Institutional Investor

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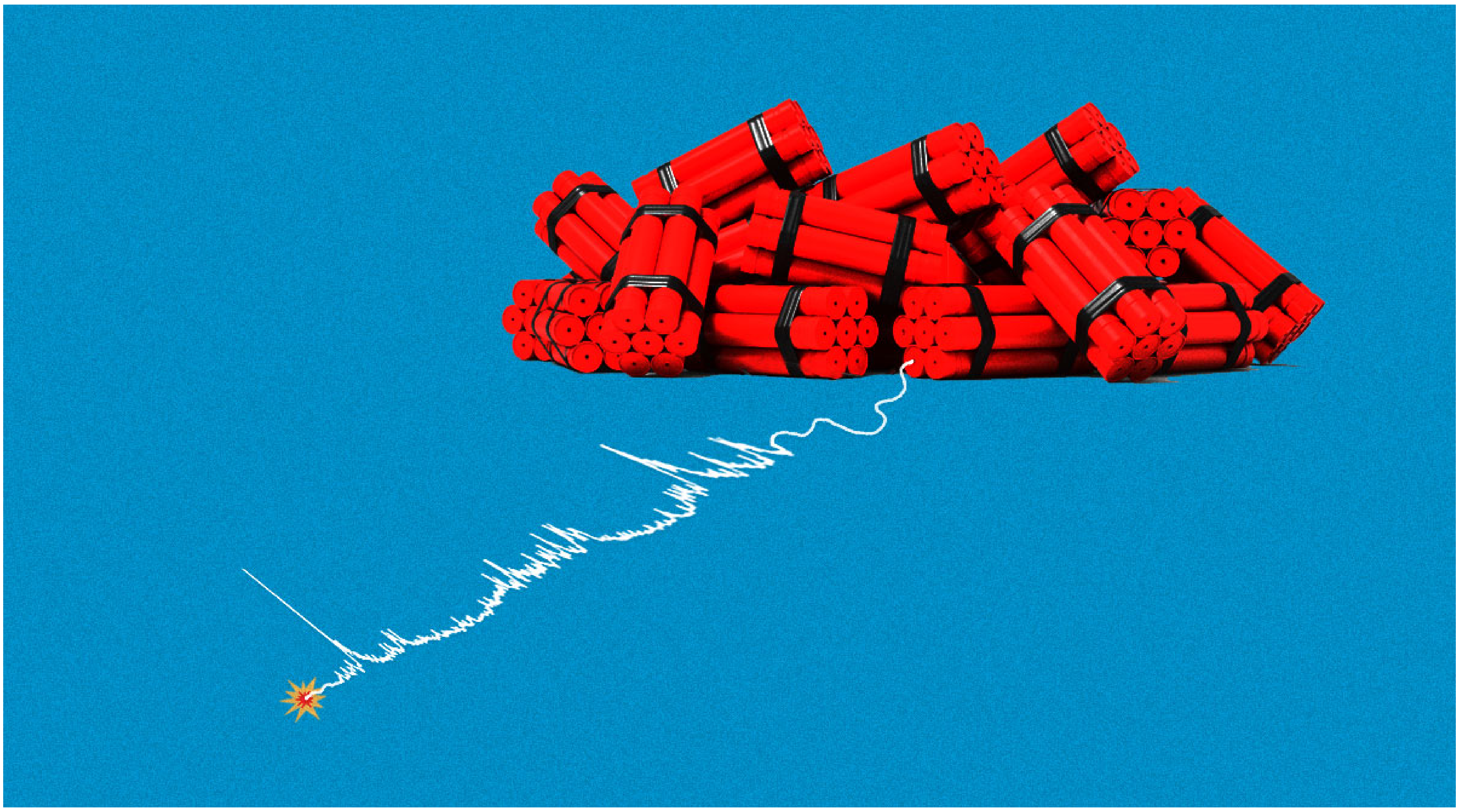
How to Lose a Billion Dollars Without Really Trying



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Volatility trades — which have caused major losses at hedge and pension funds alike — are the toxic subprime mortgages of the Covid Crash.

By Leanna Orr June 24, 2020

Malachite Capital Management embarrassed its hedge-fund rivals for years before facing its own fatal humiliation.

