, a return stream that moves with nothing else is worth paying for.

Two firms chase it differently. Bridgewater runs **risk parity**: stocks, bonds, gold and commodities, each sized by its risk, then levered, because the mix is too diversified for everything to fall at once. Citadel, Millennium and Point72 run the **multi-manager** model: hundreds of portfolio teams, each with its own capital and risk limits, whose bets net into a steadier whole. By LCH Investments' count, Citadel has made

more for its investors than any hedge fund in history. (Those platforms do not literally charge 2 and 20: they pass their costs, mostly pay, through to investors on top of a performance fee, which usually costs more.)

Getting your money out now takes longer. Funds hold more illiquid assets (private credit, whole companies, power plants), and you cannot sell a power plant to meet a redemption. And demand for the top funds exceeds their capacity, which gives them pricing power. By 2021 Citadel's terms could stretch a full exit over four years, and Millennium had a share class that takes five.

Treasury: the client everyone else serves

Every seat above ultimately trades around the needs of real companies. When I describe my own job to a CEO, I say I do three things: **liquidity** (there is always cash for payroll and rent), **risk management** (neutralize currency, rate, commodity and counterparty risk so the business can take the risks it chose; this is the main one) and **yield** (invest idle cash within the risk budget).

Apple sells iPhones in Paris for euros but owes its shareholders dollars, so it hedges its net currency exposure. It does not want to lose money if a currency collapses, and it does not want to make money on it either: that is not its business. On the yield side, the biggest treasuries run small investment desks, and the securitizations above show up in them.

REAL MARKET DATA

Alphabet's cash portfolio, December 31, 2025 (Form 10-K). Of \$96.1 billion in marketable securities, \$17.7 billion (18%) was mortgage- and asset-backed securities, alongside \$50.5 billion of government bonds and \$21.6 billion of corporate debt.

The CFO plays offense: how to raise money, invest it and return it. The test is the **cost of capital**. If your investors expect 10% a year, a project earning 8% destroys value however busy it keeps people, and holding that line is what financial discipline means.

Raising debt shows the whole chain. The CFO calls the banks. The banks, now underwriters, call every bond buyer they know and **build a book** of orders. With twice the demand, the CFO can upsize or keep the size and tighten the coupon; with too little, it is a higher coupon or a smaller deal. The banks' fee is a **flotation cost**, and it belongs in the cost of capital. It is far larger for equity: a mid-sized US IPO has long paid about 7% of proceeds, a large investment-grade bond well under 1%. That gap, the higher return shareholders demand and the tax shield on interest are why companies borrowing at scale reach for debt first.

REAL MARKET DATA

Funding the AI build-out, February 2026. Alphabet, Amazon, Meta and Microsoft guided to roughly \$650 billion of combined 2026 capital spending, about 2% of 2025 US GDP (\$30.8 trillion). On February 9, Alphabet sold \$20 billion of dollar bonds against more than \$100 billion of orders, its longest tranche (due 2066) at 0.95 percentage points over Treasuries.

When the chain breaks

2008. Securitization works only if someone checks the loans going in. Lenders originated mortgages knowing they would be sold on, banks packaged them, and rating agencies competing for the banks' business kept stamping the senior classes AAA. Nobody in the chain lived with the risk, so underwriting collapsed, and defaults that the models assumed would be scattered all hinged on one thing: US house prices. Bear Stearns, Merrill Lynch and Wachovia were sold to stronger banks. Lehman Brothers was not rescued; it went bankrupt in September 2008.

The London Whale. In 2012 a trader in JPMorgan's Chief Investment Office, a unit meant to manage the bank's own risk, built a credit derivatives position so large that hedge funds saw it. Saba Capital was among those that took the other side and waited for JPMorgan's risk managers to force a cut. The bank lost more than \$6 billion.

The same pattern, live. In late 2025, banks heavily exposed to the AI build-out bought credit default swaps on Oracle, Microsoft, Meta, Amazon and Alphabet to hedge. Saba was a seller, taking the view that those credits are sound and collecting the premium. One side wants less risk, the other wants more, and a derivative moves it between them.

Takeaways

- For any trade, ask where the money went and where the risk went. The second question is the job.
- The same instrument can be a hedge or a bet. Know which before you judge the position.
- Bid-ask spreads price liquidity, not volatility.
- Fees and flotation costs are part of the cost of capital. Count them before you count the return.
- Finance is not one career. Each seat creates value differently (products, liquidity, risk-bearing, resilience) and needs different skills; knowing the seats next to yours makes you better in your own.

Go further

- Michael Lewis, *The Big Short* (2010).
- Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report* (2011).
- US Senate Permanent Subcommittee on Investigations, *JPMorgan Chase Whale Trades: A Case History of Derivatives Risks and Abuses* (2013).

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