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The Pain Isn't Over

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Steve Marsh and his partner Robert Tymoczko first noticed large stock-price swings—20 percent to 30 percent—among small-cap stocks in the U.S. and in Europe, devoid of jarring news to justify them.

The investment veterans, who manage AlphaStream U.S. Equity Market Neutral, a hedge fund with offices in San Francisco and Zug, Switzerland, don't believe this summer's subprime meltdown was due to trading models. "It's easy to blame a model," says Marsh, "it never talks back." But market movements and volumes can tell a tale.

That was the last week of July, when the rest of us were still thinking of our homes as cash cows. Suddenly quant models were pushed out of the driver's seat and forced selling dominated trading decisions. The woes of the subprime market were behind the selling, a rush to liquidate equities for badly needed cash. That helped depress the price of shares in an already jittery market, which caused more selling to cover equity positions—what Marsh calls "a vicious spiral."

Someone was selling stocks indiscriminately, according to Marsh. "It wasn't difficult to tell which stocks were being liquidated," he says. From there it was easy to compare those stocks with broker ratings, notes Marsh, and it was interesting to see that highly rated stocks were being sold while poorly rated stocks were being bought, which is indicative of covering short positions. Rumors centered on Goldman Sachs and its Global Alpha Fund. While the market fixated on Goldman, some other funds put a freeze on redemptions.

They weren't trading, says Tymoczko, they were "dumping," which put downward pressure on the share prices, fostering panic in other shareholders and issuers. "The first characteristic out of Europe that we noticed was Fiat complaining of unusual activity in its stock," explains Tymoczko. "We looked for an international fund with bad performance that might lead to liquidation." In July it may have been only Goldman selling off, but by August others had joined them.

Through layering—funds of funds—and its concomitant leveraging, the hedge fund industry controls a huge sum of money. "But how much could you actually liquidate?" Marsh challenges. "Bear Stearns had boasted of 50 percent returns over three years; now investors have zero. If you got out before the fund suspended redemptions, you made out—at a cost to the others. When you don't make it out you lose everything." It's like a roach motel—"You can check in any time you want, but you can never leave," he quips.

The larger problem is hedge funds themselves, says Marsh, who learned the business back in his native England, first at Zurich Financial Services and then Scudder Kemper Investment. "Much of the industry is predicated on over-valuation of illiquid securities," he says. "Hedge fund managers have considerable latitude on security valuations compared to, say, their brethren in the mutual fund industry." Marsh gives the example of a company that's burning through capital. No one is buying it, but the last price it traded at was $1. The hedge fund operator offers to buy shares for 50 cents a piece directly from the company in what is known as a Pipe, or private investment in public equity, deal. "Boom, you just made 100 percent return if you value it at the previous publicly traded price" exclaims Marsh.

In late June, Securities and Exchange Commission chairman Christopher Cox announced that the SEC will investigate the methods hedge funds are using to value their holdings. There are concerns, he said, that the funds "aren't marking the assets to their proper value."

The freezing of redemptions can cause further angst for investors. AlphaStream—which has $53 million in assets under management—never froze its redemptions, says Marsh. The fund had a segregated account that did ask to liquidate. The account was small, he says, and the decision left the client out of a subsequent bounce in the market that would’ve replaced most of his losses.

The SEC is auditing some of Wall Street’s top banks to see how they’re valuing mortgage-related securities. They’ll be looking for consistencies within banks. An article in the Sept. 2 New York Times, for example, examined the failed Bear Stearns High Grade Structured Credit Strategies Fund, which investors claim misrepresented the risk of its exposure to subprime mortgages.

The good news, in Marsh’s view, is that he doesn’t think quantitative—especially fundamental—models had anything to do with the poor results posted by market-neutral funds in the wake of the subprime-induced liquidation. “Most losses were panic selling, and these short-term price movements were driven by the weight of money,” he says. “You have to believe that the market is efficient enough to absorb corporate economic fundamentals and reflect these in its pricing over the longer term”

But the bad news for the mortgage market may not be over, says Tymoczko, noting that we’re “only in the top of the first inning.” He says that teaser interest rates on regular and jumbo mortgages will continue to adjust upward—only 10 percent to 15 percent are done. That will increase pressure as already stretched borrowers face higher repayments.

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