Sand Spring Advisors LLC

Dealing with Chaos: Is This All Really Bullish?

by,

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We were struck recently by two very different – and yet similar – situations in the financial world. First, was the rapid fall from grace of hedge fund manager Amaranth Advisors. The second was the *Fortune* magazine cover story "Chaos at Google: Managing on the Edge, The inside story of anarchy at the $125 billion money machine. And why it's all part of the plan."

You see, in my mind, the Amaranth business model and the Google business model are not that dissimilar. Both have been firms deemed by investors to be "money machines;" both firms expanded very quickly over recent years; both firms have been run chaotically as they expanded their many moving parts; and both firms have exhibited clear "master of the universe" hubris that anything can be accomplished. The difference of course is that Amaranth is now being wound up, while Google is still being lauded on a pedestal.

Hold on – you may say – what does a firm like Amaranth with an overly aggressive natural gas trader (who just happened to blow up) really have to do with a software/media/web technology/advertising giant like Google? Many of Google's projects may or may not end up working in the end, but surely, none could bring the firm down in a "wush" the way Amaranth fell from grace.

Yes, this is true. Things sometimes go badly faster in the hedge fund world than the corporate world, but the faith and confidence that investors still place in Google to get things right still leaves me speechless. As the *Fortune* article aptly points out:

> "[Google's] new products haven't made nearly the splash that its original search engine did…What concerns investors is whether Google can come up with a second act. There is nothing to suggest that its growth engine – ad-supported search – is in trouble. But it's clear from Google's tentative lurches into new forms of advertising and its spaghetti method of product development (toss against wall, see if sticks) that the company is searching for ways to grow beyond that well-run core….Successful second acts are exceedingly rare in the technology business – or in any business, for that matter.

For all its new products – depending upon how you count, Google has released at least 83 full-fledged and test-stage products – none has altered the web landscape the way Google.com did."

Like Google, once upon a time, Amaranth had a good core competency – a successful first act -- as well. Amaranth had a defined expertise at convertible trading, volatility trading, and event-driven/merger arbitrage trading that was attractively set-up and very successfully run by Nick Maonis who I have met and continue to respect as a very smart individual. I actually will admit to being invested with Amaranth between 2003-2005.

Amaranth's Greenwich CT Headquarters

But somewhere about the time that Amaranth passed $3 billion in assets on the way to $9.2 billion, and the firm was adding new energy and long-short equity teams, Sand Spring and its investment partner Weston Capital sent in our redemption notice. In our mind, the hubris factor had taken over, and our ability to keep our hands around the burgeoning Amaranth organization was being diminished. There was certainly no guarantee that all of Amaranth's new endeavors would work as well as Amaranth's original core competency. More recently, any person paying any attention to Amaranth's P&L and risk attribution report would have seen that some 75% of their year-to-date 2006 return was coming from energy trading. The same risk report showed average Amaranth leverage running at about 4-1. Levered energy trading is of course inherently volatile – particularly when it involves natural gas derivatives. Amaranth's substantive May 2006 drawdown was the last warning sign that Amaranth's risks in this area were massive. At worst, most good fund of funds managers and institutional investors should have run for the hills at that juncture, but alas many did not. Instead, these investors likely looked back at Amaranth's past track record, and subconsciously tried to ignore the clearly developing risks in their current portfolio. If 75% of a firm's revenues are coming from one area, but a firm has massive footings in many other areas, what happens when that one key area screws up? Bad stuff.

Interestingly, and continuing to discuss the fund of funds side of Sand Spring's business, this type of return distribution is exactly the same type of situation that we previously saw with a firm called Ritchie Capital back in 2004 when Ritchie was spinning out their new Ritchie Energy Fund. The Ritchie Multi-Strategy Fund had returned approximately 8.7% in 2003, but Ritchie was touting its new carve-out Ritchie Energy Fund as having produced a 32% annual return over this same period. While some may have been lured by the latter return as a great new investment opportunity (and we admittedly expressed at least some initial interest to look at Ritchie Energy as well), we focused on another question: "Exactly how much of Ritchie Multi-Strategy was allocated to Ritchie Energy in 2003?" 20% was the answer provided. Ah ha, we thought – let's do some simple math. Here we have a multi-strategy fund with many moving parts and groups, but a single naturally volatile strategy area accounted for 73% of the Ritchie Multi-Strategy Fund's annual 2003 performance. All the other areas of Ritchie were clearly not firing on all cylinders, and what would happen if this energy group were to take a misstep as energy groups inevitably seem to do? In went our redemptions in late 2004, and today we are very thankful that they did as Ritchie currently faces many well publicized problems. The recent Amaranth situation is almost déjà vu of this earlier story.

