Boston Business Journal - March 25, 2002
http://boston.bizjournals.com/boston/stories/2002/03/25/newscolumn6.html

Boston Business Journal

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Your Money

Derivative hedge funds are ticking like time bombs

Prescott Crocker

As the endless Enron inquiry unfolds, it has become clear that America's corporate balance sheets are telling less and less of the whole truth to the investment community. It's always been said about balance sheets that "what the big print giveth, the little print taketh away."

And so now, as we learn daily of the corporate dismissals of the Arthur Andersen accounting partnership, it has become evident that much information was never given · it was just hidden.

Indeed, as they peel away the sticky lawyer-laden layer cake that we call Enron, investors are compelled to learn the arcane game of derivatives and to understand where or in what industries accounting time bombs may be lurking. Just what are these instruments and how do we look for them?

The word "derivative" is itself a derivative -- it is used to describe a contract that is referenced to, or "derived from," underlying cash or physical financial markets. Markets for such items as foreign exchange, or debt and equity securities, or even the general bond and stock markets in which they trade are all good examples.

Now, a derivative is a contract, or even a bundle of contractually created rights and obligations, based on future price expectations for specific financial markets. Each contract has a buyer and seller and a middleman or counterparty that has arranged the contract. Inevitably, each time we hear of the use of financial derivatives we almost always also hear the words "risk management."

That is to say, those who play with these often-dicey financial bomblets generally excuse their use by explaining it away as a means of modifying risk. For example, a gold mining company can employ derivatives as a hedge against price movements beyond certain limits. That company might sell calls to deliver gold above a certain price and use the funds received to acquire gold at a lower price. Voila´! The company has transferred the risk of gold price movements off its balance sheet and underlying income statement -- it has "risk-managed" the impact of price volatility out of its business model.

But has it really negated risk to its shareholders? Of course not. The gold mining company has simply stabilized gold price risk to profits within a defined collar of price range.

But it has also significantly exposed itself to possibly substantially larger opportunity loss or gain should the price of gold spiral beyond its price collars.

If the company sells calls to deliver gold at $300 an ounce and the market price rises to $340 an ounce, the company has transferred away from its shareholders the opportunity for significant profit gain.

And if that company has long-term contracts to deliver gold at market prices of $300, and it experiences unforeseen production declines, it will be unable to deliver gold into the contract at specified volumes and will be forced to buy in gold at far higher market prices to meet its obligation. Looked at this way, the gold hedge risk-management strategy turns into an onerous debt obligation, previously inscrutable to investment analysis.

One can see even in its simplest form how the use of derivatives can be dangerous. Imagine now how convoluted multiple contracts can become when other permutations of the derivative strategy are employed.

These might become options on forward contracts struck at multiple price points with requirements to modify the delivery amounts.

They might be swaps between layers of buyers and sellers of financial commitments obliging purchase of underlying commodities at interlocking price and volume points. Such might be a description of the position that major counterparty financial institutions have taken in these contracts.

In a visit to my office in June of last year, the chairman of a major gold producer was asked his perspective on the risks that rising gold prices might have to the financial system. "Just how large do you think the train wreck will be when the rest of this industry decides to close out its hedge book" was the question posed. He answered that he thought it could even bring down a major Wall Street investment bank.

Indeed, as we learned from the terrifying crumble of John Meriwether's ill-fated Long Term Capital hedge fund, the American banking system can be compromised by the unraveling of derivatives of a single hedge fund. It's not hard to imagine how the fall of an industrial labyrinth on the scale of Minos' that is the gold industry might take out at least one major American bank.

At its peak, those who operate offices at the top considered Enron to be far more of a hedge fund than the operating gas-and-energy distribution company that most investors thought it was.

So mighty were the visions of these masters of the universe from Houston, one is reminded of a popular joke in the hedge fund community: "What's the difference between a hedge fund manager and God? Answer: God doesn't think he's a hedge fund manager.

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