Bear Stearns funds collapse hits subprime securities market

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The major investment and brokerage firm Merrill Lynch is going ahead with a sale of $850 million worth of financial assets seized from two troubled hedge funds controlled by another major Wall Street firm Bear Stearns.

The confrontation between the two Wall Street giants started to unfold on Tuesday following news that the two hedge funds, set up only 10 months ago, were experiencing sharp falls in the valuation of their assets.

Initial reports suggest there is interest from other investors in purchasing the assets, consisting mainly of collateral-backed debt obligations, mostly related to subprime mortgages. Provided buyers can be found, the sale process is expected to proceed smoothly. But if the assets have to be liquidated at so-called “fire sale” prices this could trigger turbulence across financial markets.

The decision to sell came after the rejection of a plan by Bear Stearns to save the funds. Under the plan, Bear Stearns would have put up $1.5 billion with other banks contributing $500 million in new equity to meet margin calls. In return, creditors would have had to agree not to make margin calls for another 12 months.

Merrill Lynch apparently rejected the plan because it felt that over a period of 12 months the market could move against the Bear Stearns investments.

The collapse of the two funds is symptomatic of problems in US financial markets caused by the fall off in the housing market, which has exposed the risky financing operations undertaken during the housing boom. It is estimated that since 2000 Wall Street has created more than $1.8 trillion worth of securities backed by subprime mortgages.

Now with the national median home price set to show the first annual decline since the Great Depression and the stock of unsold homes at a record 4.2 million, Wall Street firms, which have invested heavily in mortgage-backed securities, are beginning to feel the effects.

Goldman Sachs, the world’s biggest securities firm, and Bear Stearns, the largest underwriter of mortgage-backed securities in 2006, have both reported that the increase in foreclosures has hit their profits. Bear Stearns said profits fell 10 percent, while Goldman Sachs reported a 1 percent gain, the smallest increase for three quarters.

The brief history of the failed Bear Stearns hedge funds is indicative of the way in which the market pressure to accumulate ever-greater profits leads to increasingly risky ventures.

The two funds—High-Grade Structured Credit Strategies Enhanced Leverage Fund and the High Grade Structured Credit Strategies Fund—were set up by Bear Stearns just 10 months ago.

As the length of their names indicates, they were to be engaged in highly complex operations in the securities markets. But while the methods were complicated, the underlying profit plan was simple: the aim was to borrow a large amount of money to make big bets on the sub-prime mortgage backed securities market. The market has seen an increasing degree of turbulence in the recent period because of the increased level of mortgage defaults by high-risk borrowers.

The funds manager, Ralph Cioffi, described by the *Financial Times* as having a “stellar reputation”, apparently believed that collaterised debt obligations (CDOs) backed by subprime mortgages would start to increase in value over the longer term following their recent decline.

With Bear Stearns, one of the biggest operators in the mortgage business, and given Cioffi’s reputation, money for the funds was not hard to come by. Some of the world’s biggest finance companies, including

Citigroup, Barclays, Merrill Lynch, Goldman Sachs, Deutsche Bank, Credit Suisse and Bank of America extended as much as $9 billion in credit. The funds also raised around $600 million in equity from investors, including $40 million from Bear Stearns and its executives.

Problems started to emerge last month when Enhanced Leverage reported that its value fell 6.75 percent in April after its bets in the mortgage market had gone wrong. Two weeks later it reported that the loss was 18 percent, sending a shiver of fear through investors.

The sudden increase in the loss estimate indicates the inherent valuation problems in the complex derivatives markets in which the funds were dealing.

As an article in Wednesday's edition of the *Wall Street Journal* explained: "Unlike stocks and Treasury bonds, whose prices are continually quoted and easily explained, many of these derivative instruments trade infrequently and don't have clear market prices. To come up with market values for these investments—a process known as 'marking' their positions to market—investment funds often rely on their own valuation models.

"They might also ask the dealers who sell them the bonds to update them on changes in the bonds' underlying value. When there are no sales to base prices on, dealers come up with prices based on their own statistical models and an array of assumptions about what's happening in the market or the assets that back the securities."

This means that there can be some very rapid shifts in valuations. A market value in "normal" times may be very different from one obtained in a period of stress—and the transition from one period to another can take place quickly.

According to the *Wall Street Journal*, there has been "no indication that Bear Stearns's managers sought to mislead lenders or investors about the value of the funds. Indeed, the firm's approach to valuing its securities seems to be in line with guidelines set up by Moody's Investor Service, which evaluates hedge-fund practices. But this crisis does point to the kinds of valuation problems hedge funds and their investors can run into, even when they follow sound practices."

These words bring to mind the collapse of the Long Term Capital Management (LTCM) hedge fund in 1998. LTCM also followed "sound practices"—its valuation and pricing model was designed by Nobel laureates—but an unexpected shift in currency market valuations led to the collapse of the fund, necessitating a $3 billion bailout organised by the then Federal Reserve Board chairman Alan Greenspan in order to prevent a meltdown of the financial system.

Since the LTCM collapse, the spreading of risk had made markets less vulnerable to the collapse of a single fund. But as *Financial Times* commentator Gillian Tett observed: "Although the financial system has absorbed *isolated* failures, no one knows what might happen with a string of collapses.