A Hedge Fund Views Subprime Melt Down from Inside

By Maureen Nevin Duffy

Steve Marsh and his partner Robert Tymoczko first noticed large stock price swings -- 30 – 40% -- among small cap stocks here and in Europe, devoid of some kind of jarring news to justify them.

The hedge fund veterans, who manage Alpha Stream U.S. Equity Market Neutral LP, a hedge fund with offices in San Francisco and Zug, Switzerland, never believed the subprime meltdown of summer 2007 was due to trading models. "It's easy to blame a model," says Marsh in a thick British accent, "it never talks back." But market movements can tell a tale.

This was back in the last week of July, while the rest of us were still thinking of our homes as large porcelain pink piggys with little slits in their backs. Suddenly quant models went out the window as panic selling took over the wheel and started driving trading decisions. The fall of the subprime market was fueling a rush to liquidate equities for badly needed cash.

Someone was selling stocks indiscriminately, says Marsh. "It wasn't difficult to tell which stocks were being liquidated," he says. From there it was easy to compare those positions with the largest funds and narrow probabilities down. "The other funds had put a freeze on redemptions, so it was easy to see who was selling the stocks. I looked to see who had longs; Goldman Sachs kept coming up," says Marsh. "The trail led to Goldman Sachs' Global Alpha fund."

The Global fund had positions "virtually everywhere," says Marsh.

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. We looked for an international fund with bad performance that might lead to liquidation."

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In July it may have been only Goldman selling off but by August others had joined them; Highbridge Capital, JP Morgan, AQR Capital Management, and Renaissance Technologies Corp., recalls Marsh, who uses models for stock selection, but not for automated trades.

Alphastream prefers to rely more on fundamentals, such as quality of the earnings, than technical indicators. "We may watch price movements in comparison with growth in earnings. But we like to avoid the herd mentality," says Marsh, whose fund had just rebalanced its positions the previous day before what it calls "a vicious spiral," the big hit and has "almost gotten everything back."

And the herd mentality often follows large companies like Goldman, he says. "If Goldman Sachs says it is this way, that's the way it is."

The larger problem is hedge funds themselves, says Marsh, who learned the business back in his native England first at Barings Asset Management and then Scudder Kemper Investment. "Most of the industry is predicated on over valuation of illiquid securities. You can put whatever value on them you want." Marsh gives the example of a stock 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 all shares for $.50 a share. "Boom you just made 100% return!" exclaims Marsh. "That's the pipe industry."

Most of the hedge fund industry is valued on the aggregate value of hedge funds. "But could you actually liquidate that?" he challenges. "Bear Stearns had boasted of 50% returns over 3 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 the Eagles' Hotel

California. “You can check in any time you want, but you can never leave.”

In late June, director Chris 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.”

And then there are those management and performance fees. “Some hedge funds have taken their fees on investors’ deposits,” says Marsh, who compares it to ‘The Wild West.’ “The fund made nothing! And they can freeze the redemptions whenever they want.”

Alphastream never froze its redemptions, says Marsh. The fund had one, a segregated account, liquidate. The account was small, he says, and the decision to liquidate left the client out of a subsequent bounce in the market that would’ve boosted his holdings.

The Securities and Exchange Commission is auditing some of Wall Street’s top banks to see if they’re properly accounted for losses in the sub-prime market.

The good news, Marsh might say, is that he really doesn’t think quantitative – especially fundamental models had anything to do with the sub-prime induced liquidation in the equity mutual funds. “Most losses were panic selling.”

But the bad news, as Tymoczko says, is that we’re “only in the top of the first inning.” He notes that teaser interest rates on regular and jumbo mortgages will continue to adjust upward – only 10 – 15% are done and 25% of jumbos – through October and November of this year.