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On Wall Street: Lessons of the Amaranth meltdown

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Consumers want it all. First-class airline tickets should mean Champagne, flat beds and early boarding. Expensive restaurants should mean excellent food, polite waiters and a pleasant ambience. Consumers are no different in the hedge fund world, where fees are generally 2 per cent of assets and 20 per cent of gains. Investors expect superior returns produced by managers experienced at taking large but calculated risks to beat the market.

For their part, hedge fund managers are all too aware that if they do not produce big returns, their reputations will suffer and investors will pull out.

But that awareness creates an additional and vital consideration for the investor. The pressure on hedge fund managers to deliver outsized returns to justify those high fees produces the temptation to take on risks based on optimism and self-belief rather than rational analysis.

The $6bn of energy trading losses that emerged at hedge fund Amaranth Advisors this week, wiping out 75 per cent of the fund's assets, was a reminder of what can happen when a fund manager surrenders to that temptation.

Amaranth made its name trading the convertible bond market. But then the profitability of "convertible arbitrage" largely dried up. Rather than close down, as some funds did, founder Nick Maounis decided to diversify into other asset classes, notably energy.

To run Amaranth's energy strategy, Mr Maounis took another, perhaps calculated, risk – hiring former Deutsche Bank trader Brian Hunter. Mr Hunter had made big money for Deutsche trading US gas futures, but had left the bank minus his bonus. Deutsche claims he posted substantial losses and exceeded his risk limits. Mr Hunter is still battling Deutsche in the courts.

For some time, Mr Hunter's bets on the natural gas market paid off. In 2005, he reportedly made $800m for Amaranth, and until just a few weeks ago, the fund was up 30 per cent on the year and was the darling of its investors.

But what is perhaps more startling than the scale of Amaranth's losses is that the list of its investors reads like a who's who of savvy money managers. Funds-of-hedge-funds operated by Morgan Stanley, Credit Suisse, Bank of New York, Deutsche Bank, Man Investments and Goldman Sachs all had stakes in Amaranth.

That roll-call begs an unanswered question. How were all these supposedly sophisticated, expert investors persuaded to put their clients' money into a fund with such a perilous risk position? Where was the due diligence?

For many pension funds, endowments and wealthy individuals making their first foray into hedge funds, the fund-of-fund manager has been the vehicle of choice. In return for a second layer of high management and performance fees, fund-of-fund managers promise a diverse portfolio of hedge fund investments run by the best and the brightest in the industry, with the pesky work of background checks and risk analysis taken off clients' hands. Amaranth's dramatic losses have shown that funds-of-funds may not always screen investments as rigorously as these first-time investors hope.

Those investors will be reminded of the same consideration that Morgan Stanley, Credit Suisse et al may have overlooked. The pressure on fund-of-fund managers to deliver outsized returns to justify their high fees leads to the temptation to invest in hedge funds making big returns, even if they might be taking dangerous levels of risk.

The same psychology is at work at the fund-of-funds level as at the individual fund level, but with an added dimension. The fund-of-fund manager who avoided the fund posting 30 per cent returns – Amaranth, just a few weeks ago – could face an uncomfortable reckoning with their clients.

The bottom line for each level of investor is that hedge funds are not for the faint of heart. Managers are paid high fees to take big risks.

But hedge funds are also not for the naive. The funds want investors to believe their risk management is adequate, just as fund-of-fund managers want investors to believe their due diligence is sound.

They probably believe it themselves; in many cases it may be so. But those who believe them without doing their own homework do so at their peril.