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Largest Hedge Fund Collapse Since the LTCM Case of 1998

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Amaranth is an ornamental and useful plant frequently found in tropical regions. It is almost indestructible and can survive for a long time without water. Its spinach-like leaves, and especially its flowers, are extremely nourishing, and served as the chief source of nourishment for the Incas. In Greek mythology, amaranth is a plant dedicated to the goddess Artemis and a symbol of immortality. The Greek word *amarantos* means "always blooming." In light of its contrast with the quickly fading rose, Aesop dedicated one fable entirely to the two plants. Milton also designated it in his *Paradise Lost* as the "immortal amaranth," which was once nourished in Paradise by the "tree of life."

Is there a better name to call a hedge fund, in order to lead investors to believe in minimal risk and ever higher returns? For a while, everything went for the best with this hedge fund. But in September 2006, the plant suddenly withered. Amaranth Advisors LLC, a $9 billion-strong hedge fund, within two weeks, suffered the loss of 65% of its investment capital, because of bets on natural gas futures, and now stands at the brink of total collapse.

Measured in lost capital, about $6 billion, this is the greatest collapse of a hedge fund internationally since the collape of Long-Term Capital Management (LTCM) in September 1998, which collapse at the time brought the world financial system to the edge of the abyss. As was LTCM, Amaranth is also headquartered in Greenwich, Connecticut.

And, as in the case of LTCM, the managers of Amaranth believed that they had uncovered the formula for risk-free earnings from speculation, making use of the extreme swings of the closing prices for natural gas on the New York Mercantile Exchange, which occur almost daily. However, the closing prices for the contracts, differentiated according to months of future deliveries, rise or fall more or less in tandem. And the one thing one could always depend upon in the past: If the hurricane season has just ended and Spring is setting in, natural gas rates begin to fall in the United States. The prices of natural gas then follow lawfully.

In past years, the price of natural gas was always less in April than in March. Therefore, the March natural gas is properly more expensive than April natural gas. And on this empirical situation, Amaranth bet billions of dollars, which it had collected from banks, insurance companies and, not the least, pension funds. The bets went bad.

One can conceive of the special derivatives contracts of Amaranth for the present as a double set of futures: the purchase of a considerable volume of natural gas for delivery in April 2007, and a simultaneous short sale of exactly the same amount of natural gas for delivery in March 2007. A short sale is the term for when one sells something which one doesn't own, but which one buys after the conclusion of the sale. In other words: In anticipation of the falling price, one buys in April and sells everything in March.

Now, in the real world, unfortunately, the fact that March 2007 occurs before April 2007, and that in March, one really owns nothing to sell, is a limitation from which one frees one's self on the derivatives markets. Through trade with the paper version of natural gas, such a distortion of causality presents no basic problem.

In order to dramatically raise the earnings on its risked capital yet again, Amaranth had added a further variant to this double set of futures. The difference between the price in March 2007 and the price in April 2007 was separated from the double set of futures, and Amaranth invested in this difference. This would mean enormous profits, if the natural gas price in March 2007 were two or three dollars more than the natural gas price in April 2007; but if the opposite case were true, if both prices coincide, it would be a total loss. And this is exactly what happened.

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The almost indestructible amaranth plant. Unfortunately, its hedge-fund namesake doesn't share the plant's ever-blooming characteristic.

The other speculators on the NYMEX are proceeding on the basis of the current hurricane projections for the Fall and Winter, that the yearly price break this time will occur in December (not March). And since the difference in the natural gas price futures for March and April 2007 has therefore been lost, Amaranth is now bankrupt, totally independently of what the actual natural gas price should turn out to be in Spring of next year—*rien ne va plus.*

JP Morgan Chase and Citadel Step In

Almost exactly eight years after the LTCM disaster, once again an immediate intervention by the "Plunge Protection Team," comprised of the Federal Reserve, the U.S. Treasury, and the leading banks, was demanded, in order to save a huge hedge fund from collapse. But this time, as opposed to what happened in September 1998, it was considered advisable to arrange no melodramatic and publicized *Nacht-und-Nebel* action, and thus to raise no unnecessary dust. In 1998, the heads of the 16 largest banks in the world, including Deutsche Bank, were snatched on short notice out of offices, beds, and golf courses, and dragged to an emergency meeting on the premises of the New York Federal Resrve, in order to agree on a common "bailout" plan, whether or not they were directly entangled with LTCM.

On approximately Sept. 20, 2006, Amaranth chairman Nicholas Maounis put out the news. In his letter to the funds' investors, he shared the fact that, unfortunately, between Sept. 1 and Sept. 19, more than $6 billion, or 65% of the investors' capital, had evaporated. But, there was still $3 billion on hand, and there would not be any more losses caused by the natural gas contracts, because they had sold these contracts to a "third party." This step, according to Maounis, was necessary, "in order to prevent the termination of our credit facilities, and to avoid the risk of a subsequent, forced liquidation by our creditors."

At the same time, the news was handed to the media about "two persons participating in the transactions," namely, that the "third party" involved two financially powerful enterprises: the investment bank JP Morgan Chase, and the $12 billion Citadel Investment Group, a hedge fund with headquarters in Chicago. This had been prearranged. This leads one to speculate whether, and in what way, JP Morgan and Citadel were compensated for their good deed on behalf of the continuation of the derivatives casino, through the Federal Reserve or the U.S. Treasury.

Although it was possible to save the derivatives contracts of Amaranth without creating a great furor, there was nevertheless a long list of victims. To begin with, there were the investors in Amaranth: the pension funds of San Diego, the 3M enterprise, and the Caisse de Depot et Placement of Quebec, the largest pension fund in Canada.

There is, for the moment, no comment from the current, affable Amaranth member, who worked out the natural gas bets, one Brian Hunter, a 32-year-old Canadian, with a university degree in applied mathematics. He left behind in his office only a half-empty bottle of whiskey.

The most important creditors of Amaranth were JP Morgan and Merrill Lynch. They must have written off some of the debt. Other victims are presumably those enterprises whose credits had been supported by Amaranth. In addition to the natural gas contracts, Amaranth had been involved with high-risk loans, probably loans for financing of private equity negotiations. These loans have now been sold at lightning speed to other investors. The new owners will be changed shortly into actual debtors and place certain demands. Counted among these debtors are the German cable company TeleColumbus, the German mobile phone company Debitel, the British auto subcontractor TI Automatove, and the English football club Manchester United.

Regulating the Speculators

Even if the Amaranth bankruptcy is not comparable in its dimensions with the impending implosion of the American real estate market—the latter has a thousand times greater amount of bonded credits and corresponding derivatives in play—the case raises anew the question of regulation of the speculative funds. In the United States, the Bush government has lifted the previous ban on pension funds investing in hedge funds.

In Germany, on the contrary, the head of the financial oversight group BaFin, Jochen Sanio, had made a strong case for worldwide regulation of hedge funds, pointing out that these were like "black holes" of the financial system. Sanio has since come under heavy pressure, with people demanding his head. First there was a fraud case in BaFin's computer division, followed by a fierce confrontation between Sanio and the personnel board.