

### What we can learn from MotherRock and Amaranth

By Edmund Wandeler, client relationship manager, AlphaSwiss Group

**THE EXPONENTIAL GROWTH** of the hedge fund sector and subsequent inclusion of hedge funds into extended asset allocations is a clear sign the industry has matured from a specialist domain to the mainstream.

The inclusion of hedge funds into traditional portfolios has also meant that risk management and internal procedures at banks, insurance companies, pension funds and other institutional investors had to be upgraded. Some of the institutions followed a proven and well thought out due diligence process and others used an outsourced solution. It's certain that without proper risk management standards and procedures, hedge fund investments are bound to cause problems.

Our company, AlphaSwiss, has heard of billion dollar fund launches, which apparently are soon going to be closed to new investors, which were not able or willing to provide interested parties with a standard offering memorandum and documentation. We were also told the documentation would be ready at launch, but interested parties are being advised to commit now to guaranty capacity. This is clearly a sign that some parties are not following the appropriate steps before committing capital.

After a period of low returns, investors' appetite for risk has increased. In some cases this has led to disregarding appropriate due diligence and risk management standards and procedures. This seems to have been the case in two recent hedge fund failures: MotherRock and Amaranth.

AlphaSwiss was asked by two exposed institutional investors to produce an *ex ante* report on MotherRock. In looking at the fund, it was clear that a drawdown of more than 10% was highly likely and even a drawdown of more than 50% was possible. The investment strategy was well-documented and generated a homogenous alpha without unexpected style drifts. Since the fund's track record wasn't statistically significant, the weight of the report was on the qualitative analysis.

Operational due diligence resulted in above-average infrastructure and systems.

Background checks signalled an excellent pedigree. MotherRock had a premium custodian, broker and even changed its auditor from an average-ranked one to a top-ranked one. The administrator had recently changed from a high-ranked to a low-ranked, which raised questions.

Critical risk factors were found in the long redemption period. The initial lock-up period was one year with a quarterly redemption notice of 90 days, which is especially problematic when the concentration in the highly volatile natural gas sectors is taken into account. There was no diversification across the energy sector and natural gas trading accounted for nearly 90% of its net exposure. Due to the highly-complex long/short portfolio, with an asymmetric derivative payoff structure, high monthly volatility was expected. Leverage of up to five times also could have signalled problems, given the characteristics of the liquidity in the natural gas market. To summarise the analysis, the risk of blow-out was not eminent, but the potential was there.

#### The problem of risk

What can be said, from a risk management point of view, in the case of Amaranth? We haven't generated a detailed manager profile of Amaranth but there are some obvious similarities – concentration in potentially illiquid commodity spread commitments, leverage and a high return expectation which involves a lot of risk.

As a multi strategy fund, Amaranth was paid to change its exposure from one asset class to another – wherever risk generated the highest return. The concentration of Amaranth's portfolio in natural gas and the effect of high volatility on the portfolio were discussed ahead of the problems.

A fund of funds analyst whose firm was invested in Amaranth said: "Yes, some investors asked them to reduce volatility. Amaranth told them that they would, but it's not what they did. They were in the process of doing it. That's a fine line. I guess they didn't act fast enough." Asked if Amaranth did the right thing or not, this investor said, "it's somewhere in the middle."

What really happened won't be clear until the case is settled, no doubt in the courts. But at this point it can be said that Amaranth did what it was paid to do by investors. Unfortunately that turned out to be misguided in the present market, and turned into a disaster.

Investors were seduced by Amaranth's strong track record, operational infrastructure and apparent skill. But given all the facts, we assume some were not aware of the risk Amaranth was exposed to. ■



**EDMUND WANDELER** is client relationship manager, responsible for sales, marketing and distribution, at AlphaSwiss Group, a leading Swiss provider of investment management advice (portfolio and risk management). The company and its team specialise in alternative investments. AlphaSwiss's focus is on the Swiss institutional market, but also offers its products and services to institutional clients worldwide. Wandeler was previously partner at a Swiss-based CTA. From 2000-2003, he was responsible for starting and building the hedge fund brokerage business at Bank Vontobel in Zürich. He received an MBA and Master of Science in financial markets and trading from Illinois Institute of Technology in Chicago.