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the innovators

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From the beginning of recorded history, there has been one form or another of forward or futures markets where merchants and farmers could hedge their inventories, but it was not until 1952—the same year that Harry Markowitz (see page 56) published his remarkable paper on quantitatively measuring financial risk—that contracts to hedge money, the ultimate commodity, finally appeared.

Invented by Leo Melamed, a young Polish-Jewish immigrant who arrived in Chicago during World War II, financial futures were, like many great inventions, a child of necessity.

Educated as a lawyer, Melamed turned to commodities trading as a way to supplement a young attorney's meager income and help support his family. Gradually, he learned to survive, and eventually prosper, as a commodities trader on the Chicago Mercantile Exchange (CME). An ambitious trader who was well respected by his peers, he rose through the ranks to become the CME's chairman in 1969.

Founded in 1898 as a butter and egg exchange, the CME migrated to meats when the butter and egg market collapsed in the mid-1960s. But the CME, for all intents and purposes, was a single-industry exchange. "If meats were to collapse, the CME would be out of business," Melamed recalls.

Melamed notes his invention came about for several reasons. The first was the coming demise of the 1944 Bretton Woods agreement, which fixed the values of major currencies to each other. The second was a personal interest in currencies culled out of his flight from the Nazis as a child, taking him from Poland to Lithuania to Russia to Japan to New York, and, finally, to Chicago. The last, and likely most significant reason, was his perception that the CME he was now in charge of needed diversified products to trade.

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Never an economist, Melamed argued with himself that if financial futures (which they were later to be called) were such a good idea, why hadn't anybody thought of it?

Eventually, Melamed described his idea to the prominent economist Milton Friedman, who was enchanted with the idea. In 1971, he commissioned Friedman to write a feasibility paper so his invention would gain credibility. In August that same year, President Richard Nixon unpegged the dollar against gold and the Bretton Woods world of fixed currencies was no more. In 1972, the first currencies futures contracts began trading on the CME.

Financial futures did more than just permit people to hedge money. They also allowed Markowitz's modern portfolio theory to develop because price discovery of macro instruments like the currencies and later T-bills, T-bonds, and stock indices, was publicly available in a continuous, second by second, series of pricing events.

Previous to futures, these instruments were traded in over-the-counter markets amongst big dealers where bids and offers were usually not public knowledge. Indeed, no one could measure the exact value of financial instruments, except for stocks.

The commodities exchange practice of open-outcry changed all of this. Now, exact values of major financial instruments were instantly available at any point in time. This, as much as finally realizing they could hedge their inventories, is what persuaded financial institutions to accept Melamed's invention and all the various hybrids that were soon to follow on many other exchanges.

Milton Friedman has sometimes been credited with being the co-inventor of financial futures, but in a foreward to one of Melamed's books, Friedman says clearly that the idea was Melamed's.

While Melamed, not being an economist, was never honored with a Nobel Prize for his remarkable invention, the enormity of the economic and social benefits his creation has bestowed on the world in the last two decades argues that he should have been.

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