

Peloton fund fall highlights the danger of overreaching

NEWS ANALYSIS

A search for value among the debris of the credit crunch could backfire, write **James Mackintosh and Gillian Tett**

The sudden collapse of Peloton Partners' flagship \$2bn hedge fund last week caused panic selling of mortgage-backed securities – a foretaste of what could happen if a series of hedge funds fall.

Similar forced selling of a leveraged portfolio hammered several Swiss mid-cap stocks in which Focus Capital was invested at the end of February as rumours emerged that the \$1bn New York hedge fund was liquidating its portfolio.

Both failures highlight the impact of even relatively small funds when they use leverage to invest in illiquid, or hard-to-trade, markets. As markets fall, geared investors are forced to sell to lower their borrowings, pushing down the market and forcing other leveraged investors to sell – with the potential nightmare being a wave of forced deleveraging.

Peloton was founded by

former Goldman partners Geoff Grant and Ron Beller.

"Hedge funds have done a good job over the last several months of deleveraging," said the head of fixed income prime brokerage at a large bank. "But those that have stepped in to catch the falling knife [buying cheap assets] are finding themselves seriously injured."

It was the search for value among assets already hit by the credit crunch that took down Peloton's ABS fund, previously one of the rising stars of the London hedge fund industry. Peloton bought about \$6bn of long positions in the ABX index of synthetic asset-backed securities, say people who

saw the portfolio put up for sale last week, in the belief that they were good credits trading at a discount.

But the credit squeeze pushed the ABX down at the same time as banks, growing more concerned about their own balance sheets, increased margin requirements for what they regarded as risky assets.

When Peloton was forced to sell, with some of its assets seized and sold by banks, the parts of the ABX where it had its biggest positions were hammered. According to rivals, Peloton's big long index positions were in the two 2006 indices – the top-rated AAA and AA tranches – that went

into freefall (see chart). The later 2007 indices declined but far more slowly.

"It will have some ripple effects on other funds," one Peloton ABS investor said. Another who looked at the fund this year but declined to invest said he was not aware of other funds gearing up to take the same bet.

In a letter to investors last week, Mr Beller and Mr Grant said the ABS fund was hit by the poor liquidity of the asset-backed market. "In addition, because of their own well-publicised issues, credit providers have been severely tightening terms without regard to the credit-worthiness or track record of individual firms, which has

Mortgage-backed securities indices

Markit ABX.HE 07-2 AAA

Markit ABX.HE 06-1 AAA index



Source: Markit

compounded our difficulties and made it impossible to meet margin calls," they wrote.

So far there is little evidence of prime brokers reining in leverage to hedge funds, partly because of competitive pressures. But repo desks, which use reverse repurchase agreements to provide leverage to hedge funds and others in credit markets, are clamping down, according to analysts and some bankers, potentially forcing further sales.

There is growing concern among regulators and investors that credit markets could be heading for a new downward cycle owing to forced sales and deleveraging in the hedge fund sector.

This partly reflects a general fear that a wave of forced sales could depress asset prices further, which would not just hurt hedge funds but also force banks to recognise new losses as a result of pressure to

mark their books to market.

But the lack of transparency makes it hard to tell where assets are held – meaning forced asset sales could lead to an unexpected wave of chain reactions. Even the level of leverage is unclear, with the Financial Services Authority, the London market regulator, refusing to publish aggregate data it collects twice a year on hedge fund borrowing.

It is this sense of uncertainty – or fear of "lots of little grenades going off", as one regulator puts it – that is leaving investors fearful.

"Out of this whole episode will come far greater pressure for transparency – the big problem [of recent months] is that banks don't know what the [other] banks are exposed to and one of the reasons why people cut lines was that they didn't know where the risks were," Paul Tucker, head of markets at the Bank of England, told a conference this week.



Ron Beller founded Peloton with another ex-Goldman partner, Geoff Grant

Ben Stansall