In the gossipy and arcane world of volatility trading, just about everyone knows, and has an opinion on, everyone else. And in 2014, Malachite founders Jacob Weinig and Joe Aiken started making the others look bad.

Weinig and Aiken — a confident pair of former Goldman Sachs guys, which may be redundant — said yes to exotic trades with Wall Street banks, while their competitors studied the what-ifs and frequently balked at what they found. Malachite led the pack in insuring banks against infinite losses during an extreme stock-market crash, all in exchange for tidy premiums. The firm also borrowed money from banks — sometimes the same ones — to make far more of these trades. As a result, those tidy premiums became competition-topping returns and marketing gold.

The hedge fund raked in hundreds of millions of dollars from charities, colleges, pension funds, and other investors during its six years of life. With $600 million in chips and the magic of leverage, Weinig and Aiken had bets worth upward of $1.5 billion in other people's money on the table early this year. But the only thing certain about a safe bet is that, as grizzled gamblers and traders know, eventually someone gets burned.

So when Malachite blew up in March, it left a hole in the ground twice as large as the fund itself.

The Covid-19 Crash immolated entire firms, investment teams, and product divisions representing billions in capital. But they're nearly all of a kind. "A number of vol-related strategies haven't fared so well, and haven't survived — meaning total liquidation," says Doug Kramer, quant co-chief at Neuberger Berman.

Fatalities include Malachite, Ronin Capital ("the plumbing just kinda fell apart," per one vol pro), Parplus Partners, and Allianz's ill-named Structured Alpha hedge funds. ("Now that's a *whole* rabbit hole. They drifted from their mandate — not a good example of a disciplined vanilla put-selling program.")

The severely wounded include Alberta's public fund AIMCo, which killed its aggressive vol unit after losing C$525 ($387) per woman, man, and child in the province. Another is $100 million hedge fund Plinth Capital, founded in the Malachite model by "a reasonably nice sales guy from Barclays" with backing from a Texas institution. Plinth "only lost" about 40 percent "because they didn't have a portfolio full of scary stuff yet," an associate says. Graham Capital's Jeremy Wien hit his firm's 10 percent maximum drawdown limit and had to try to get out of positions, several sources report. That may not have been easy, depending on the portfolio. "With what happened in March, counterparties and markets were not functioning," says one pension fund investor. "You can have to sell, but if there's no bid on the other side, there's no buyer." Vol shop JD Capital "got walloped," per sources and press reports. The Canada Pension Plan Investment Board lost a mere C$700 million on its strategy.

Unlike the Covid Crash, the 2008 financial crisis was "a slow-motion train wreck," starting with credit and collateralized debt obligations, or CDOs, and enlarging over time. March was different, explained hedge-fund manager Benn Eifert in a June letter to his QVR Advisors clients. "On virtually any metric you choose, the subsequent selloff was the fastest and most violent in history," aside from 1987's Black Monday. This year, just over a month after hitting its all-time high on February 19, the S&P 500 lost 34 percent — then hit reverse.

Just about every asset class and investor niche that collapsed into stock markets' deep V has clamored up on the other side, more or less. American Airlines is worth less than its inventory of Biscoff cookies, sure, but it's alive. The crash hasn't claimed a single hotel REIT either, despite the category's abundant debt and naked exposure to travel, which is on track for the worst year since CBRE started tracking occupancy rates in the 1930s.

If over-levered baskets of pandemic-stricken businesses have made it out alive so far, what has happened with volatility investing? Why have the traders, asset managers, and institutional teams with every hedge at their disposal — and almost them alone — failed?

"These trades were WMDs," says one prominent vol manager. "You knew they were going to go bad. But it's always much easier to predict the future than to know exactly when" it will come to pass. As long as everyone mostly rebuffed bankers' lowball offers for taking on extreme risks, the likes of Goldman Sachs and Morgan Stanley had to sweeten terms to make a market. And when Malachite said yes, it kicked off something like a price war, according to the trader. Or perhaps a pissing contest.

"It really was a dilemma as a fund manager: What do you do? All of these guys were outside the room doing their calculations, and then all of a sudden one or two funds just rush in," he says. "They're in there running up points, outperforming everybody, and they're going to raise the assets from investors. People had to decide whether to go in after them or not. If you do, you'll eventually get blown up and lose everything and then some. But if you hang back, you're not fully in the game, and for an indefinitely long period of time."

