Paul Samuelson’s Secret

The last two volumes of Paul Samuelson’s collected papers appeared this month, edited by Janice Murray, his assistant for twenty years. As far as I can tell, the only mention of Commodities Corp. to be found anywhere in the seven volumes appears in the final one, in the last serious piece he ever wrote, which appeared originally in Volume 1 of *Annual Review of Financial Economics*, two years ago, at a time when PAS knew full well he was slipping out the door. (He died in December 2009.)

“I skip here my long years as activist charter investor and Board of Directors member for Commodities Corporation of Princeton,” he writes in “An Enjoyable Life Puzzling over Modern Finance Theory.” “Space does not allow me to go into that intricate story.”

Somewhere, in the letters, perhaps, or in interviews with various colleagues that were taped and tucked away, further details of a great case study may be waiting for a scholar. Then again, maybe not. Samuelson left his share of loose ends. Reflections on his role in Commodities Corp. may be among them.

A good thing, therefore, that in the meantime we have “Paul Samuelson’s Secret,” chapter three in *More Money Than God: Hedge Funds and the Making of a New Elite*, Sebastian Mallaby’s very interesting book about the origins and recent history of the hedge fund industry.

It turns out that the great MIT economist was influential in the creation of one of the earliest and most influential hedge funds. Launched in 1970, Commodities Corp. blazed a trail of extremely high returns throughout the 1970s and early ’80s, before disappearing in various pieces into Bermuda mailboxes and Goldman Sachs. Many of its star traders – Bruce Kovner of Caxton and Paul Tudor Jones, chief among them—formed successful hedge funds of their own. Samuelson thus had a ringside seat at the birth of an influential industry that is still only poorly understood.

About the same time, he invested a substantial amount in shares of Warren Buffet’s Berkshire Hathaway Inc. It was in 1970, too, that he won the Nobel prize in economics, the second to be awarded. Long famous for the fortune that his pioneering textbook earned him after 1948, it turns out that Samuelson may have made more money as an investor than as an author. He was both smarter and richer than is generally understood: as an investor, a bigger winner, perhaps, than the more volatile John Maynard Keynes.
In 1965, Samuelson published a version of the efficient-markets hypothesis — a world in which all reliably predictable events are priced right, and only surprises would remain; there would be no easy pickings on Wall Street. About the same time, Eugene Fama published his own formulation, and the idea that stock prices were properly described as a “random walk” – that it was all but impossible to outperform the market – was on its way to becoming firmly established.

Not that Samuelson himself took the finding literally. He later explained, “Experience makes me think that a few folk do have an intuitive flair for making money by sensing patterns of momentum.” Others, he said, are good at “figuring out which fundamentals are fundamental and which new data are worth paying high costs to get.”

But the services of such wizards, when they could be found, would not come cheap, he warned. And even the hottest hand would sometime turns cold. Someone proposed an experiment to Samuelson – Mallaby doesn’t say who – and the idea of Commodities Corp. was born. As one of two original venture investors, Samuelson put up $125,000 – real money back then.

The key figure was F. Helmut Weymar, whose prize-winning thesis on predicting cocoa prices Samuelson had supervised a couple of years before, along with MIT finance professor Paul Cootner. “I thought random walk was bullshit,” Weymar told Mallaby for *More Money Than God*. “The whole idea that an individual can’t make serious money with a competitive edge over the rest of the market is wacko.”

Weymar had gone to work for Nabisco, buying its cocoa beans. After some signal successes, he and Frank Vannerson, a Princeton PhD who specialized in predicting wheat prices for Nabisco, decided to go into business on their own. After talking to Samuelson, they raised $2.5 million, including the economist’s five percent, and, opened for business in a bucolic Princeton farmhouse with seven professionals (including Cootner) and six support staff.

Mallaby chronicles the adventures of the fledgling firm: computers and seminars, horseshoes and softball games, and, above all, ups and downs (the title of Irwin Rosenblum’s book about those years). By 1971, Commodities Corp. was on the ropes, its remaining capital a meager $900,000: one more false step would be its last. Gradually Weymar shifted gears, from beating the market with computers alone to following trends; from gauging investor psychology to betting on macro trends.

Kovner joined the firm, after a stint as a cab driver in Cambridge, Mass., having dropped out of his studies for a political science PhD. A chance conversation with a friend prompted him to read up on derivatives markets; he borrowed $3,000 on his Mastercard and turned it into $22,000 in a few days. After Kovner answered an ad in a financial publication, Michael Marcus, the red-hot trader who had placed the ad, called Weymar and announced, “Helmut, I have in my office the next president of Commodities Corp.”

By the end of the 1970s, Mallaby writes, Commodities Corp had become a prodigious success, its capital grown to $30 million, its profits in 1980 $42 million after $13 million in bonuses. Many of its traders were earning returns of fifty percent a year. The firm’s heyday, however, was
passing. New strategies were being devised. Wall Street firms sought to lure away its top
talents. Its hardest-won secrets were gradually becoming common knowledge. In the wings of
the profession was a little-known macro-trader in London, a former philosophy student named

It’s a great story. The Mallaby book, meticulously sourced, is full of wonderful stories about this
brave new world of Long-Run Positive Alphas, as those hedge fund operators whose risk-
adjusted returns regularly beat the market are sometimes known.

