Invited Editorial

Hedge fund investing: Beware of special relationships: The remorse of Beacon Hill Asset Management Investors

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ABSTRACT **Beacon Hill Asset Management (BHAM) is a hedge fund that specializes in investing and trading mortgage-backed securities (MBS). The fund exploits arbitrage opportunities in the MBS market and does not take interest rate risk. The background of the fund management team is excellent, and its performance is stellar. Assets under management exceed US$2.0 billion. The investors include the top financial institutions. What could go wrong? The pressure to honor the commitment in a symbiotic relationship with the major investor in the fund advisory firm coerces the fund managers into committing fraudulent activities that they may not have committed otherwise. Asset Alliance Corp., a New York-based investment firm, payed $40 million for a 50 per cent ownership stake in BHAM in 1998. The purchase agreement included a claw-back provision. The provision stipulated that should BHAM fail to deliver the performance, BHAM must return up to half of the prior earnout fees to Asset Alliance. The Securities Exchange Commission (SEC) complaint alleged that the BHAM misrepresented the valuation of the securities in order to show steady and positive returns. The partners concealed the magnitude of the actual losses in order to save the operation of BHAM. The absence of a compliance officer and/or independent board facilitated the fraudulent activities, and investors' losses exceeded $400 million. In late 2004 the SEC settled the case and expected the disgorgement, prejudgment interest and penalties to be distributed to the fund investors. Investors in hedge funds and industry stakeholders**

should demand some form of independent oversight and investigate any special relationship the fund has with a third party, through the due diligence process.

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> And those who respect their trusts and covenants … . Such will be the honored ones in Gardens of Bliss. (The Holy Quran, Chapter 70, verses 32 and 35)

INTRODUCTION

Beacon Hill Asset Management (BHAM), headquartered in Summit, New Jersey, was formed in 1997 by four principals. The firm has a total of 17 employees and specializes in mortgaged-backed securities (MBS).[1] Goldstein reports that approximately 75 per cent of BHAM trading activity involves collateralized mortgage obligations. According to the complaint by the Securities Exchange Commission (SEC)[2] filed on 7 November 2002, the firm started a scheme to conceal the fund's growing losses from January to October 2002. It lost more than $400 million of the funds' assets. Four hedge funds are managed by BHAM: the Master Fund and three feeder funds – Bristol Fund, Safe Harbor Fund and Milestone Fund. The fraud was committed through the Master Fund.

The essence of BHAM's fraud was its method of valuing securities in the funds to show steady and positive returns. The partners misrepresented the magnitude of the actual losses in order to save the operation of BHAM. Verifying the valuation of thinly traded, illiquid securities is extremely difficult. The manipulative security valuation allowed BHAM to report stable growth in net asset values (NAVs) and hide losses in these funds during 2002. In October 2002, when BHAM's prime broker, Bear Stearns & Co., challenged the valuation of the Master Fund, the fund managers were forced to admit that the fund had incurred substantial losses.

Although illegal and unjustifiable, this attempt, I suspect and speculate, was well intentioned. The managers were expecting (and hoping) to recover the losses. Once the fund was above water, the valuation manipulation may have ended. Unfortunately for BHAM, market conditions proved too humbling.

The four fund principals involved in this fraud were as follows:

John D. Barry, the President of BHAM and Chairman of its Management Board, is responsible for marketing, sales, client relationships and overall management of the firm. He was 43 years old in 2004. Barry claimed a distinguished career in the industry, occupying senior positions at Citicorp and Prudential Securities, among others.[3]

Thomas P. Daniels was the Chief Investment Officer, and was 46 years old in 2004. He managed the overall portfolio management, securities valuation, systems development and risk management of the firm. Before BHAM, he was a director and was responsible for the mortgage-trading group of Prudential Securities.

John M. Irwin was the senior portfolio manager in charge of mortgage portfolios, and shares portfolio management responsibilities, all trading decisions and securities valuations with the Chief Investment Officer, Daniels.

Mark P. Miszkiewicz, a certified public accountant, was the purported Chief Financial Officer and was responsible for the firm's financial, accounting and administrative operations, and NAV calculations. Although Mr Miszkiewicz was qualified to take on the responsibility of the compliance function, there was no evidence that he ever did, or even that a compliance role ever existed.

