

Amaranth Advisors' \$6 billion lessons

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September closed with a fresh derivatives trading horror story: the star natural gas trader at Amaranth Advisors, one of the largest US hedge funds, lost about \$6 billion in a week's time. For derivatives traders, understanding the *hows* and the *whys* of the Amaranth debacle is important.

While Amaranth represents the largest financial loss made by a single trader, it is not an isolated incident. Here are some examples that have occurred over the years:

Year	Company	Market	Loss
1993	Metallgesellschaft	Crude oil	\$1.3 billion
1994	Orange County, California	Various financial derivatives	\$1.7 billion
1995	Daiwa Bank	Bonds	\$1.1 billion
1995	Barings Bank	Japanese securities	\$1.2 billion
1996	Sumitomo Corp.	Copper	\$1.8 billion
1998	LTCM hedge fund	Russian securities	\$3.5 billion
2001	General Electric	Various derivatives	\$1.2 billion
2001	Frostman Little & Co.	Various investments	\$2 billion
2002	Allied Irish Bank	Foreign exchange	\$690 million
2002	Ford Motor Company	Palladium	\$925 million
2003	GPIF (Japanese pension fund)	Various investments	¥6 trillion
2004	National Australia Bank	Foreign exchange	A\$360 million
2004	China Aviation Oil	Oil derivatives	\$540 million
2005	HSBC	Interest rate derivatives	\$500 million
2006	Amaranth Advisors	Natural gas	\$6 billion

On varying scales, similar events occur with greater frequency than is commonly known. While in most cases firms avoid wider publicity, a recent McKinsey&Company study of 200 leading financial firms found 150 cases of *significant financial distress*¹ during a five-year period. In other words, the average firm has a 75% probability of suffering financial distress once in five years.

While the tendency to experience losses stems from a variety of factors, nearly every case involves **loss aversion** – the psychological phenomenon that often drives traders to chase after losses with more bets. The case of Amaranth's star trader is typical in that respect. Brian Hunter became a minor legend on Wall Street in 2005 when he made over \$1 billion trading natural gas. The Wall Street Journal published a lengthy interview with the *wunderkind* trader, in which Mr. Hunter shared some of his secrets. For example, when markets go against him "he asks himself, 'Do I still like my position?' If he does, he adds more."

This is another name for running after bad trades with ever bigger bets: when Mr. Hunter joined Amaranth, the fund's natural gas positions were limited to 7% of total exposure. By September 2006 this number had increased to over 50%, precipitating a disastrous end for Amaranth Advisors. This case (and others preceding it) offers the following three lessons:

Amaranth's key lessons:		
1	There is no such thing as a "star trader"	George Soros once warned his star trader Victor Niederhoffer, "Get off your high horse Victor, <u>you're only as good as your next trade.</u> " Mr. Niederhoffer moved on to become the world's No. 1 fund manager in 1996. In 1997 he too brought total ruin to his fund by chasing after losses.
2	Resist favoring past winners	Any trader can have a run of bad luck which can start at any moment. Your risk budget should be equitably spread among traders, even the not-so-brilliant ones. They might be your future winners. <u>Favoring past winners disadvantages future winners</u> , choking performance.
3	Never chase after losses	When losses occasionally mount beyond a trader's <i>comfort zone</i> , the urge to take action can be hard to resist. A <i>quick fix</i> maneuver may not be worth the risk. Patience, perseverance and discipline form the best foundation for long term success.

These lessons sum up the reasons why Equilibrium Solutions delivers decision support through a set of three or more **independently functioning** trading strategies. Further, our strategies have two key advantages over "star traders": they don't cost exorbitant sums and they never chase after losses.

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¹ McKinsey defined *significant financial distress* as either a bankruptcy filing, a credit ratings downgrade of two notches or more, an earnings decline of over 50% below analysts' consensus estimates, or a decline in total returns to shareholders of over 20% below the overall market in any one month.