Plus, Aiken and Weinig looked like they were getting rich.

The pair had a knack for inspiring envy. As two "VP-level sales guys" on Goldman's derivatives desk, peers say, they got a "pretty incredible" $25 million seed investment from a former client of theirs, Global Endowment Management, and started Malachite in 2013. They'd tripled the firm's assets in a little more than three years and returned a stunning 22.3 percent in 2016, *Futures Magazine* reported in a glowing 2017 profile called "Malachite Capital: Next Stop, $1 Billion AUM."

"We are relatively young managers. We didn't have experience at hedge funds," Weinig told that publication. (Malachite's founders did not respond to *Institutional Investor*'s request for comment.) "We weren't trained to look at the world from a trade-first perspective. We were trained to look at the world from a product-first perspective." What did big banks want? To get risk off their books. Institutions' investment staffs wanted the 7, 8, or 9 percent returns their bosses expected and pension payments or scholarships relied on. Malachite delivered on both, and numerous competitors jumped in to follow.

Malachite's success was all the more striking (and tempting to mimic) given the backdrop. Investors soured on hedge funds through the record-long bull run for U.S. stocks, HFR data show. Blue-ribbon institutions such as the MacArthur Foundation invested money. Emory University's $7 billion endowment was checking references ahead of presenting Malachite to its oversight committee as of mid-2018, former employees say. Emory stopped reporting even basic return figures several years ago, and would not confirm if the investment went ahead. But chances are good that it did. At the time, an estimated nine of ten investments pitched to the committee ended up in the portfolio, according to one former staffer. Emory likely sank at least $70 million into Malachite, he estimates.

Aiken and Weinig's most powerful backer, with the possible exception of seed investor Global Endowment, was a Cincinnati consulting firm: Fund Evaluation Group, which advises or directly runs portfolios for many charities, universities, and other institutions, gave Malachite its stamp of approval and a sizable chunk of client money.

FEG's consultants recommended the esoteric vol fund as a "diversifying strategy" to institutions — including Utah's public education trust — as recently as October 2019, a confidential FEG report shows.

The trust doesn't appear to have put money with Malachite, unlike other FEG clients. The University of Toledo Foundation had $3.6 million invested as of late last year, and the University of Illinois System dropped an AQR Capital Management fund to invest $20 million in Malachite, its latest annual report states. (Illinois no longer has any money with Malachite, a spokesperson said in March.)

Malachite represented 5.6 percent of a pool of hedge-fund investments that FEG built for clients — called a fund of funds — as of year-end 2019, regulatory filings show. The FEG Absolute Access Fund is one of several such vehicles that the firm channels money into from institutions whose portfolios the firm controls. "The funds were designed to provide investors the opportunity to gain exposure with a smaller minimum investment than would be required to invest directly with institutional-quality hedge-fund managers," a 2016 FEG disclosure explained. "The funds capitalize on the experience of the FEG's principals with evaluating and recommending to clients nontraditional investment funds (i.e., hedge funds) by creating a fund-of-funds product."

In other words, small charities and college funds paid FEG for its advice and manager network. The result was that Malachite, the Kool-Aid Man of selling short tails, took their money.

Aiken and Weinig each owned half of the firm, which kicked off an estimated $12 million in fees for 2017, based on reported returns, assets, and a client's fee schedule (1 percent for management and 15 percent of performance, notably without a hurdle rate to clear.) If Malachite gained its median 10 percent in 2019, the four-investor staff made about $15 million in their prelapsarian year.

"Allocators would talk about different strategies or funds that had put up really big numbers over the last five or six or seven years," says Eifert, whose Silicon Valley hedge fund QVR specializes in quantitative vol. QVR made a killing in the first quarter. "You had to be careful in explaining what you were doing and what you weren't doing and why you were never going to make as much money as those guys in that kind of market environment."

QVR's flagship vol products (called "absolute return") gained 59 percent as Malachite and others imploded during the first three months of 2020. Was it edifying?

"Yeah. Very much so," Eifert says.

He's among this crisis's *Big Short*-type investors — those who both called a collapse and turned it into a windfall. But even hedge-fund managers admit little pleasure whispering "I told you so" as the economy disintegrates and livelihoods vanish.