INVESTMENT STRATEGY

BHAM's investment objective was to hedge out many of the risks while capturing the spread between the rate of return on collateralized mortgage obligations (CMOs) and the risk-free rate on US Treasury securities. To accomplish this objective BHAM invested and traded in CMOs on a leveraged basis. Because each CMO has a unique set of features, the hedge must be developed to accommodate the individual CMO. *Presumably BHAM employed a low-risk market-neutral (CMO-based) strategy.* That is, the strategy made positive returns (12–18 per cent per year) regardless of market direction. The company's marketing material described the fund as an arbitrageur that exploited market inefficiencies and shunned speculating on the direction of interest rates. The firm used hedging strategies to mitigate the effects of interest rate movements on the value of the portfolio, and employed considerable leverage to increase returns. BHAM shorted two dollars in Treasury bonds for every one dollar it invested in the MBS.[4] The prepayment risk was managed by adjusting the duration of the short Treasury positions. The fund borrowed $3 for each dollar of investors' money, not unusually high compared to other funds in the same fixed income securities category.

BHAM hedged interest rate risk by shorting Treasury securities, and managed the prepayment risk by adjusting the duration of the short Treasury positions. Between 1 June and 20 September 2002, the prices of the Treasury securities rose significantly as interest rates fell to the lowest level in 40 years. Logically, mortgage-refinancing activity booms while interest rates decline. The rate of mortgage refinancing hit a record high in September 2002. Owing to prepayments brought about by the falling interest rates, the prices of many CMOs plunged.

In an interview with Global Fund Analysis,[5] Tom Daniels stated, 'If these rates were to ratchet down significantly as the Fed eased short rates, then the prepayment rate would rise markedly, as there would be a huge flurry of refinancing as homeowners sought to lock in the lower rates. But at the moment this is not a scenario to which we attach a big probability'. Mr Daniels in essence dismissed the worst-case scenario.

The hedge that did not hedge

In 2002, BHAM's MBS portfolio was not performing well. BHAM believed the extreme declines in interest rates would revert to the mean soon. However, during the period June–September 2002, US Treasury Bonds prices increased as interest rates descended to their lowest point in almost 40 years. Task[6] claims that 'according to several bond market

participants, Beacon Hill was short Treasuries through September and then covered just before prices on the 10-year peaked on October 9th'. The firm expected interest rates to climb back to normal levels and refinancing activities to cool off. This would have helped the performance of the MBS portfolio. Unfortunately, the hedge BHAM made on interest rate risk was rendered useless overnight when interest rates dropped and Treasury prices spiked. When interest rate volatility shot up and rates fluctuated sharply, the normal correlation collapsed. Not only this, but the excessive volatility magnified the challenge of estimating option-adjusted spreads on the MBSs in the portfolio. BHAM was, according to Andrew Crescenzi, 'betting against volatility'[6] and they ultimately lost. The volatility in the market disrupted the correlation between the 10-year Treasury and the MBS market. Consequently, BHAM was defeated on both sides of the trade. They lost on the long position in MBS and were squeezed on the short position in Treasury bonds. In essence, the hedge exposed BHAM to the risk of a short position in convexity, by virtue of the short positions in Treasury bonds.

FACTS OF THE FRAUD

The price of a bond typically increases as interest rates decrease, as do MBS. However, the increase in MBS prices owing to the interest rate decline could be partly offset by an increase in mortgage principal prepayments. When interest rates decline, borrowers are likely to refinance their mortgages. This is called prepayment risk. In addition, MBS are subject to liquidity risks, evidenced by the high dispersion of market-maker quotes and special processing requirements.[7]

SEC's initial complaint against BHAM

Discrepancies in the value of the funds were first discovered by BHAM's prime broker, Bear Stearns. Throughout the month of September 2002, principals at BHAM told Bear Stearns that the value of the funds was $756 million. However, on 1 October, when Bear Sterns performed its own calculation of Bacon Hill's NAV, they found the funds to be valued at just under $257 million (Zuckerman). On 31 July 2002 they communicated to investors via e-mail that the year-to-date net returns of the Bristol and Safe Harbor funds were 8.78 per cent and 8.76 per cent, and then 9.5 per cent and 9.48 per cent in August, respectively. This information was also sent to a hedge fund database for all investors, current and prospective.

