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Amaranth hit by $6bn loss

Amaranth Advisors, a Greenwich-based multi-strategy hedge fund manager, suffered close to a $6 billion loss in September after huge concentrated positions in the natural gas market went awry. The losses have forced the firm to sell its energy portfolio to Chicago-based hedge fund Citadel and JP Morgan.

The speed at which Amaranth's energy derivatives portfolio, managed by Calgary-based co-head of energy Brian Hunter, notched up mark-to-market losses has taken investors by surprise: on September 14 alone, it lost $565 million.

Speaking to investors on a conference call on September 22, Nick Maounis, founder and chief executive of the fund, highlighted the illiquidity of the natural gas market as a key reason for the losses. "A series of unusual and unpredictable market events caused the funds' natural gas positions, including spreads, to incur dramatic losses, while the markets provided no economically viable means of exiting those positions," he said. "Despite all our efforts, we were unable to close out the exposures in the public markets."

The value of the fund fell by 65% in September, and is down 55% in the year to date. Following the losses, the leverage on the fund was reduced to 1.3 times its capital. Prior to the unravelling of its natural gas positions, Amaranth had around $9.5 billion in assets under management.

Maounis sought to reassure jittery investors, telling them the fund was currently solvent and planned to stay in business with its non-energy portfolios, which include convertible arbitrage and merger arbitrage. Citadel and JP Morgan bought Amaranth's energy positions on September 18.

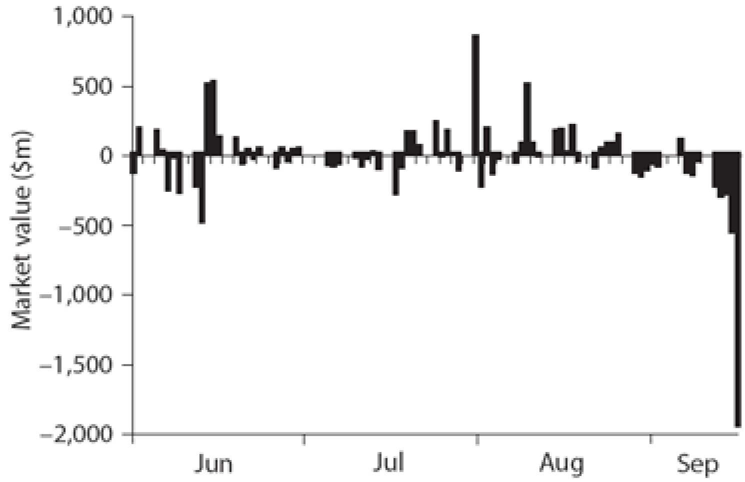
However, investors are furious that the fund was able to take on large, concentrated positions in an illiquid market such as natural gas in the first place. "It was insulting for market professionals to listen to the fact that they thought they had done everything right and that it was simply unanticipated moves in the market-place," says one investor participating in the conference call. Amaranth's investor base is believed to include funds of funds at major firms such as Goldman Sachs, Morgan Stanley, Credit Suisse, Bank of New York, Deutsche Bank and Man Group.

The energy fund had several key positions that caused the losses, say market sources. One strategy involved going long the March natural gas futures contract, while shorting April futures. The trade seeks to profit from the fact that, historically, natural gas prices rise during winter and fall after March as demand for heating among consumers tails off. If an investor believes there will be a harsh winter or an active hurricane season that will disrupt supplies, then the trade makes sense.

However, a relatively uneventful hurricane season in the US caused the March/April 2007 natural gas spread to contract sharply in September. Amaranth's trade, which would profit in a widening spread environment, was plunged into negative territory as the March/April spread narrowed from 2.05 points on September 1 to 0.75 points on September 18.

During the tense conference call, Maounis argued that Amaranth's losses were not a result of poor risk management. "Although the size of our natural gas exposures was large, we believed, based on input from both our trading desk and the stress testing performed by our energy risk team, that the amount of risk capital ascribed to the natural gas portfolio was sufficient," he said.

1 Daily change in profit/loss from inferred natural gas positions: June 1–September 15, 2006



Source: Hilary Till and Premia Capital Management

Her analysis shows that, at the end of August, the expected one-day standard deviation of the fund's net income would have been 2.2%, while the expected monthly volatility would have been 9.7%. On September 15, however, natural gas futures spreads moved by a whopping 9 standard deviations. "If the fund had relied on a simple value-at-risk and volatility analysis, then at the end of August this would have vastly underestimated the risk of its strategies during a liquidation-pressure event," says Till.

A failure to account for illiquidity seems to have been Amaranth's biggest mistake, say market participants. "[Hunter] built these positions that the market couldn't digest. When you try to get out of them, there isn't enough there to liquidate efficiently," says Bill Wallace, a broker at Man Financial in New York.

On a high-activity day, the market trades more than 100,000 contracts, while in quieter times that figure might only be 50,000-60,000, says Wallace. It is estimated that Amaranth held well over 50,000 natural gas contracts.

"When people get a sense that someone is on the ropes, they're going to exacerbate the problems that he has," adds Wallace. "Those with risk capital are going to short whatever he has, believing the guy will have to capitulate and that they will be there to take his capitulation selling."

- Jayne Jung