

Hedge funds

Flare-up

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The Image Bank



Banks scramble to assess their positions after a hedge fund makes bad bets on natural gas

CALGARY, Alberta and Greenwich, Connecticut might be expected to mix about as well as oil and (sparkling) water. Calgary, which has boomed in recent years on the back of oil money, in its soul remains a cow town. Greenwich, a leafy suburb of New York, is anything but. The only herding done there recently is by the hedge funds that call it home following the latest investment fad.

It was one of those fashions—the seductive commodities boom—that rocked Calgary, Greenwich and the wider financial world this week. A young, though by no means junior, energy trader in Calgary made some very big bets on natural-gas prices that went spectacularly wrong. They have cost his employer, a Greenwich-based hedge fund called Amaranth Advisors, \$6 billion since August 30th. That is more than half of what not long before was \$9 billion it had under management.

In a letter to investors on September 20th, Amaranth reportedly said its losses this month alone could reach 65% of its funds. Withdrawal by investors—not to mention a possible exodus by managers deprived of their bonuses—are likely to hurt it more. The fund could be wound up if a buyer is not found.

Meanwhile, investors in America and abroad—including the sort of pension funds that have recently stocked up on their hedge-fund investments—are smarting. The pension fund at 3M, an American manufacturer, and the San Diego County employees' retirement fund were among those exposed to Amaranth. Funds of hedge funds run by Goldman Sachs and MAN Group expect to see losses of 2% to 3% as a result of its troubles. Funds run by Credit Suisse and Morgan Stanley were also hit. Meanwhile, investment banks have been assessing their losses as a result of lending to Amaranth through their prime-brokerage arms.

Yet unlike the panic after the 1998 collapse of Long-Term Capital Management (LTCM), the biggest hedge fund ever to blow up, the Amaranth case has thus far been met with general calm. Christopher Cox, head of America's Securities and Exchange Commission, said this week the incident was a reminder that hedge funds are not for all investors. But financial markets took it in their stride.

How did it happen? Brian Hunter, the 32-year-old Canadian energy trader, had made a fortune for Amaranth in 2005 when he bet that natural-gas futures would

rise and then benefited from surging gas prices after Hurricane Katrina. Last year *Trader Monthly* ranked him the 29th highest-earning member of his profession, estimating his annual income at \$75m to \$100m. He was named head of Amaranth's energy-trading operations in the spring. This summer no big storms materialised and the same sort of positions—highly leveraged and insufficiently hedged, analysts say—left the fund exposed to falling prices. Natural-gas futures prices have dropped by two-thirds in the past nine months (see chart).

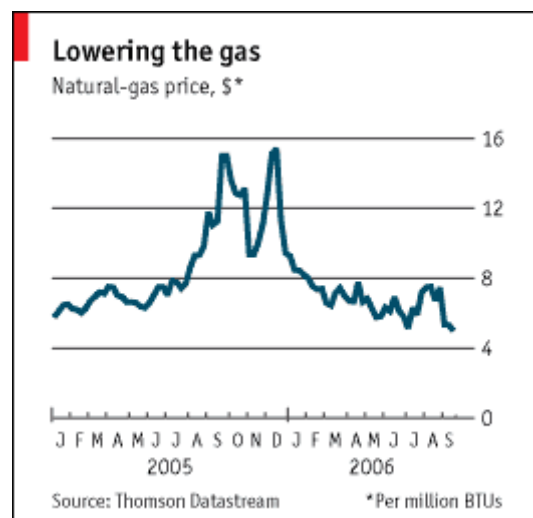
"I've never seen a hedge fund so highly leveraged in energy," says Peter Fusaro of the Energy Hedge Fund Centre. He reckons that the fund held about 10% of the global market in natural-gas futures. "Somebody was not monitoring this correctly." As its losses mounted, last weekend Amaranth quietly summoned a group of investment banks to its Connecticut headquarters to try to sort out the financial mess. With teams from each firm ensconced in separate rooms, officials from Amaranth shuttled between them, seeking to sell off positions, craft bridging loans and possibly negotiate a takeover. By the end of the weekend, enough had been done to prevent panic. Unlike at LTCM, the Federal Reserve did not have to intervene. To help cover its losses, Amaranth also sold a big chunk of its leveraged loans. They were snapped up, mostly by buyers in Europe.