In one last example of a subtle risk management point missed by others but picked up by Sand Spring and Weston, in March 2003, multi-billion dollar manager Vega Fund Managers' Relative Value Fund experienced a -2.7% drawdown. This was supposedly a very non-volatile, non-directional fund that espoused doing low-risk relative value trading -- mostly in fixed income. We called the manager and asked for a brief explanation for this loss which was somewhat larger than that fund's historic norms. The response came: "Well, many of our relative value trades appeared to be more correlated to the movement in the U.S. 10-year over the month than we thought they would or should be. Basically, the 10-year move to lower yield levels really hurt us." I was in my car when I took this call from the manager, and I can still remember politely hanging up from the call, and then trying to do the simple math in my head without a calculator. Vega was approximately a $12 billion hedge fund at the time. And U.S. 10-year yields had only moved from approximately a 4.70% yield to a 4.55% yield over the month. If Vega was attributing almost all of their -2.7% ($324 million) monthly loss to this 10-year move, exactly how many 10-year note futures equivalents were they short? I vaguely remembered from my note futures trading days that it took a price move of about three 32nds (with each futures tic worth $31.25 per contract) to get to a full basis point yield move. Call it roughly $94 per basis point move per futures contract, or approximately $1410 per contract for a 15 basis point move like the one the market had delivered that March. To lose $324 million dollars, that meant Vega, via various different exposures and spreads, had to be effectively short the equivalent of 229,000 ten year future equivalents – a huge bet! We redeemed promptly. By August of that year, the same bet caught Vega off sides in a much bigger way, and others were rushing for the exit doors much later and at a far worse NAV redemption values than we had.

We tell these stories not to say that we have avoided every hedge fund fall from grace, but just to point out that recognizing the warning signs of potential trouble within a given hedge fund really isn't that tough. Admittedly, you have to be paying attention, and no one exactly rings a bell marking the time to exit a given hedge fund involvement. But if one takes the time to do simple math and one applies a bit of common sense as opposed to myopic greed, the right path to take usually reveals itself pretty easily.

So it is that we present these hedge fund stories as analogs to Google: lots of moving parts, lots of in-house talent with grand ambitions, lots of interesting prospects for new businesses, but in Google's instance, really only one key business driving their bottom-line revenue stream – paid web-based search. The bottom line of this business model is that in the minds of many investors, all the other moving parts are simply forgiven – viewed as free options that might (or might not) be worth something someday – but not entirely important, as long as the key business delivers. But the key business of this technology company is basically advertising, and its key clients such as WPP Group are also potentially its biggest competitors (as discussed in more detail within the *Fortune* article). Google must tred a very narrow path of working with firms like WPP and deriving revenue from them, but also clearly constantly standing on the brink of alienating them. If consumers ever start to reign in their spending (and won't they, at least someday?), Google's core advertising business would also stand at great risk. Google is not a lay-up business proposition – the next Microsoft -- as many people may believe it to be. Instead, it is a media company "experiment in motion" which in *Fortune*'s own words, is filled with "hubris and with chaos."

Might Google, the stock, still have one more hurrah to new highs into our February 2007 PEI cycle window? Sure, this is possible, and maybe even probable. But this company reminds us so very much of hedge fund firms like Amaranth, Ritchie, and Vega that eventually had their wings clipped in such an ugly and painful way.