Meanwhile, by the mid-1970s, John Bogle had founded the Vanguard Group, to offer index
funds to those ordinary investors who chose to buy the market as a whole rather than try to beat
it. Samuelson declined to join the Vanguard board, not because he didn’t approve but because he
would thus remain free to enthuse about its products — “the only mutual fund group dedicated
solely to its clients’ interests,” as he described it — more vehemently than had he been an insider.
That’s in “An Enjoyable Life,” too.

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Economists, at least those of a certain ilk, have always traded on their own accounts; otherwise,
they say, what would be the point? In a memorial essay for his fellow Midwesterner Cootner
(who died in 1978 of a heart attack at 48), an article that is not included in his Collected Papers,
Samuelson recalled one season of soybean mania in the late 1940s. The bulls of the MIT
economics department on the third floor of their building and the Sloan School bears on the floor
above could have saved considerable commissions by dealing directly with one another; instead,
he said, perhaps all of them lost money.

Why trade in each new market as it came along? To avoid “the kind of naïveté that so often
mars the works of those who analyze scars but never felt a wound,” Samuelson answered. “If
Casanova is not the definitive authority on sex, neither is a eunuch.”

But why secret — or rather, an unspoken role? Samuelson’s involvement with Commodities Corp.
was known around the department, but it became no part of his legend in the outside world.
When Weymer took the stage at Samuelson’s memorial service last year, along with MIT
president Susan Hochfield and eight well-known economists, his presence surprised more than a
few in the audience. The answer seems to be that Samuelson’s low profile as an activist investor
made it easier to gather information.

Field work is an old if little-honored tradition in economics. Just the other day, Malcolm
Rutheford, of the University of Victoria in British Columbia, described how John Fitch spent ten
months visiting Pittsburgh steel mills at the turn of the twentieth century, often guided by
workers themselves — in order to document the 12-hour, seven-day-a-week schedule (including a
day of round-the-clock labor every two weeks in exchange for 24 hours off two weeks later!) that
was at the heart of the bitterest union disputes. Similarly economist Frederick Mills went
undercover as a hobo in California, joined the IWW, rode the rails, picked oranges, slept in
haystacks.
“What I did,” Samuelson wrote of his Commodities Corp. experience, “was become a useful monitor of traders.”

What did he learn? He learned that most stock-pickers were not very good; hence his growing and widely-communicated enthusiasm for index funds. He learned not to influence with his macroeconomic view the good traders with whom he dealt, for the best of them somehow had the knack to go beyond what was already in the financial pages. In time, he learned how at least some of them did it.

A favorite story, late in life, had to do with the huge profits David Ricardo reaped after the Battle of Waterloo, the details adduced by Ricardo’s biographer, Piero Sraffa. The bond trader had an observer stationed near the battle. Once the outcome was clear, he galloped quickly to where a packet ship was waiting. So Ricardo in London received the early news, and conveyed it to the British government.

Then he went down to his customary chair at the Exchange – and sold! Other traders, suspecting the worst, sold too, the prices of Treasuries tumbling, until at last, Ricardo reversed course and bought and bought and made a killing, his greatest coup ever, one that put even the Rothschild brothers in the shade.

“If not illegal, an ethical purist would have to fault Ricardo for in effect profiting from his own spreading false rumors,” Samuelson wrote. “In this millennium that might be something to criticize or even to litigate.” Even so, the ploy was not unheard of in the present day, he would confide, given that new news, not yet digested, was what sent markets spinning.

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The MIT Press worked overtime in order to produce the last two volumes of The Collected Scientific Papers of Paul A. Samuelson in time for the institute’s 150th anniversary, which kicks off this month. The tomes’ design was long ago modeled on The Scientific Papers of J. Willard Gibbs, the great nineteenth century physical chemist who was among Samuelson’s heroes.

In nearly 2,100 pages, the two new volumes contain a trove of work published since 1986, often in out-of-the-way journals, and three early pieces not included in previous volumes: a 1960 adumbration of the efficient-markets papers, “Economic Brownian Motion”; a foreword to The Political Economy of the New Left, by Assar Lindbeck (1971); and an uncharacteristically harsh 1968 review of Beat the Market, by his MIT colleagues, E.O. Thorp and S.T. Kassouf, with a preamble added in 2009.

(Thorp’s Princeton-Newport Securities, founded in 1969, was for many years Commodities Corp.’s main rival as a quantitative hedge fund, though it pursued very different strategies. “To make stew, first catch your rabbit,” Samuelson wrote in 1968, by way of expressing doubt that a perfect hedge could be arranged. “My 1968 nihilism prepared me for the 1998 Long Term Capital Management debacle after it happened, but not before.”)
Most of the papers in *Volume 6* concern, in one way or another, the history of economic thought. *Volume 7*, in particular, with all Samuelson’s late papers on investing, and a rich trove of biographical material on various teachers, friends, and rivals, while not cheap, at $90, is for a certain kind of person a bargain.