Hyper-complex and opaque financial products kindled the last great financial crisis as well — take CDOs, for example. Designed to fill bankers' bonuses more than to efficiently package value, they blew up spectacularly and, some would say, predictably. Just like a certain strain of volatility trades this time around.

"What happened with Malachite and the others was no accident," says the prominent trader. "People on the buy side knew it. People on the sell side knew it. The allocators should have known it."

In what feels like Alberta's northern reaches — but is really less than halfway up — the capital city of Edmonton lumbers low and wide under a vast sky. Night falls for the last time in mid-May and doesn't return until the end of July." At Halloween, kids' costumes go over snowsuits: Fat Ninja, Chubby Princess, Actually Frozen Elsa. It's the industrial capital of the Canadian oil business and seat of the furthest-right government in Canada, and perhaps all of Canadian history — Premier Jason Kenney's administration with the United Conservative Party.

The province's investment arm, AIMCo, manages C$119 billion of public money with the explicit mandate of performing like a private corporation. "Good enough for government work" is not good enough for Canadian pension funds. The country boasts some of the world's most sophisticated and best-performing public investment funds, which essentially operate like Wall Street firms but siphon profits to former bus drivers and retired nurses.

AIMCo is not among that top tier, experts and data suggest.

For example, the Ontario Teachers' Pension Plan delivered 9.8 percent annualized over the last decade, whereas AIMCo gained 8.2 percent — a gap of more than 1.5 percentage points per year, which may not seem like much, but most definitely is when speaking in billions.

Even within its own province, AIMCo has trailed the smaller Alberta Teachers' Retirement Fund. AIMCo is slated to vacuum up ATRF's C$18 billion or so in assets, despite teachers' and fund leaders' protracted opposition. Had this already happened, AIMCo's wayward volatility trades would have cost educators' pensions C$300 million, the teachers' fund calculated. That's on top of an extra C$1.3 billion the fund has now because it didn't let AIMCo manage its money, according to the estimate.

"It's the Tiffany Trump of Canadian pension funds," says one local industry player. "In everything I've ever done in pensions, AIMCo has never been there. They are just nowhere to be found in the pension community. CPPIB, Caisse de Depot, PSP, BCIMC" — public funds for Canada, Quebec, the military and Royal Canadian Mounted Police, and British Columbia, respectively — "are kind of incestuous in that they all trade staff. Nobody joins AIMCo from CPPIB."

The architect of AIMCo's wayward vol program has only ever invested at the Edmonton fund, according to an archived version of his LinkedIn profile. (He wiped it after being tied to the losses.) David Triska rose from junior analyst to portfolio manager in nine years, picking up derivatives along the way. He claims to be the vol strategies' developer, head trader, portfolio manager, and committee chair, with "full oversight of all equity-related trading needs," including staffing, internal and external compliance, governance, and risk.

Putting the same person in charge of delivering high returns and controlling risk defies standard practices and basic logic. At CPPIB, for example, “the investment risk group has teams that sit on the trading desk and really are experts. They would absolutely be involved in an ongoing way” with the volatility program, says someone close to CPPIB. “This is not where an investment team goes off and just does something. On the contrary, everybody has to sign off. When risk is getting too close to where we set limits, the risk managers come” to CPPIB’s top brass.

Whether Triska in fact wielded unchecked authority over AIMCo’s quantitative equity book isn’t clear, and many resumes contain puffery. But the organization’s decision to kill Triska’s creation mid-crisis suggests, experts say, that leaders — including CEO Kevin Uebelein — either didn’t understand what they’d gotten into or lost their nerve at the worst possible moment.

CPPIB and many of its peers take abundant risk and run vol programs, which for many — if not most — shed blood this year. “But unlike AIMCo, you’re not closing down the program and locking in massive losses,” says the pension pro. “It’s really too bad. Kevin Uebelein should know better.”

Many vol investors believed that they were effectively getting free money. In one common trade — of so-called capped-uncapped variance swaps — Wall Street banks paid hedge funds and Canadian pension funds to cover unlimited losses in the event of an extreme stock-market crash.

Banks were paying to get risk off their books to pass stress tests regulators imposed after the last financial crisis. But, the thinking went, the insurance would never actually pay out, because such a dramatic crash had never happened.

