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The Future for Investors
by Jeremy Siegel, Ph.D.

Amaranth and Hedge Funds' Hidden Risks

Monday, October 2, 2006

The spectacular decline in the asset values of Amaranth Advisors LLC, the once highly-successful hedge fund, illustrates an important lesson for investors: there is no easy path to higher returns.

Hedge funds are often sold as "alternative investments" that control their risks and are uncorrelated with other markets. But Amaranth shows, as the collapse of Long Term Capital management (LTCM) did nearly a decade ago, that "controlled" or "hedged" risks can easily go awry. Investors must be aware that the history of hedge fund performance is far too short to reveal the true risks hidden in their operations.

Hedge Fund Mania

Amaranth, based in Greenwich CT, specialized in energy trading. But the collapse in natural gas prices forced it out of its positions after its two main funds plunged more than $6 billion, or 65%, since the end of August. It's the largest hedge fund collapse since LTCM went belly up in 1998.

The growth of hedge funds has been spectacular over the past decade. There are now more than 8,000 funds with over $1.2 trillion in assets. And most have performed fairly well since 2000, avoiding the bear market in stocks by staying out of technology issues and buying "alternative assets" such as commodities, particularly energy. It is estimated that about one quarter of the hedge funds assets have flowed into commodity and energy investments during the past two years.

All this hedge fund buying raised the prices of oil, gas, and other commodities substantially above their long-term average. But these higher prices have increased the risks of owning these commodities. Hedge funds argue that many of these commodities were underpriced, and that today's higher prices are justified by putting the right "scarcity value" on commodities. High prices, though painful for the consumer, encourage conservation efforts.

Risks in Commodity Investing

There's truth to this but commodity prices are notoriously unstable. Amaranth said it reduced risk by taking "spread positions" in natural gas, which means buying gas for delivery in one month and selling another month, hoping to benefit by a change in the relative price. Spread positions are usually more stable than taking an outright position in the commodity.

But spread positions in and of themselves can be very unstable. In fact, spread positions torpedoed LTCM eight years

ago. It entered spread contracts between the yields on government bonds and corporate bonds, often called “credit” or “swap” spreads as well as spreads between the yields of government bonds with different maturities. These yield spreads, which usually stay in a relatively narrow range, rise when investors perceive greater risks in financial markets and fall when risks subside.

In 1998, when Russia defaulted on its sovereign debt, there was a mad rush to buy gold-plated U.S. government bonds and sell risky securities. The buying of U.S. treasuries was augmented by the fear of an upcoming shortages of U.S. bonds caused by “looming fiscal surpluses” that were widely (and wrongly) predicted at that time. Credit and term structure spreads increased well beyond previous bounds, causing LTCM to collapse.

Although the full story of Amaranth has yet to be told, it’s believed that the unusual behavior of spreads of natural gas between different delivery dates caused its decline. Prices of some natural gas contracts collapsed when the widely predicted hurricanes that would have hampered gas production never materialized and softness in the economy caused the commodity bubble to deflate.

Real Risks Understated

What happened to Amaranth illustrates that hedge funds, for all their talk about “controlled risk,” cannot escape the natural volatility of the markets. The more active markets become, the more likely they are to experience unusual speculative moves. Amaranth claimed that the probability they would have lost so much in spread trading was “extremely remote.” But extremely remote events do occur, even for markets with as much history as government bonds, as LTCM sadly discovered.

Nor are markets likely to be as “independent” and uncorrelated as most hedge funds claim them to be. The prices of commodity and stocks markets may have low correlations in normal times, but become highly correlated in financial crises. Immediately after 9-11, not only did stocks tank, but commodity prices fell dramatically, too. Expectations that the economy, and the travel industry in particular, would stall in wake of the attacks did not bode well for stocks or energy prices.

Many observers, noting the similarities between the problems of LTCM and Amaranth, have called for increased government regulation of hedge funds. But that would be a mistake. LTCM used far more leverage (reportedly nearly 25 to 1) than Amaranth (said to be 4.5 to 1) and disrupted the vital government bond and corporate bond markets. It was understandable that the Fed stepped in to facilitate the orderly transfer of assets (in no way did the Fed or government “bail out” LTCM, as is widely believed). But Amaranth caused no comparable disruption to markets.

I would not object, however, that hedge funds be required to disclose their lack of knowledge of the true risks that their positions entail. Because of their investment strategy, historical analysis of ten or twenty years or longer may not properly reflect the volatility of their positions. Investors should be made aware of these facts.

Market Significance

What does this mean to ordinary investors? The hedge fund flame-outs could ultimately help stocks. The more that people understand that there is no magical way to generate 10% to 15% returns in alternative markets, the more investors will be satisfied with average returns of 8% to 10% in stocks.

As an asset class, I believe stocks now look far more promising than bonds, real estate, or commodities, whose price declines may extend much further before they recover. Amaranth is just another reminder that there are no easy paths to higher returns.

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