The multi-billion dollar demise of hedge fund Amaranth

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There has been a sigh of relief from global financial markets following the relatively smooth liquidation of the US hedge fund Amaranth, which lost billions of dollars in natural gas bets in September. However, while an immediate crisis has been averted, there have been warnings that Amaranth's spectacular demise could be a sign of problems ahead.

The Connecticut-based fund first indicated it was in trouble when it revealed on September 18 that losses for the year could total 35 percent, exceeding $4 billion, after bets on natural gas had gone bad. A few days later the fund reported that the sale of natural gas positions had generated "additional significant losses."

Overall, Amaranth, which held $9.5 billion in August, lost 65 percent of its funds in September. A few weeks before, it had been up 30 percent for the year. Then it lost $6.4 billion almost overnight.

According to the fund's founder, Nick Maounis, the cause of its demise was the "highly improbable" movement of natural gas prices in September. The fund's Alberta-based trader, Brian Hunter, bet that the difference between natural gas price futures for the summer and winter months would continue to widen, following a trend that had begun in 2004.

Instead the gap narrowed, as prices fell by more than 40 percent after August due to increased storage and refining capacity in the US and predictions of a relatively mild winter.

While the collapse of the fund is being blamed on Hunter, an individual trader who took "risky" bets, Amaranth was well supported with investments from some of the biggest names on Wall Street, including Morgan Stanley, Credit Suisse, Bank of New York, Deutsche Bank, Man Investments and Goldman Sachs. Hunter had made $800 million on his gas trades and the fund was regarded as a "darling" of the markets.

The attempt to present the massive losses as the result of the activities of a "reckless" or "rogue" trader ignores the underlying processes which lead to the undertaking of riskier ventures.

There are now estimated to be more than 8,000 hedge funds with a total of $1.2 trillion in assets, more than double the figure of five years ago. One of the reasons for this rapid growth is that financial institutions, such as pension funds, are much more willing to invest cash in hedge funds because the stock market has provided much lower returns since 2000.

But the increase in both the number of funds and the amount of cash at their disposal means that the rate of return in less risky operations is lowered. Consequently, the funds have to engage in higher risk operations just to make the same return as in the past, let alone increase it.

Hedge funds have also been diversifying their operations. This process is a two-edged sword. On the one hand, it brings greater stability. On the other, however, it can mean that a crisis in one area of the financial system can spread to other parts of the market that seem unrelated.

Amaranth, which was founded in 2000, called itself a multi-strategy fund specialising in energy trades as well as mergers and bonds. In recent years, it had diversified, buying assets unrelated to gas including loans to Manchester United Football Club, TI Automotive, a British car parts firm, and Debitel, a German mobile phone operator. The sale of these assets helped cover its debts, thereby minimising the shock to the rest of the market.

But, as *Financial Times* writer Gillian Tett noted, this should not be a cause for complacency.

"One consequence of this process of investor 'diversification', is that seemingly unrelated asset

classes have now become more interconnected than ever before.

"At times of ample liquidity, this is a huge advantage, helping to smooth away shocks—as Amaranth shows. But what is crucially unclear is what this interconnectivity might mean if liquidity was ever sucked out of the financial system, on a large scale.

"If *five* Amaranth-style losses were to occur, say, would the markets still be able to absorb the blow? Or would it trigger a panic in the leveraged loan market—and mean that the shock from natural gas losses was amplified, touching investors across the world?"

In a comment published on Monday, *Financial Times* columnist John Plender warned that the wrong lessons were being drawn from the Amaranth collapse. The argument was being advanced that recent innovations in the derivatives market enabled the liquidation of Amaranth to proceed without the dangers to the whole system that had accompanied the demise of Long Term Capital Management (LTCM) in 1998. (LTCM was the subject of the $3 billion bailout organised through the Federal Reserve Board.)

These claims, he wrote, ignored the fact that "Amaranth posed nothing like the systemic test that LTCM did." This is because Amaranth was brought down by highly risky operations whereas many other hedge funds were engaged in the same sort of deals as LTCM. Consequently, when LTCM hit trouble they "dashed for the exit as one" whereas "no such herd followed Amaranth."

The collapse of Amaranth, however, cannot be dismissed as a "one-off" event. The risky strategies it adopted were the result of the intense pressures to lift the rate of return in conditions of increasing competition. In other words, Amaranth could well be a sign of things to come.