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Bear Stearns' Subprime Bath

Hit by the subprime market's collapse, investors in a highly leveraged—and losing—hedge fund find they can't get out

by Matthew Goldstein

Investors in a 10-month-old Bear Stearns (BSC) hedge fund are learning the hard way the danger of investing in risky bonds with borrowed money. The investment firm's High-Grade Structured Credit Strategies Enhanced Leverage Fund, as of Apr. 30, was down a whopping 23% for the year.

The situation is so bleak that Bear Stearns' asset management group is suspending redemptions at the onetime $642 million fund—meaning investors have no choice but to sit on their losses. And that's got some hopping mad.

"At the end of the day, I'd like someone to be honest with me about what's going on," says one investor in the hedge fund, which bet heavily on bonds backed by subprime mortgages, or home loans to consumers with shaky credit histories. An investor in Europe, who didn't want to be identified, says he's been trying to get his money out of the hedge fund since February.

NO QUESTIONS

He's particularly incensed that on a June 8 conference call the fund's managers set up to discuss performance, Bear Stearns officials refused to field investors' questions. "They specifically said they weren't taking any questions," says the investor. "They didn't want to say anything."

A Bear Stearns spokesman declined to comment. Several hedge fund managers also didn't respond to an e-mail request for a comment. But in a June 7 letter to investors, Bear Stearns says it's suspending redemptions because the "investment manager believes the company will not have sufficient liquid assets to pay investors." Bear Stearns' asset management group, led by Ralph Cioffi, took the action after investors stormed the gates, seeking to redeem about $250 million, sources say.

In barring investor redemptions, Bear Stearns is trying to buy time for the hedge fund. But there's no guarantee the fund, now down to about $500 million in assets, can turn it around.

SWIFT DECLINE

In fact, things deteriorated rather quickly at the fund. The hedge fund got off to a good start, posting a cumulative 4.44% return over its first four months, according to a Bear Stearns investor letter. But early this year the fund's performance began to suffer as the market for subprime mortgages began to implode. Coming into April, the fund was down 4% for the year.

Then things really fell apart. In April, the hedge fund posted an 18.97% decline, according to the June 7 letter obtained by *BusinessWeek*. But even more shocking than that big loss: only weeks earlier, the company had said it lost just 6.5% for April, according to a May 15 letter the firm sent fund investors. It's not clear what happened in those intervening weeks to force Bear Stearns to significantly revise upward its estimated April losses.

Bear Stearns isn't the only big investment firm with a hedge fund that ran into trouble making bets on the subprime market. In May, UBS (UBS), the Swiss-based banking giant, announced it was shutting down its Dillon Read Capital Management hedge fund after incurring a $123 million loss because of its exposure to the U.S. subprime market. The hedge fund's woes helped drag down first-quarter profit at UBS.

THE PERILS OF LEVERAGE

Bear Stearns is scheduled to report second-quarter earnings on June 14, but its hedge fund troubles are not expected to weigh on the firm's results. Still, there's concern about whether the pain in the subprime market will start to crimp profits at big Wall Street firms, which rake in fat fees from underwriting mortgage-backed bonds and generate big revenues from trading in those securities. Lehman Brothers Holdings (LEH) eased some investor fears on June 12 when it reported that second-quarter profit at the New York investment house rose a healthy 27% from the year-ago quarter, to $1.25 billion.

But the trouble at Bear Stearns' hedge fund is another illustration of the danger facing funds that rely heavily on borrowed money to make investment bets. True to its name, the High-Grade Structured Credit Strategies Enhanced Leverage Fund made liberal use of borrowed money. People familiar with the fund say many investments were leveraged 3 to 1, meaning for every dollar invested in a risky bond, the fund would borrow another three. Making highly leveraged bets works well if the value of an investment rises, but it can quickly crush a hedge fund if the investment declines in value.

That's what happened last September to Amaranth Advisors, which lost nearly $6 billion in a single week after a highly leveraged bet on the future price of natural gas prices blew up. "While leverage is great for returns in good times, leverage also magnifies the effects of a mistake and can hurt returns," says Janet Tavakoli, a Chicago financial consultant who specializes in advising clients on asset-backed investments

The losses this year are much smaller at another Bear Stearns hedge fund which invests in similar bonds, but doesn't use as much borrowed money. Bear Stearns' High-Grade Structured Credit Strategies is down about 5%, according to sources. Launched in October, 2003, it has enjoyed a good run. The fund has generated annualized average returns of 12.82%, according to a Bear Stearns investor letter. The "structured credit" fund was the model for the "enhanced leverage" fund. The marketing literature for both hedge funds say they mainly invest in "high quality, floating rate, structured finance securities," which includes asset-backed bonds, collateralized debt obligations (CDOs), and bank loans.

Meanwhile, the poor performance of the 10-month-old "enhanced leverage" fund is another black eye for Bear Stearns' plans to roll out an initial public offering for its Everquest Financial affiliate. The investment firm created Everquest last fall, and filed documents on May 10 to sell a stake to the public (see BusinessWeek.com, 5/11/07, "Bear Stearns' Subprime IPO").

Bear Stearns' two hedge funds then sold some of their riskiest CDO investments to the new entity. A CDO is a sophisticated bond made up of pieces of lots of other asset-backed bonds—often bonds backed by subprime loans. Nearly two-thirds of Everquest's portfolio of CDOs were purchased from two hedge funds. In return, the hedge funds got $149 million in cash and 16 million shares, valued at $400 million, in the soon-to-be public company. But even that largesse from the Everquest deal wasn't enough to overcome the fund's poor April showing.

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