On 17 October 2002, BHAM finally came clean and announced the huge losses to investors. BHAM sent a letter to investors dated 18 October 2002 in which they acknowledged that it was in the best interests of the fund and its investors to move toward a liquidation of its portfolio and termination of the fund, and that this would hopefully 'obtain the best possible recovery for our investors and reduce some of the Fund's losses'.[8] They revealed to investors that the fund lost 54 per cent, and not 25 per cent as was originally reported on 8 October. The SEC[9] claimed that the principals knew or should have known that the fund's previously reported NAVs and returns were overstated, and the losses in the funds were understated.

On 7 November 2002, the SEC filed litigation against BHAM alleging fraud, a violation of Section 206(2) under the Investment

Advisers Act of 1940.[9] From 31 July to 30 September 2002, BHAM allegedly 'materially overstated' its NAVs and rates of returns for its Bristol and Safe Harbor funds. The SEC accused BHAM of misrepresentation through a series of emails that contained inflated and inaccurate figures of the funds' performance.[10]

The SEC swiftly ordered the transfer of asset management from BHAM to the rival investment manager, Ellington Capital Management.[11]

The complaint by the SEC alleged that the misrepresentations of BHAM included the calculation methodology they used for estimating NAVs, assertions of hedging and trading strategies as 'market neutral', and the actual performance of the funds. To present stable and positive returns, BHAM manually adjusted the prices of securities. BHAM did not follow the valuation methods stated in the documents offered to investors. Consequently, BHAM was able to report continuing growth in NAVs and to hide losses of the four funds in 2002.

The complaint also affirmed that the motivation behind the fraud was in large part a consequence of the purchase agreement in 1998 with Asset Alliance, which ultimately owned a 50 per cent stake in BHAM, the advisor to the four funds under management. Under the agreement, Asset Alliance was obligated to pay BHAM's principals an 'earnout' payment based on the increases in net assets under management and investment returns. If BHAM were to fail to maintain a certain level of performance as determined by the formula in the agreement, a 'clawback' provision stipulated that BHAM return up to half of the prior earnout fees to Asset Alliance. This provision placed huge pressure on the fund managers (Barry, Daniels, Irwin and Miszkiewicz) to produce the sizable returns necessary to secure the earnout fee.

Asset Alliance claimed to have paid the funds principals an extra $26.4 million performance bonus shortly after the funds' assets values were overstated. BHAM's management clearly had a $26 million-dollar motive for misrepresenting the value and earnings during this time period. This payment can be seen as the smoking gun in the case against BHAM's management. In addition, if the performance target was missed, BHAM managers could have potentially lost $7 million, recouped from the previous bonus.

Smaller fraud activities

BHAM executed transactions that benefited two institutional clients (managed accounts): HSBC Managed Trust, which was set up by Lehman Bros., and Lyxor Master Fund, which was set up by Societe Generale. The two institutional customers sold a number of bonds from their accounts to BHAM Master Fund at prices that were higher than the purchase price. BHAM investors were not informed about these transactions. The gains for the two clients were in excess of $8.5 million. In addition, in September 2002, four principals of BHAM liquidated their own accounts and sold securities back to the Master Fund without disclosing the transactions to investors. This obviously violated the principals' fiduciary responsibilities to the investors and Asset Alliance. Seemingly, the four principals were all actively involved in the above transactions. Had there been a compliance officer (or any form of external oversight) with a professional obligation to act independently of other officers of the fund, the fraud could have been stopped or at least prevented from escalating.

THE RELATIONSHIP WITH STAKEHOLDERS

The auditor of BHAM hedge funds was Ernst & Young. Amsterdam Trust Corp (ATC) Fund Services (Cayman) Ltd. was the administrator of the fund.[12] On several occasions, BHAM reported materially higher NAVs than its prime broker Bears Stearns did. In July 2002, the gap was greater than 31 per cent. After seeing the growing gaps between the two valuations, Bear Stearns decided to notify the SEC in October 2002.

