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No One Rings a Bell

An Editorial Commentary on What Allocators Tend To Miss in Situations Such as Amaranth Advisors

By Barclay Leib

As Justin Mamis first wrote in his useful 1977 text, *When To Sell:*

"There are plenty of different tools available in the market for investors to decide on potentially compelling investments. But the skill that few seem to master is deciding upon an adroit moment to sell – the point where a good idea has become overvalued, and has become more of a liability than an asset."

In similar fashion, different databases and capital introduction events are useful tools to identify new hedge fund talent. Further qualitative due diligence can usually ferret out managers that will likely do well over time. But once a hedge fund has hit its stride and is growing by leaps and bounds, no one quite rings a bell at the appropriate moment to redeem.

Flash into real time: $9.2 billion multi-strategy manager Amaranth Advisors was presenting itself to potential investors at a distinguished Goldman Sachs hedge fund conference at the Pierre Hotel on September 14th while concomitantly, one of its energy traders in Calgary, Alberta was causing Amaranth's main Multi-Strategy Fund to incur approximately a -65% monthly loss.

How could such a thing happen and leave so many investors caught by surprise? By one recent media count, 40 out of the 50 top institutional funds of funds held positions in Amaranth Advisors. Yet Amaranth is unfortunately just the latest in the line of many large hedge funds that have suddenly hit the rocks. Past situations have included the now infamous LTCM situation, but other more distant situations at firms such as Tiger Management and Vega Asset Managers, as well as more recently at Ritchie Capital.

Yes, it seems that with hedge funds, size is not always a great attribute. With size sometimes comes hubris; and with hubris, too many new businesses and moving parts can result. The same creative entrepreneurism that makes hedge funds

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great can also backfire as some or all the various new endeavors fly apart.

Worse yet, if an investor in one of these funds dallies just a tad too long before pulling the redemption rip-cord, it is far worse than being a day or two late getting out of a liquid stock, bond, or mutual fund. Once hedge fund managers face sudden redemptions, they often impose "gates" that limit withdrawals; in other instances, they may create "side pockets" for illiquid investments that must be maintained despite a redemption request; or sometimes they simply suspend redemptions altogether under their "fiduciary responsibility" to liquidate a portfolio in an orderly fashion. During a period of stress, any expected normal transparency into a portfolio may be lost, and an investor may end up feeling trapped by initial offering documents that are invariably tilted in the favor of the General Partner over the Limited Partner.

If investment losses start to smell of potential manager fraud, there is also often much frustration at navigating a proper course to address such. Short of clear evidence of fraud having been committed, the SEC or CFTC generally will have little interest to investigate a hedge fund on the rocks. After all, most hedge funds are privately issued Regulation D Securities, and Reg. D Securities are expected to be illiquid and volatile. And yet, a circular situation often exists whereby an investor may not have enough information to prove fraud without some regulatory intervention and help. Hedge funds managed by a Registered Investment Advisor will indeed bring faster SEC scrutiny, but even then, the process to get the SEC to launch a formal investigation may not be entirely straight forward.

At about this point in a given situation, an investor may also think about bringing a law suit or going to a judge to ask for an injunction to prevent a hedge fund manager from taking certain actions that may potentially harm Limited Partners. But threaten to sue a hedge fund manager, and that manager may be quick to point out that under his or her hedge fund offering documentation, the General Partner has the right to be reimbursed by the Limited Partnership for its legal expenses to defend itself – so unless one can prove gross negligence on the part of the General Partner, the cost of any law suit may only serve to diminish a fund's available assets for final distribution to investors.

Someday our regulatory authorities will hopefully sort out a better standardized process of recourse for hedge fund trouble periods. I personally would love to see a website where if a certain number of investors into a given fund entity request an investigation, the SEC is obligated to take the time to launch a formal probe.

But for now, the best offense against getting into such situations is found in a strong defense. All of these situations are best avoided by simply redeeming from a manager on the first glint of potential problems. This is where a good fund of funds manager or consultant can be invaluable by smelling something subtly going on at a firm earlier than the end investor.

In the case of Weston Capital, yes, we were once invested in Amaranth Advisors, but we were so back in 2003 when they still had under $1 billion under management and a definable edge in convertible, event driven, and volatility trading. Somewhere about the time that they passed $3 billion in assets, and Amaranth was adding new energy and long-short equity teams, we 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 their new strategies would work 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 falters? Bad stuff.

Interestingly, this type of return distribution is exactly the same type of situation that we saw with 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 Weston, in March 2003, multi-billion dollar manager Vega Securities' Relative Value Fund experienced a -2.7% drawdown. 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 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

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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 tic worth $32.50 per futures contract) to get to a full basis point yield move. Call it roughly $100 per basis point move per futures contract, or $1500 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 216,000 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 far worse NAV redemption values than we had.

Admittedly, Weston has not always exited every manager before bad things have happened, but we do try to stay on our toes. Maybe the simple lesson of this article is: it almost always pays to be a bit suspicious, to ask good questions, and to do the simple math. And the bigger hedge funds get, it is worth being even more wary, not less. Then never wait around too long if something seems "off."

This is partly the reason why Weston loves to find managers in the $50mm to $100mm AUM region who want to quietly grow their business to around $500mm and then close to new investment. In this latter instance, empire building hubris is simply not something that we need to worry about.

Events like that of Amaranth Advisors or some of the other past situations mentioned above are unfortunate for the hedge fund industry. Thankfully, they are far from the norm. The key for investors to avoid future such situations is to avoid myopic and overly trusting allocators who confuse past track records of success with potentially flawed hedge fund business models that may be anything but sound. ■