While we are on this general topic of hubris and chaos at Google, perhaps an even more interesting *Fortune* article was the one preceding the Google piece in the October 2nd issue. This article begins:

> "Bill Ford finally joined the club just before Labor Day weekend. That's when he became the latest chief executive of a giant corporation to cop publicly to the most fundamental and alarming of business problems: His business model doesn't work anymore….And he is not alone. Ford's lament is the signature cry of our age. Across sectors – retailing, brokerage, software, publishing, computers – business models that produced profits for decades have shut down. In most cases managers aren't sure what the new model will be, but they are absolutely certain that it won't have a multi-decade lifespan."

Fortune then goes on to discuss the trend of the times: Sumner Redstone abruptly firing Viacom's CEO Tom Freston for not delivering; Intel recently announcing that is laying off 10,500 people; Dell having acute problems with its PC direct-selling model; eBay and PayPal disrupting the credit card business; Google now trying to disrupt PayPal; YouTube and Tivo disrupting the television advertising model; Apple's iPod and MySpace starting to disrupt the music industry; while on a much larger scale, the two huge auto giants of GM and Ford are of course suffering great general duress.

Whether one actually believes *Fortune*'s thematic bent or not, the article speaks of an era where the lifespan of the average business is shorter, and where companies no longer build 30-year periods of dominance, but instead are forced to adapt every two to three years -- just to survive. Maybe this is just faster and more chaotic corporate Darwinism and competition in motion – something very natural, and not particularly worrisome. But maybe – just maybe – this assertion has more sinister implications that *Fortune* seems to stop short of discussing.

In our mind, and at least conceptually, the average investor in Peoria is still trying to latch on to the next big growth story – the next new Microsoft, or the next new Philip Morris, that theoretically they would want to tuck away and hold onto forever. Certainly, this is the way most managers in the pension fund industry still think. But if companies are going to be "less dynastic," and are going to potentially hit potholes in their business model every two to three years, who can really blame many investors for turning more schizophrenic and short-term in their investment orientation – for buying today, with one eye to sell tomorrow. Chaos in the structure and success of different business models should theoretically beget even more chaos and volatility in financial markets. If business empires aren't going to be built the way that they were in the past – with the same long-term life expectancy for a given business as in past decades – then maybe all of the basic Wall Street assumptions of average price-earnings multiples that companies should carry over time are also garbage assumptions that need to be adjusted lower.

And yet, therein lies the rub: equity volatility is currently trading near decade lows, and price-earnings multiples are not exactly cheap. While U.S corporations may admittedly be enjoying a period of high after-tax returns on sales and capital, can such peak earnings really persist? Or are corporations being priced on forward looking earnings multiples that are wholly incorrect? Does *Fortune*'s very cover story that partially praises the virtues of chaos management at Google mark a symbolic moment when such business models will fall from grace?

The fixed income market – with its inverted yield curve and a forward Fed Funds rate trading below current rates -- certainly appears to be discounting a recession next year. There certainly seems to be a real disconnect between the equity and bond markets here that is unlikely to persist.

And how most immediately did we come to the current situation?

September's decline in energy markets certainly helped embolden both equity and bond market investors alike. The bad dream of $3.00+ gasoline has temporarily gone away, and we can all celebrate and go back to upbeat American ways!

But was this energy decline driven in part by short-term technical situations? Consider the following:

Pension managers are known to move slowly, but when they get moving within an asset class, they play in big size.

So it is that very few pension managers were paying attention to the Goldman Sachs Commodity Index (GSCI) back in the early 1990's, but today approximately $100 billion in pension assets track this Index. Getting more commodity exposure has recently been deemed by many pension fund managers as the "cutting edge" thing to do.

But the GSCI is an index that is periodically reconstituted by Goldman Sachs, and people often forget all the technicalities of how markets work. With the recent elimination of MTBE in the gasoline pool, the NYMEX decided in to halt trading in its New York Harbor reformulated gasoline contract (symbol HU). A reformulated blendstock (symbol RB) contract became the only remaining futures contract, and owing to the contract change, Goldman Sachs reduced the gasoline portion of its index from 8.72% to 2.3% over a period of a few months. Within an already tender seasonal period for energy demand, with no hurricanes showing up on the radar screens to cause gasoline refining shut-ins, the GSCI reconstitution meant that approximately $6 billion of gasoline futures demand simply did not show up as rollover buyers, and today we pay $2.19 for a tank of gas instead of $3.19 awhile back.