But in trader-speak, these kinds of deals are called “selling the small puts,” and are often described as picking up pennies in front of a bulldozer. Malachite’s founders tried to challenge that mentality. According to someone familiar with their thinking, even post-demise, the pair saw their strategy as “much more like picking up $100 bills in front of a Tyco truck.”

Whatever the vehicle, it’s the getting-crushed part that matters, experts point out. Alberta’s public investment fund lost $2.1 billion trading vol through March, and swiftly killed its program. AIMCo has a reputation among Canadian pension peers for standoffishness. Among some Wall Street traders, its known for eating up their crash risk.

“Imagine betting 4 billion fake dollars on black and red and it lands on green,” the youthful day traders on Reddit’s Wall Street Bets forum remarked, referring to an initial $4 billion loss estimate in “fake” Canadian dollars. “Someone YOLO’d a pension fund.”

French derivatives connoisseur and theoretical physicist Gontran de Quillacq quite agrees.

“The capped-uncapped strategy is amateurish,” he says. “Selling the small puts is a beginner’s mistake

"The capped-uncapped strategy is amateurish," he says. "Selling the small puts is a beginner's mistake. Anybody with experience in options and volatility trading knows that those 'century-rare' events happen every few years — much more frequently than the simple math would tell you. It's a guarantee," says de Quillacq, a vol market veteran who consults for institutions and attorneys when funds blow up. "How often should you play Russian roulette? How about with three bullets?"

Amateurish strategies often mean its amateur hour, suggests de Quillacq, who has led or traded on equity derivatives desks at Nomura, Société Générale, hedge fund Tykhe Capital, and Lehman Brothers. Volatility plays go in and out of fashion, and the total number of dedicated vol experts isn't all that large worldwide. (Although France seems to have more than its share.) Outside of banks and quant-y hedge funds, only the largest institutions and asset managers will have specialists on staff — so they tend to call up math-minded generalists as needed.

A self-trained vol trader is a poorly trained vol trader, de Quillacq warns. "On a derivatives trading floor, you are monitored and mistakes are corrected. You learn a lot from the people around you and from your and others' mistakes. Portfolio managers who have learned volatility trading on their own represent a risk; they have often not absorbed the collective wisdom and self-restraint."

The most technical and cryptic niche of finance might be vol. Tourists get blown up, but so do doctors of mathematics. Adding to the area's innate weirdness, volatility and risk aren't concrete *things*, or even proxies of assets. A piece of a company or spread of land has some inherent worth, which should grow over time since economies generally do too. Not so for volatility. Like currency trading, these are zero-sum bets on *movement*, not assets. Who chooses to specialize in something so hard to grasp, sell, and make money on?

The same people who'd become theoretical physicists instead of plastic surgeons. Others get swept in at amateur hour when vol is trendy, learning just enough to be dangerous.

If Malachite Capital embarrassed the vol market by YOLOing risk management, this spring's salvo of blowups rightly spread around the humiliation. Sedate institutions and a leading consulting firm that should have known better were exposed feasting at the short-tail trough. When FEG's leaders learned their Malachite recommendations and investments would be exposed, they dodged phone calls and messages to avoid questions, and then scrubbed online evidence of the relationship. AIMCo inflamed a *whole citizenry* through capped-uncapped variance swaps, which is a feat. The Canada Pension Plan, in contrast, embraces its hard-charging reputation and split out volatility trading in its annual report for the first time. Losses of $700 million on intangible derivatives trades don't usually get the showcase treatment, but CPPIB knows better.

If certain vol trades are the CDOs of the Covid Crash, then the likes of AIMCo and FEG are mullets: Business in the front, hot mess in the back.

"With the capital in these funds, it's not a video game," a longtime trader stresses. "These are pensions and endowments that pay teachers' retirements and college scholarships. On that level, yes, I am upset. As a trader, I thought some of these were a cancer on the space. The capital chases returns. If the trend kept going for another five years, it would just keep getting bigger. So you're happy that the shoe finally dropped on a much, much smaller scale than the mortgage crisis."

Calling the bad ending "is a Pyrrhic victory: You're right, but you're not rich," he gripes. "Eventually, we're going to try to raise money and people will say, 'Well, how do I know you guys aren't like the funds that blew up in 2020? Before, so often it was, 'Why can't you do what those guys do?'"

For the intimate community of volatility players, he says, everybody lost in March — including the investors who won on paper, such as Eifert from QVR, and those who did not. "I think there is a long emotional overhang when you lose 50 to 100 percent," the trader says. "But who won?"

