News
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DAVID WEIDNER'S WRITING ON THE WALL: Luddites Of Wall Street Have Their Day

By David Weidner

NEW YORK (Dow Jones) -- Brains, the flesh and blood kind, are back on Wall Street.

Gray matter is the new silicone.

In the wake of the credit crisis, there is a new premium placed on the kind of active management that's not a bunch of souped-up computers running algorithms and firing off trading orders.

The high-profile collapses of funds that we've come to know as "quants" or quantitative funds has challenged what had been an arrogant confidence in the power of computers, models, formulas the efficiency of electrified trading.

That the $9 billion Global Alpha fund could suffer a nearly 30% decline was unthinkable. That the fund's steward, Goldman Sachs Group Inc. (GS) , needed angel investors to shore up its battered hedge funds and restore confidence was sacrilege in the church of Wall Street.

"I've always said fundamental analysts are never going to go away," said Sandy Gross, managing principal with the executive recruiter Pinetum Partners which works in the hedge fund industry. No matter how good your technology is "you can never predict what will happen based on what happened 20 years ago."

There is something to be said for good judgment, Gross said. "And people (in the hedge fund industry who have survived) are rethinking a lot of that." Gross might know something about overconfidence. Her previous job was at Amaranth Advisors.

The 'red herring'

In the last half-decade, a kind of hubris about technology has taken hold on Wall Street. The market has been on a sensational run. Simultaneously, the relics of the 20th century - floor traders and specialists at the New York Stock Exchange, public companies and public markets - have been shunned in favor of unfailing circuitry and switches.

And much of this - like choosing an email over a handwritten letter delivered by post - is only natural. Any carpenter will tell you that no job is difficult if you have the right tool, but we also thought, for a time, that the Titanic was unsinkable and nuclear power would save us.

And any professor at MIT will tell you that the most advanced computer is still no more powerful than a dim flashlight when it compares with the human mind.

One of those professors, indeed, S.P. Kathari, the deputy dean at the MIT Sloan School of Management, said that it was less technology's failure to stem the credit crunch and fund disasters than our overconfidence that computers would adjust to a wild swing in the markets.

"Technology is the red herring here," he said. It's the managers "who are overconfident in some ways. They're making much bigger bets and they're leveraging. The old fashioned approach is not leverage ... so they bet big and now they're losing their shirt."

Kathari thought quantitative funds were being blamed for the subprime mess - a crisis he blamed on buyers who weren't evaluating risk. But when I asked him if buyers weren't using computers to evaluate the risk, Kathari agreed that computers - and our faith in them - again were at least partly to blame.

Computers, he said, were unable to vet loan applications and lending institutions' lax standards. Risk management software could not tell that, in Kathari's words, "even the homeless could buy a home."

They always 'reverted back'

How then to explain Goldman's Global Equities Opportunities Fund. Though it's no secret that other Goldman hedge funds have been battered as badly or worse, GEO was levered 6-times assets, when it should have been levered about 3.5-times assets.

Faith in formulas and an ability to adjust tripped up the most respected name on the Street.

David Viniar, Goldman's chief financial officer said, "some of these relative moves in the equity long-short position are just unsustainable long-term. When you look at 22% and 25% and 29% standard deviation moves, we have seen them twice in our history before, and they've always mean reverted back."

Except when it didn't.

Goldman, like most of the hedge funds blindsided by the sudden freeze and lack of liquidity in the credit markets, is hunkering down with its $3 billion in fresh cash to recover what it can.

Smaller funds that may not have had the same losses may be in worse shape. They are fighting redemption requests and trying to right the ship.

Gross, who makes a living based on the strength of the job market for these funds, is still working, but she admits that many funds are in the bunker and most workers are worried they may not have a job at yearend. What she does know is that faith in quantitative side of the business has been shaken. For now, the human touch is in demand.

Confidence in technology got us into this mess. Our heads and hands will have to dig us out.