On September 20th, Amaranth said it had reached agreement to transfer its energy portfolio to JPMorgan Chase (also a futures-clearing broker for the fund) and Citadel, a Chicago-based hedge fund. That is ironic, since Citadel lost a fortune by short-selling natural gas last year and is still rebuilding its gas-trading business. Amaranth is not the first hedge fund to suffer from the wild swings in natural-gas prices in recent months. In August a smaller fund called MotherRock collapsed after big losses; it had been run by Robert Collins, a former head of the New York Mercantile Exchange.

Mr Fusaro reckons that hedge funds have \$67.4 billion invested in the energy sector, up from \$30 billion two years ago. They still account for a tiny share of the \$7

trillion global energy market, but the combination of volatility in energy markets and the growing pool of investment in them means an increasing number of investors are exposed.

Also, banks and brokers will have to assess how prudently they are lending to their high-rolling clients, and whether they are calculating the risks well enough. "A lot of people are going to be looking at their energy exposures", says Kate Hollis of Standard & Poor's, a rating agency. "When the markets wobble, everyone feels it."



What Went Wrong at Amaranth

Mistakes at the Hedge Fund

Include Key Trader's Confusing

Paper Gains With Cash Profits

By ANN DAVIS in Houston and HENNY SENDER and GREGORY ZUCKERMAN in New York

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One of the mistakes that led to Amaranth Advisors' multibillion-dollar losses on natural-gas investments is a common one in fast-shifting energy markets: confusing paper trading gains with cash profits.

The hedge fund's chief energy trader, 32-year-old Brian Hunter, misgauged when to take his chips off the table, losing roughly \$5 billion in a week for a hedge fund that boasted of world-class risk-management systems. While Amaranth had traded energy for several years, its roots were in convertible-bond trading, a different, less-volatile market that involved profiting from small discrepancies in stocks and bonds.

According to natural-gas investors who traded alongside Amaranth, Mr. Hunter repeatedly used borrowed money to double-down on his bets. Buying more futures contracts of the kind his fund already owned supported their price by increasing demand, propping up paper gains, these traders say. But that support only lasted as long as Amaranth and its lenders were willing to spend cash to buy more contracts. Such trades may also have masked growing weaknesses in market fundamentals, his trading peers say.

AMARANTH ADVISORS

- [See a graphic detailing facts about the hedge fund.](#)

As Connecticut Attorney General Richard Blumenthal vowed to investigate the losses, the once-mighty Greenwich-based hedge fund is scrambling to explain to investors how its risk controls went awry, cutting its assets to about \$4.5 billion, from \$9 billion.

Working from his hometown of Calgary, Canada, Mr. Hunter employed a routine commodities strategy, exploiting the difference between the prices of contracts for delivery of natural gas at various future points. He also was buying options to buy or sell natural gas at prices that others in the market thought unlikely but that would provide big payoffs if the prices came to pass.

Both strategies are supposed to be less risky than simply betting that volatile natural-gas prices will move either up or down.

In an interview on Aug. 29, when Mr. Hunter was still flying high with big paper gains, Amaranth founder and Chief Executive Nick Maounis contended that the natural-gas bets were designed to have minimal risk and maximum reward. "Spreads and options are of their very nature instruments for positions which are designed to allow the user to capture upside with a much clearer understanding with respect to downside exposure," he said.

Mr. Maounis was unavailable for interviews yesterday. In a letter to investors Monday, he said the fund so far had met all demands for more cash to back their trades and was aggressively unwinding its natural-gas bets "in an effort to preserve investor capital."

By early September, Mr. Hunter had become something of a contrarian. As gas prices fell precipitously because of a storage glut, Mr. Hunter held and increased bets that would pay off exponentially only if natural-gas prices rebounded, either on the prospect of a cold winter or a nasty hurricane that hit natural-gas facilities. That didn't happen, and prices fell more as evidence pointed to a meek hurricane season and mild winter.

What Amaranth's systems hadn't measured correctly is how much downside risk it faced and what steps would be effective to limit losses. The risk models employed by hedge

funds use historic data to figure out how much money a fund can make or lose from its positions across a wide swath of the markets. But the natural-gas markets have been more volatile this year than any year since 2001, so models might not accurately predict the possibility of big moves. They also might not predict how much selling of one's stakes to get out of a position can cause prices to fall and obliterate paper gains.

"It was a total failure of risk control to put your entire business at risk and not seem to know it," says Marc Freed, a managing director at Lyster Watson & Co., an investment advisory firm that invests in hedge funds on behalf of clients but had no money with Amaranth. "They were more leveraged than they realized."

