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Volatility Trade Buffett Embraced Backfires for Wall Street Hedge Experts

By Jeff Kearns and Andrew Frye - Jul 29, 2010

A bullish stock market trade embraced by the smartest money is backfiring. And that has investors wondering if what Warren Buffett and Goldman Sachs Group Inc. know about derivatives is obsolete.

Goldman Sachs, the world's most profitable securities firm, reported losses from derivatives last quarter after selling insurance that protected clients against stock swings during the Standard & Poor's 500 Index's biggest retreat in more than a year. Buffett, the chairman of Omaha, Nebraska-based Berkshire Hathaway Inc., underwrote $37 billion of the contracts since 2004, filings with the Securities and Exchange Commission show.

The combination of hedging by insurance companies, tighter regulation of bank speculation and reluctance among securities firms to write derivatives known as variance swaps means speculators who sold them are now facing losses, according to Morgan Stanley and Societe Generale SA. Money-losing trades in both rising and falling markets show the hazards of the business for even Wall Street's most sophisticated investors.

"It's as extreme as I've ever seen," said Neil Davies, head of structured equity products at SunTrust Robinson Humphrey Capital Markets in Atlanta. "There's a lot of uncertainty in the over-the-counter volatility market, illustrated by the fact that long-dated volatility levels are reminiscent of October 2008. Rumors abound, specifically that some institutions are closing out short positions."

Playing Volatility

Goldman Sachs said its bets that stock swings would narrow lost money in the second quarter, according to its earnings statement. While the firm didn't break out the loss, Goldman Sachs said revenue in the division arranging the trades slumped 62 percent from a year earlier to $1.21 billion. Ed Canaday, a spokesman for the New York-based company, declined to comment.

"Primarily in response to our client needs, our equity derivatives business was short volatility entering

the second quarter and posted poor results," Chief Financial Officer David Viniar said on a conference call with reporters on July 20. "We took the other side because you know we deal with our clients all the time," he said. "We had that position going into the quarter and volatility just spiked."

The Chicago Board Options Exchange Volatility Index, which ended the first quarter at 17.59, rose as high as 45.79 on May 20 as the S&P 500 lost 8.4 percent. The VIX, a measure of investor expectations for stock swings known as implied volatility, has since decreased to 24.25, or 19 percent above the average over its two-decade history, while the equity index has rebounded 3.2 percent, data compiled by Bloomberg show.

'Consenting Adults'

"Either they took the position on purpose or they took it because they couldn't get anyone else to take it," said Jason Brady, a managing director at Thornburg Investment Management in Santa Fe, New Mexico, which oversees about $57 billion. "There are two consenting adults to every trade on the over-the-counter market or on an exchange. They consented at some level, and maybe their hedges were bad. Maybe they sincerely believed in the trade and they got hung out to dry."

While demand for insurance against declines in the next 30 days retreated as shares rallied this month, prices for longer- dated protection surged to a record. Ten-year variance swaps, contracts that pay buyers when stock swings increase, are trading at levels that imply S&P 500 volatility is poised to exceed its rate during the 2008 credit crisis, Paris-based Societe Generale's data show.

Sellers' Strike

Swaps are agreements between parties to exchange one right for another, while variance swaps let investors speculate on the magnitude of movements by an index. They are a type of derivative, or contract whose value is derived from stocks, bonds, loans, currencies and commodities, or linked to specific events such as changes in interest rates or price fluctuations.

Over-the-counter variance swaps have appreciated so rapidly that firms that sold swaps in January at a volatility level of 28.5 and $1 million per point faced paper losses of as much as about $8.2 million this month when swap rates rose to a record 38.5 points, according to data compiled by Bloomberg and Societe Generale. Their expected gain based on past volatility levels would have been about $5 million, according to Societe Generale.

Life insurers, which sell retirement products with guaranteed minimum returns even in declining markets, rely on derivatives to hedge against stock slumps. Variable annuity sales rose 5 percent in the

first three months of the year to $32.4 billion, the first quarterly increase in two years, according to Limra International, a trade group.

'Liquidity Shortage'

"Wall Street historically has been able to meet demands for longer-dated volatility products," said Pav Sethi, chief investment officer of Chicago-based hedge fund Gladius Investment Group, which uses variance swaps. "Regulations, tighter risk limits at the banks and a limited number of interested participants have created a large liquidity shortage."

