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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
 September 20, 2006; Page C1

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.

WALL STREET JOURNAL VIDEO

WSJ's Greg Zuckerman comments on the ailing hedge fund Amaranth and the riskiness in betting on natural gas and the overall energy markets.

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.

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 Calgary, Alberta, Mr. Hunter employed a routine commodities strategy, exploiting the difference between the prices of contracts for delivery of natural gas at various future

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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 prices will move either up or down.

In an Aug. 29 interview, when Mr. Hunter still had big paper gains, Amaranth founder and Chief Executive Nick Maounis said his bets were meant to minimize risk and maximize 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.

AMARANTH ADVISORS



- See a graphic detailing facts about the hedge fund.

Mr. Maounis was unavailable yesterday. In a letter to investors Monday, he said the fund so far had met all demands for more cash

to back trades and was unwinding natural-gas bets "to preserve investor capital." An Amaranth spokesman declined to comment. Mr. Hunter has not responded to recent interview requests.

By early September, as prices fell precipitously because of a storage glut, Mr. Hunter held 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. But as evidence pointed to a meek hurricane season and mild winter, prices fell more.

Amaranth's systems didn't appear to measure correctly how much risk it faced and what steps would limit losses effectively. The risk models employed by hedge funds use historic data, but the natural-gas markets have been more volatile this year than any year since 2001, making models less useful. They also might not predict how much selling of one's stakes to get out of a position can cause prices to fall.

"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 not 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 other markets. On the main exchanges, traders typically post 10% of their position's value, whereas in the stock market, 50% is common.

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So say, for example, gas is trading at \$7 per million British thermal units and a trader buys one contract to buy or sell 10,000 million-BTUs for \$70,000. That trader posts just \$7,000 to make that bet. If the price of gas goes down 10%, the trader has to post another 10%, or \$7,000. The trader now has \$14,000 tied up in the market, and the value of his position has dropped to \$63,000.

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Compound that with generous lines of credit from banks, and it is easy for commodity hedge funds to get highly leveraged quickly.

Funds like Amaranth are able to borrow three to eight times their initial capital to make bets thousands of times over. Mr. Hunter sometimes held 100,000 positions in a single contract, say traders familiar with his bets.

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The volatile trading that distinguished Mr. Hunter was a departure for Amaranth. Denis Joseph, Amaranth's senior vice president for human resources until 2004, said Mr. Maounis, the CEO, sought to centralize oversight of traders and discretionary trading authority on the fund's Greenwich trading floor. After big gas prices fell, Mr. Hunter was allowed to trade from Calgary. "To have a relative newcomer...rely on discretion is just shocking to me," Mr. Joseph said.

Still, the fund's high returns from energy last year and earlier this year were popular with investors. When Amaranth reported returns of roughly 12% in April, it told investors that profit was from energy trades. After Amaranth lost about 10% in May, or roughly 20% overall, mainly on energy trades, it told some investors that it was cutting back on leverage in the market, the investors say.

Mr. Hunter's bets ultimately went bad because he misjudged the movement of the spread between prices for different month contracts, known as the spread. People familiar with the trades say he bet prices for nearby-month contracts would fall and winter contracts would rise. These people say he also presumed gas might be scarce in March if used this winter and prices would then fall off in April.

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

The \$7.7 billion San Diego County Employees Retirement Association last year paid \$100 million in Amaranth. "We're extremely disappointed," said Brian White, its chief executive.


Fortunately for its investors, Paloma Partners, a \$2.2 billion Connecticut firm, withdrew its money from Amaranth in late 2004, saying the firm had grown too large.

Now other institutional investors are trying to do likewise. Hedgebay Trading Corporation, a market for trading hedge fund stakes, was inundated with calls from burned investors.

sell Amaranth stakes and bottom fishers looking to buy.

"Sellers want 30 to 40 cents on the dollar, but buyers are only willing to pay 10 cents on the dollar," said Hedgebay founder Jared Herman.

Amaranth Advisors
Connecticut headquarters



Facts about Amaranth Advisors hedge fund pressure for huge losses in natural-gas im

- **Offices**
Greenwich, Conn
Toronto; London
Singapore
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- **The Name**
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- **Strategies**
Convertible arbitrage (buying a convertible
selling short a percentage of the stock into
bond is convertible); statistical arbitrage ("anomalies" in markets compared with his
trends); energy trading; merger arbitrage;
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 natural gas and its long-term moving average is one reason natural gas is considered a volatile investment.



PHOTO: Douglas Healey

Sources: the company; Reuters via WSJ MarketWatch

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