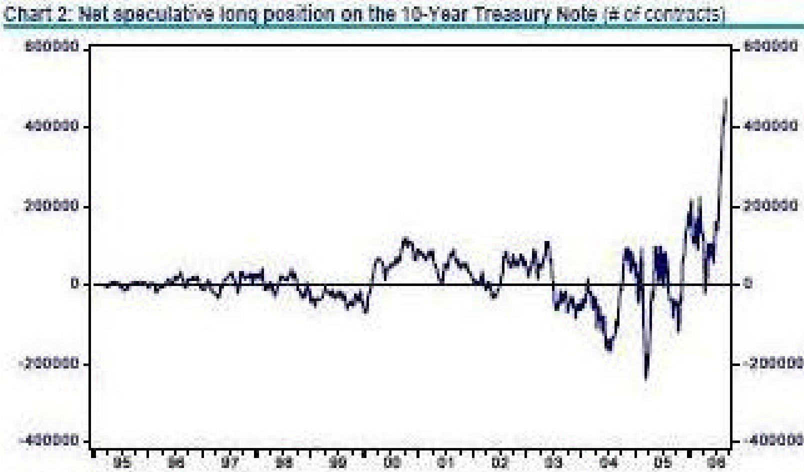
It wasn't quite that simple, of course, but a few technicalities taken together, mixed with a market caught off-sides with its long-term focus on the need for energy infrastructure development, and presto: the illusion of short-term nirvana and goldilocks soft-landing scenarios spring to life in pension fund managers' minds.

But speaking of being off-sides, Sand Spring could not have been further off-sides itself during September and early October with its premature bearish equity views. As such, we wish to offer no specific market opinion in the short-term. This letter – and its ramblings – will also be another gratis missive to current subscribers, with all subscriptions automatically extended another month. We remain personally short the broader equity indices both in the U.S. and abroad, and against these positions, we just recently added a few longs in the beat-up energy sector. But we have not been making money of late, and cyclically admit confusion.

A time for more rational market behavior and investing will eventually arrive. But it does not appear to be in the immediate offing. In the short-term, if the bulls want to enjoy a feeding frenzy, so be it, but in the longer-term, it is starting to feel an awful lot like early 2000 all over again.

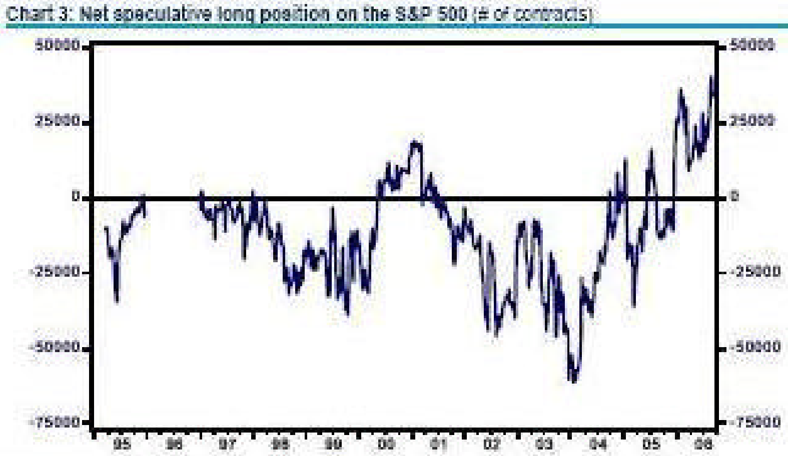
Indeed, the two Long Speculative Commitment of Trader (COT) charts below sent to us recently by a reader (and originally published by Merrill Lynch) actually would argue that the markets may already be far more excessive than they were in 2000 – with speculative excesses in *both* stocks *and* bonds this time around.

Chart 2: Net speculative long position on the 10-Year Treasury Note (# of contracts)



Source: COT, Merrill Lynch

Chart 3: Net speculative long position on the S&P 500 (# of contracts)



Source: COT, Merrill Lynch

This will all end in tears.

Send us your comments at information@Sandspring.com.

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