The financial regulation bill signed into law July 21 by U.S. President Barack Obama strengthens oversight of derivatives and forces banks to take less risk with their own capital. How that will affect banks and insurers isn't clear yet, causing some institutions to scale back their use of derivatives, Morgan Stanley analysts said in the July 15 note.

"Originally it was large institutions hedging their long- dated exposures," said Anand Omprakash, an equity derivatives strategist at BNP Paribas SA in New York. "After that started pushing implied volatility levels up, there were other parties who started to cover their short positions. This drove the price up significantly."

Margin Call

Berkshire lobbied Congress against a higher collateral requirement for previously written derivatives trades under the financial reform law, David Sokol, the head of the company's energy business, said in April. Buffett, who uses derivatives to speculate on the direction of stock markets, has about $37 billion at risk in equity-linked contracts, whose pricing may be influenced by the variance swaps market. Buffett didn't reply to a request for comment e-mailed to an assistant.

"He handcuffed himself during the crisis by selling puts at the top of the market," said Jeff Matthews, author of "Pilgrimage to Warren Buffett's Omaha," a Berkshire investor and founder of hedge fund Ram Partners LP. "His whole company is a bet on a rising market over a very long period of time. So to then sell derivatives on the basis of that is doubling the chips on black. And that limits his flexibility when he gets the chance to really deploy massive amounts of capital during the crisis."

Equity Premium

Berkshire got premiums of $4.9 billion on the equity index puts and is free to invest that cash over the lifetime of the contracts, Buffett said in his letter to shareholders last year. At the time he estimated

Berkshire would owe about $9 billion if the four indexes it covers fell 25 percent from their levels when the contracts were written. Buffett has said Berkshire sold the swaps from 2004 to the first quarter of 2008. Buffett's contracts mature between June 2018 and January 2028.

"We are delighted that we hold the derivatives contracts that we do," Buffett said in his letter to shareholders in February. "If Berkshire ever gets in trouble, it will be my fault. It will not be because of misjudgments made by a Risk Committee or Chief Risk Officer."

Berkshire posted $550 million in collateral on the equity index derivatives and its credit default swaps at the end of 2008. As markets recovered in 2009, the requirement plummeted to $35 million at Dec. 31. In the second quarter of 2009, Buffett renegotiated six of the equity index puts to shorten the durations and lower the strike prices.

More Cash

Buffett drew down Berkshire's $44 billion in cash during the 2008 credit crisis to finance companies whose traditional sources of funding pulled back. Deals to inject $5 billion into Goldman Sachs and $3 billion into General Electric Co. pay 10 percent coupons and boosted Berkshire's investment income. The premiums gave Buffett more cash to invest, said Thomas Russo, a partner at Gardner Russo & Gardner in Lancaster, Pennsylvania.

"What really did matter was that he had ready cash to invest, $5 billion of it, during one of the great buying opportunities of all time," Russo, a Berkshire shareholder, said. "He's been historically unrivaled by his willingness to take on short-term pain for long-term risks."

The stock market's retreat from its 2007 peak has led to billions of dollars of charges against Berkshire's earnings. As of March 31, the Omaha, Nebraska-based company listed a liability of $7.13 billion related to the contracts on its balance sheet, up about 55 percent from the end of 2007.

Investment Income

Buffett says Berkshire has no counterparty risk because it collects premiums at the inception of each contract, and that the collateral requirements are minimal. The 79-year-old investor says he expects the contracts to be profitable, even if Berkshire has to pay out, because of investment income he expects to generate over the decade or two he holds the premium.

"The shadow of Warren Buffett really impacts the psychology of both positive and negative market bets," said Michael Yoshikami, who oversees about $1 billion as chief investment strategist at YCMNet

Advisors in Walnut Creek, California. “Him exiting these trades will impact variance, because his movement alone will increase the anxiety levels in these markets.”

Berkshire Equity Index Options Positions, in Billions:

2010	Assets	Liabilities	Maximum loss
1Q	--	$7.131	$36.760
2009			
4Q	--	$7.309	$37.990
3Q	--	$8.012	$38.592
2Q	--	$8.233	$37.480
1Q	--	$10.188	$35.489
2008			
4Q	--	$10.022	$37.134
3Q	--	$6.725	$37.042
2Q	--	$5.845	$39.878
1Q	--	$6.171	$40.088
2007			
4Q	--	$4.610	$35.043
2006			
4Q	$0.016	$2.463	$21.396
2005			
4Q	$0.035	$1.592	$14.488
2004			
4Q	$0.069	$0.380	$4.626

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