The notion briefly stumps him.

"Ultimately, the people who maybe won were these moms and dads, retail investors in Europe with structured products. You had this epic run making money and then missed the downside."

[redacted]

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Mark Wiseman (Kevin Van Paassen/Bloomberg)

Alberta's controversial public investment fund (AIMCo) has secured Mark Wiseman — a Canadian pension guru fresh off his own controversy — to lead its board of directors starting next month, the organization said.

Wiseman built a sterling reputation and an enduring legacy at the Canada Pension Plan Investment Board, which he built into a global powerhouse as chief executive officer. But his next position — BlackRock's global head of active equities and potential heir to Larry Fink — ended badly.

Fink ousted Wiseman last December for failing to disclose a romantic relationship with a colleague. Wiseman also quickly stepped down from the board of FCLTGlobal, the nonprofit group he helped found to promote long-term thinking in investing and business.

The Alberta appointment marks a return to the public eye and institutional investing's power elite.

"He's such a well-known figure in Canada and in investment circles that his circumstances are pretty unique," Paige Scott, a recruiter with Kingsley Gate Partners who specializes in placing C-suite asset managers, told *Institutional Investor* Wednesday. Scott is not personally close with Wiseman. "CPPIB has been the most progressive, most modern, and perhaps successful pension allocator — they are emulated everywhere."

Alberta Investment Management Corp., or AIMCo, manages C$119 billion ($87 billion) in public pension assets, working capital, and oil wealth for the province, official figures show. But wayward trading of arcane volatility products cost the fund billions earlier this year, and ignited public outrage. The organization said it's investigating, while pointing out that "oversight of AIMCo's investment strategies and risk management is the responsibility of the board of directors."

[*II* Deep Dive: How to Lose a Billion Dollars Without Really Trying]

Wiseman will be chair of that board in one week. He takes over the governing body July 1, when current chair Richard Bird finishes his second three-year term.

Landing a prominent board position at a public entity within months of his ouster speaks to an "utterly unique" expertise and background. But marketability as a board member doesn't directly translate to the rest of the asset management job market, Scott cautioned.

"There's a huge difference between being an adviser and actually running the business. When you're an adviser, you're not involved in actual day-to-day operations. You're there to leverage your Rolodex, contacts, and wisdom to guide management through crises," she said. Many professionals in Wiseman's position end up advising or founding their own investment outfits rather than returning as big-firm executives.

"It's just very difficult in this day and age, when the bar and standard is really high around leadership," Scott said. "It doesn't matter what the indiscretion is — whether you're the President of the United States or someone running a very big business — the question raised is judgement. Or lack thereof."

That doesn't make redemption impossible, she noted. "Can people learn from their mistakes? I like to think so."

Board work can be an excellent place to start.

In this case, the Alberta government is "trying to spin off AIMCo into its own platform separate and apart from the Canadian pension system. I can totally see why they would turn to Wiseman. There's an almost non-exist talent pool of people who know how to do that."

Wiseman is a tremendous asset to the troubled fund, according to those who know him. That's the case whether or not the far-right provincial government succeeds in pulling Alberta out of CPPIB — which, thanks in part to Wiseman, has handily outperformed AIMCo.

"He's an optimist; he's a winner; he's a team player, and he loves the work. I think it's fabulous," said Eric Wetlaufer, who led CPPIB's vast public markets portfolio under Wiseman for years, in an interview. "His resume speaks for itself. What's not on paper — and what's really critical for this kind of a role — is that he understands and appreciates intersection between talent and strategy. Our business is a talent business and Mark gets that.

In Wetlaufer's experience, "a lot of large plans do their strategic work and then try to find the talent that can execute. They develop an everywhere, everything, all-the-time approach that, at the end of the day, looks like paint-by-numbers. Good structures are important and can help keep you out of trouble, but they don't give outperformance. That's where Mark can really help. He knows to focus on the real areas where they can perform and take risk."

Wiseman's motivation for joining AIMCo's board may be public service, or to put space between the BlackRock incident and now, or just for something to do, or all of the above.

But it's not for the money.

"Mr. Wiseman will be donating his compensation as chair of the board to the United Way to assist communities across Alberta," AIMCo said in its announcement.

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