Hedge Funds, Once a Windfall, Contribute to Bear’s Downfall

Gregory Zuckerman
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Abstract (Summary)

Some hedge funds also fret that if they pay back the money they have borrowed from Bear, the prime broker may not quickly return the collateral the hedge fund gave it to secure loans in the first place, possibly because they have used the securities elsewhere.

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Full Text

(859 words)
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For years, Bear Stearns Cos. reaped a windfall lending money to hedge funds and conducting trades for them. As these funds multiplied, the firm was among the leaders courting them, providing everything from advice on how to launch a fund to helping them find office space.

The hedge-fund business came back to haunt Bear Stearns last week, however, as a wave of nervous funds pulled their accounts, helping to put the brokerage firm in a precarious position. The moves, which came even though the hedge funds' accounts often are separate from Bear Stearns's own accounts, serve as a reminder of the growing importance of the uncertain business of catering to hedge funds. Indeed, one of Bear Stearns's most valuable remaining assets, and one that was certainly attractive to announced acquirer J.P. Morgan Chase & Co., is this lucrative business called prime-brokerage, some argue.

Through all the tumult, however, one huge hedge fund, Paulson & Co., has stuck with Bear Stearns, despite a rocky history between the two, adding some support to the embattled brokerage firm.

Some see a delicious irony: Paulson pocketed a whopping $15 billion last year on bets that the housing market would crumble and that the value of subprime mortgages would shrink. Bear, meanwhile, was brought to its knees by poor mortgage-bond trades in its own hedge funds and by the growing credit crunch, which began with the mortgage turmoil.

The pressure on Bear Stearns has built for weeks as big hedge funds like Citadel Investment Group and Renaissance Technologies Corp. pulled accounts and shifted them to other prime brokers. The movement away from Bear Stearns accelerated last week as rivals such as Bank of America Corp. received calls from hedge funds interested in moving assets.
Some traders wonder whether hedge funds also have been betting against Bear itself. They suspect that hedge funds might have been shorting Bear Stearns shares, or betting its stock price would fall, as it lost profitable prime-brokerage business.

Paulson, which manages about $30 billion, had no current plans to drop Bear as its prime broker as of late yesterday, according to people close to the matter, as the fund awaited the outcome of negotiations between Bear Stearns and J.P. Morgan. The hedge-fund firm, run by John Paulson, a former Bear Stearns investment banker, has been a longtime client. Last year, the two firms engaged in a public feud when Paulson & Co. accused Bear Stearns of contemplating steps to prop up the value of mortgage bonds, something that would have hurt Paulson's bearish bet on these same bonds. Bear has denied any such plan. While Paulson has moved its cash accounts away from Bear Stearns in the past year, and also uses Goldman Sachs Group Inc. and Deutsche Bank AG as a prime broker, it doesn't have plans to pull the plug on its relationship with Bear Stearns, the people say.

Behind Paulson's confidence: The hedge fund, like most others, is a client of Bear Stearns Securities Corp., a separate, regulated entity that is supposed to have excess capital to survive any problems. At the same time, the Paulson funds have borrowed little money to make trades, so they haven't handed securities over to Bear Stearns to serve as collateral for any borrowing.

Funds pulling their accounts from the firm say they would rather be safe than sorry, and are concerned that the protection of the entity won't hold up, or that Bear Stearns Securities might have lent money to its parent company.

When a hedge fund borrows money from a broker like Bear Stearns or uses it to conduct a trade, the fund usually places securities in an account at the brokerage firm. Hedge funds fear that their account could be frozen in some way if their prime broker runs into trouble, especially if the broker files for bankruptcy protection.

Some hedge funds also fret that if they pay back the money they have borrowed from Bear, the prime broker may not quickly return the collateral the hedge fund gave it to secure loans in the first place, possibly because they have used the securities elsewhere. Another concern is that a wounded broker like Bear Stearns could abruptly cut off financing to hedge funds, which would force them to liquidate investments, possibly sustaining losses, to repay loans.

"The unknown is what Bear's prime-brokerage clients have been reacting to," said John Broadhurst, a partner in the hedge-fund practice of San Francisco law firm Shartsis Friese LLP. "Some hedge-fund managers are just yanking their business. Others are weighing the perceived risks with the hassle of changing prime brokers."

The business of dealing with hedge funds has been an increasingly important business for Bear Stearns, representing 10% or more of revenue, and a higher percentage of earnings in recent years, according to estimates from David Hendler, a senior analyst at CreditSights, Inc., a research firm.
"They are one of the original players in this market, as hedge funds grew as an investor base, they grew with it. It's a double-edged sword though; guys who were helping Bear to grow now are taking money out."

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Jenny Strasburg contributed to this article.

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Prime Asset
For Bear Stearns, prime brokerage was a key business, though its players came back to haunt the Wall Street firm this past week. Now, it may be one of Bear's most attractive assets.

<table>
<thead>
<tr>
<th>Prime-broker</th>
<th>Total assets (billions)</th>
<th>Market share</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Morgan Stanley</td>
<td>153</td>
<td>23%</td>
</tr>
<tr>
<td>2. Bear Steams</td>
<td>136</td>
<td>21%</td>
</tr>
<tr>
<td>3. Goldman Sachs</td>
<td>119</td>
<td>18%</td>
</tr>
<tr>
<td>4. UBS</td>
<td>47</td>
<td>7%</td>
</tr>
<tr>
<td>5. Credit Suisse</td>
<td>25</td>
<td>4%</td>
</tr>
</tbody>
</table>

Note: Assets as of year-end 2006
Source: 2007 Piper Jaffray Prime Brokerage League Table