Commodities trades require less margin money -- collateral to be surrendered in case of losses -- upfront than many other markets. Compound that with generous lines of credit from banks, and it is easy for commodity hedge funds to get highly leveraged extremely quickly.

Funds like Amaranth are able to borrow three to eight times their initial capital to make bets hundreds of thousands of times over. Mr. Hunter, for example, sometimes held 100,000 positions in a single contract, say traders familiar with some of his bets. While regulated futures exchanges have position limits to curb huge positions that can distort markets, these apply only the last three days of each contract month on the New York Mercantile Exchange.

The volatile trading that distinguished Mr. Hunter is a departure from what Amaranth was known for in the past. Denis Joseph, Amaranth's senior vice president for human resources until 2004, said in an interview that Mr. Maounis sought to centralize oversight of traders in a few hands and to keep anyone with big discretionary trading authority on the fund's Greenwich trading floor, where they could interact more with supervisors. After big gains in 2005, Mr. Hunter was allowed to trade from Calgary.

Still, the fund's high returns from energy last year and early this year were popular with its investors. When Amaranth reported returns of roughly 12% in April, it told investors most of that profit was from energy trades. After Amaranth lost about 10% in May, or roughly \$1 billion, mainly on energy trades, Amaranth told some investors that it was cutting back the leverage it was employing in the energy market, the investors say.

Mr. Hunter's bets ultimately went bad because he misjudged the movement of the difference between prices for different month contracts, known as the spread. Traders were eagerly emailing models to each other in recent days that showed how spreads on his presumed bets had lost a combined 30% last week.

Meanwhile, Amaranth's investors are tallying up their losses. One of [Morgan Stanley's](#) funds-of-hedge-funds, a \$2.3 billion fund, had about 5% of its investments in Amaranth, as of June 30. A spokeswoman wouldn't comment. [Goldman Sachs Dynamic Opportunities](#) Ltd., a hedge-fund vehicle listed on the London Stock Exchange since July by [Goldman Sachs Group](#) Inc., said it may post a 2.5% to 3% loss in September because of its holding in Amaranth. As of Sept. 1, Amaranth accounted for about 5% of its overall investments.

The \$7.7 billion San Diego County Employees Retirement Association last year placed \$175 million in Amaranth. "We're extremely disappointed, we're still trying to get the details," said Brian White, chief executive officer of the association.

Other institutional investors are expected to sell out of their holdings in Amaranth before they have to report their investments at the end of the month.

Amaranth Advisors
Connecticut headquarters



Facts about Amaranth Advisors hedge fund, under pressure for huge losses in natural-gas investments:

■ **Offices**

Greenwich, Conn.; Houston; Toronto; London and Singapore

■ **Founded:** 2000

■ **The Name**

Not a reference to the grain. According to the company, an antique pool table caught the eye of founder and CEO Nick Maounis. The model was named Amaranth. When he found out that was Greek for unfading, "he knew he had the perfect name."

■ **Strategies**

Convertible arbitrage (buying a convertible bond and selling short a percentage of the stock into which the bond is convertible); statistical arbitrage (exploiting "anomalies" in markets compared with historical trends); energy trading; merger arbitrage; and stock trading.

Trouble In Greenwich

Brash bets on the direction of natural-gas prices have humbled the hedge fund Amaranth Advisors. The fund disclosed its billions of dollars of losses on Monday. As Amaranth discovered, natural gas is among the most volatile of commodities.

Natural gas futures

The sometimes-large difference between the daily price of natural gas and its long-term moving average is one of the reasons natural gas is considered a volatile investment.

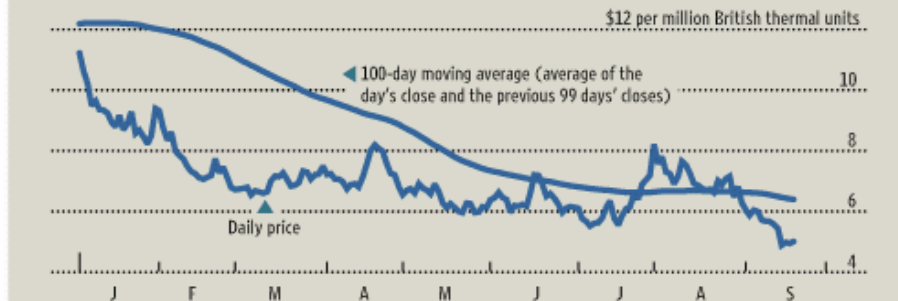


PHOTO: Douglas Healey

Sources: the company; Reuters via WSJ Market Data Group

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