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By Stanley Morgan

With the prospect of earning over the odds on derivatives trading, hedge fund managers are employing ever more high-tech means to calculate risk and predict stock market activity. But Wall Street's faith in its own predictive powers often blinds investors to the fundamental laws of investment, says risk specialist Stanley Morgan

A friend of mine was working as a quant at a Wall Street investment bank when a large and well-known hedge fund, Long Term Capital Management, went bust in 1998. Experts from a number of top financial firms were called in to help stanch the bleeding and prevent the disaster from spreading to the larger financial system. My friend was one of the people enlisted to sift through the mess and figure out exactly where the fund stood. Afterward, when I asked him how things looked, he shook his head in amazement: the people he'd spoken with at the fund had no clue about half of what they owned or what it was worth. Granted, complex derivative securities (the kind this fund had been miserably unsuccessful gambling with) can be exceedingly hard to price even when you're not in the midst of financial turmoil, but that's something you need to take into account when you're managing billions of dollars of other people's money. The fact that this fund lost enough in a week to nearly bring down the economy was a sign that its managers were playing Russian roulette with bazookas, not simply investing.

This kind of financial brinkmanship is becoming increasingly popular. Warren Buffett has called derivatives "which often encapsulate extremely complex relationships between multiple products or events, and allow you to take on risk many times greater than the actual money you have invested" "financial weapons of mass destruction". Derivatives are over-used and routinely mispriced such that companies are often giving an inaccurate accounting of the value of their holdings. And when things don't work out the way you expect, derivatives can cause staggering losses. There will be more and bigger blowups. You don't have to be Chicken Little to acknowledge that large pieces of the sky are falling all the time - from Barings Bank ('95) to hedge funds Long Term Capital Management ('98), Julian Robertson's Tiger Fund ('02) and Amaranth ('06). The particular excuse is almost irrelevant: "That surprise move in Brazilian interest rates was a 1 in 1,000,000,000,000 occurrence"; "The liquidity in that Russian mining stock suddenly dried up, so I couldn't unwind my position" "sure, but that's not going to bring your money back (or mine, if I was unlucky enough to be one of your investors). Trading desks are increasingly speculating in products they don't fully understand, using computer models that don't account for that deadly one-in-a-trillion possibility (what author/trader Nassim Nicholas Taleb calls a "black swan"), and at the same time generally shunning anything that appears too simple and comprehensible. Why?

One culprit is a familiar one on Wall Street: greed. If you think Dell will go from \$25 to \$75, you can buy a thousand shares and make \$50 thousand, or you can buy some call options and make many times that amount with the same investment. Or you can use borrowed money to increase your leverage even more. Yeah, but what if Dell ends up dropping to \$15? Hedge funds have brought the use of leverage to a point never dreamed of before, while hedging the resulting risk in ways that are not necessarily foolproof. But precisely because of the massive leverage they use, hedge funds hold out the promise of returns that dwarf the boring S&P 500 or FTSE. And they often deliver them - until that statistically impossible move in Brazilian interest rates happens. Like the entrepreneurs who sold shovels during the California gold rush, the smart money knows that the best way to get rich from a hedge fund is by running one. Fund managers take their cut off the top: they get 2 percent of your money no matter what their performance. The fund's other investors take their chances, and feel most of the pain if the fund's bets don't pan out. Still, people who can afford the price of admission are drawn to hedge

fundsâ potential returns, their exclusivity, and their general sexiness like moths to a flame, adding billions of hopeful dollars a week to the pool. The result: more pressure to pump up returns, more leverage, more borrowing, more complex derivatives, more precarious and hard-to-quantify dependencies between products and trading desks. And more risk.

A less obvious reason for the explosion in the use of leverage, and the concomitant increase in âsystemic riskâ, is 21st century Wall Streetâs love of technological solutions almost for their own sake. Sure, it costs a lot of money to hire an army of physics PhDs and build computer models that can run through a million scenarios a second, but who wants to be seen scratching out calculations on a yellow legal pad? If youâre marketing yourself as a financial genius â or if you âareâ one, like the Nobel Prize winners who founded Long Term Capital â youâd better have a flashier plan to show your investors than âthese three stocks look really cheapâ. But while strategists crank out incomprehensible new products and Rube Goldberg-esque mechanisms for managing their inherent risk (usually imperfectly), there is plenty of money being made using the mundane strategy of looking for mispriced securities â âBuy low, sell highâ â with no chance of losing three thousand times your initial investment.

Debt Fist by John Wollaston

Image: *Debt Fist* by John Wollaston

The annual ârich listsâ continue to be dominated by traditional businessmen (technology, steel, retail, media) who make money in ways that would be recognisable to a 19th century capitalist and old-style investors like Warren Buffett, who claims not to even have a quote machine in his office. For the most part, the rich continue to get richer in the traditional ways. As for the new hedge-fund billionaires, the financial rock stars of the moment (with earnings in the hundreds of millions of dollars a year), they make their money largely from fees paid to them by very rich people â not a very high-tech way to earn a living, but they donât seem to be complaining.

Stanley Morgan builds risk management systems for a Wall Street investment bank