BHAM's investors are among the elite. Two Bank One Corporation funds invested more than $10 million. Coastal Magnum Diversified Performance Fund and Deutsche Strategic Value Fund both suffered huge losses. Austin Capital and its affiliate Radix Sterling Limited invested more than $8.0 million.[12] Bank One also sued BHAM.[13]

In April 2003, 32 investors in BHAM sued the managers in a Manhattan federal court, claiming that the fund did not follow its investment strategy and misrepresented the performance.[14] These plaintiffs had invested $79 million in three funds. The investors also sued BHAM's 50 per cent owner, Asset Alliance, and ATC Fund Services, the administrator of the funds at issue. Separately, in February 2003 Asset Alliance also filed a $500 million arbitration claim against BHAM.[14]

FINAL OUTCOME

The BHAM investors lost approximately $400 million. On 24 October 2004, BHAM was fined $2 million in civil penalties and almost $2.5 million in disgorgement and prejudgment interest. No jail sentences were handed down to the fund managers.[15]

Three of the principals, Barry, Daniels and Irwin, were permanently barred from associating with any investment adviser. The fourth principal, Miszkiewicz, was similarly barred, but with the right to reapply after 4 years. The disgorged funds were to be distributed to the victims of the fraud pursuant to the Fair Fund Provision of the Sarbanes-Oxley Act of 2002 (Table 1).

BHAM conceded to comply with several requests mandated by the SEC. The major resolution agreed upon by BHAM was that management of the fund was to be

Table 1: Fines imposed on BHAM and its Principals

Party	*Civil penalty ($)*	*Disgorgement and prejudgement interest ($)*
Beacon Hill	600 000	1.00
Barry	500 000	653 270
Daniels	500 000	1 053 945
Irwin	200 000	554 227
Miszkiewcz	200 000	219 792
Total	2 000 000	2 481 235

Source: http://www.sec.gov/litigation/litreleases/lr18950.htm.

replaced. The remaining funds were transferred to the control of Connecticut-based hedge fund Ellington Management Group. Ellington is another fixed-income hedge fund, and managed slightly more assets than BHAM at the time.

LESSONS AND CONCLUSIONS

BHAM's case is a classic situation in which the fund management team is highly talented and reputable. To the team's credit, the fund's performance before the fraud was stellar. At the time, it was believed that BHAM's greater-than-expected losses were a result of a series of bad investment calls it made on the spread between the interest rates charged on US Treasuries and the interest rate earned on MBS. BHAM simply had gotten squeezed between an unforeseen acceleration in the rate of mortgage prepayments (refinancing) and a simultaneous spike in Treasury prices owing to historically low interest rates. BHAM made a large, highly leveraged bet that US Treasury bond prices would fall and interest rates rise beginning in July 2002.

Through ongoing monitoring, questioning of BHAM and communicating with vendors (accountants, auditors, prime brokers, custodians and marketers), investors could have detected the messaging of the NAVs and found out about the transactions with the two institutional investors and the sale of securities by the four principals to the Master Fund.

More important was the symbiotic relationship the fund had with Asset Alliance. Although legal, it created a perverse incentive to make risky trades that, if they were to fail, might pressure managers to engage in fraud in an attempt to hide the consequences. This outcome was facilitated by the blatant non-existence of a Compliance Officer. The most important issue for investors in this case was the lack of interest on the part of the investors and the absent disclosure of the details of the purchase agreement with Asset Alliance. In addition, there can be no oversight in the absence of a board with some independent directors.

Alternatively, BHAM managers might have attempted to comfort their investors by saying, 'we have had a bad month or two'. Although possibly true, this would not have been acceptable as a fully legitimate explanation. Investors must carefully vet poor performance especially if it persists for several months, in order to mitigate the risk of deviant activities.

Why would management go through all this trouble to defraud investors? The reasons are potentially limitless. A major motivating factor for their actions could have been greed, but fear is more likely. This is not to say their actions are in any way justifiable or defensible, but perhaps a different perspective can be applied. In many hedge funds today with their competitive nature, the manager's performance is very important. BHAM's portfolio was already lagging. The fear and pressure of losing investors or refunding the (selling) owner's 'earnout' payment, because of less than expected performance, was probably very clear. Management were waiting for that big hit to put them back in the black, but it never came; instead the firm fell into a downward spiral. More cynically, in hindsight, the investors in the funds would have been better off paying the fund managers $35 million than losing more than $400 million.

One could speculate that fraud is more prevalent than documented. Generally, the media only mention cases in which investors lose large sums. If management at BHAM

were correct in their bets, Bear Stearns would have probably never (at least in the very short run) noticed the difference in valuation. Collectively, the principals had to pay $2 million in civil penalties and $2.5 million to investors, and three of the four principals are banned from associating with investment advisors for life. So, was it really worth it? Not at all. When all else fails, be ethical.

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