Metacapital in Worst Slide as Bloodbath Roils Funds: Mortgages
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By Jody Shenn and Kelly Bit

June 12 (Bloomberg) -- Deepak Narula rose to fame as manager of the best-performing hedge fund last year by navigating the government's stimulus efforts. He's having a far harder time as the Federal Reserve moves closer to an exit.

Metacapital Management LP's flagship $1.5 billion fund lost an estimated 6.4 percent last month, the worst decline since it started in 2008, according to a letter to investors obtained by Bloomberg News. That followed drops of 0.5 percent in April and 0.1 percent in March, after 17 months of consecutive gains including a 41 percent return last year.

Narula, like other investors in government-backed mortgage bonds, is being punished by speculation the Fed will scale back its debt-buying program. That has caused the securities to underperform Treasuries by the most since 2008. Rising home prices, President Barack Obama's nomination of Democratic congressman Mel Watt to oversee Fannie Mae and Freddie Mac, and other issues have further roiled the market.

"It's been a bloodbath the last four to six weeks," said Troy Gayeski, a senior portfolio manager who helps invest client money in hedge funds at SkyBridge Capital, which manages about $7.7 billion. "It was a confluence of just about everything" from investors' concerns that refinancing would pick up among some borrowers who've had trouble qualifying to the slump in the mortgage debt that the Fed is buying, he said.

Structured Portfolio

Don Brownstein's Structured Portfolio Management LLC lost an estimated 5 percent in May for its SPM Core fund, extending losses this year to 6.5 percent, according to an update sent to investors. Brownstein, who topped Bloomberg Markets magazine's list of the top performing managers overseeing more than $1 billion in 2010, has lost an estimated 18 percent this year in his strategy that trades agency mortgage securities from Fannie Mae, Freddie Mac and Ginnie Mae.

Midway Group LP, the $600 million hedge-fund firm co-founded by Bob Sherak in 2000, and Guggenheim Partners LLC's GS Gamma Advisors LLC are among other losers, according to documents sent to investors.

Brownstein and John Morris, managing director at Midway, didn't immediately return calls. Thomas Mulligan, a spokesman for Guggenheim with Sitrick and Company, declined to comment.

Investors also have fled from publicly traded real-estate investment trusts that target agency mortgage bonds, including the two largest -- Annaly Capital Management Inc., down 17 percent since the end of April, and American Capital Agency Corp., which has slumped 26 percent in the same period.

REIT Selling

Selling by mortgage REITs that use borrowed money contributed to declines in mortgage-backed securities, Narula said in a June 10 letter to investors that shows his fund is down 4.7 percent this year.

"We miscalculated the market's response to the possible timing of the Fed's taper," he wrote in a June 10 letter. "The market response has been much more violent than we had anticipated."

Narula declined to comment on the letter, which explained his losses were primarily from investments in interest-only securities. These should gain in value as borrowing costs rise and refinancing slows. Instead they slumped on concern that a confirmation by Watt, "a career politician," would expand government efforts to help homeowners, he wrote.

Last month's performance is a stark reversal for the former Lehman Brothers Holdings Inc. mortgage trader, who founded New York-based Metacapital in 2001. He started the main fund in 2008 after closing a similar vehicle the previous year as soaring mortgage defaults created havoc in financial markets.

Successful Run

He then had a run of success predicting how the Fed, Obama administration and financial industry would react to the worst housing crash since the 1930s, buying debt that rallied as real estate recovered and trading around government attempts to stoke refinancing.

Narula's returns since 2008 total more than 500 percent and his gains last year made him the best-performing hedge fund manager in the Bloomberg Markets annual ranking. This year, he bought an apartment on Central Park West for $16 million from pop star Madonna, according to property records filed last week with the New York City Department of Finance.

Investors that focus on non-agency mortgage securities have mostly avoided the carnage as rising property prices have bolstered the debt.

LibreMax Capital

Greg Lippmann's LibreMax Capital LLC, the $2.8 billion hedge-fund firm, told investors its main fund probably rose more

than 1 percent in May and is up about 8.5 percent this year, according to a person familiar with the returns. Pine River Capital Management LP's fixed income fund, which buys both agency and non-agency, returned 0.6 percent last month to advance 8.1 percent in 2013, according to another person.
Narula's smaller Mortgage Value fund, which holds more non-agency bonds than his main one, is up about 7 percent this year.
Jonathan Gasthalter, a spokesman for LibreMax with Sard Verbinnen & Co., declined to comment. Patrick Clifford, a spokesman for Pine River at Abernathy MacGregor Group Inc., declined to comment on the returns.
Still, subprime-mortgage securities have lost about 3 percent this month, after a 0.3 percent decline in May that was the first in 18 months, Barclays Plc index data show. Returns exceed 8 percent this year.
Volatility has increased as Fed officials signal they may soon trim their $85 billion of monthly purchases of Treasuries and agency mortgage securities as the economy improves.

Relative Performance

Agency mortgage bonds have lost 1.1 percent more than similar-duration Treasuries from the end of April through yesterday, including the biggest relative monthly losses in May since November 2008, according to Bank of America Merrill Lynch index data. Fannie Mae's current-coupon securities, or those trading closest to face value and the Fed's largest target, have had declines relative to Treasuries of 2.5 percent.
Returns of hedge funds and mortgage REITs investing in the bonds typically track relative performance of the debt, because these investors can use bearish bets to hedge against changes in benchmark interest rates.
Like Metacapital, Midway and GS Gamma were also damaged by bets on interest-only and inverse interest-only securities. IOs and IIOs offer no principal payments, meaning their cash flows are tied only to how long the debt remains outstanding.
The Midway Market Neutral Fund declined 2.9 percent in May after a 1.6 percent loss in April, according to investors.
That's left it down 2.2 percent this year, after gains of 27 percent in 2012 and 22 percent in 2011. GS Gamma's fund slumped 8.2 percent in April, leaving it down 7.7 percent this year.

Interest-Only

Option-adjusted spreads on one type of interest-only security have widened to almost 12 percentage points, from 5.2 percentage points at the start of this year, according to Bank of America Merrill Lynch index data. Wider spreads typically mean investors such as funds with hedged strategies are losing money. Those investing in IOs have also lost in recent weeks because they buy traditional mortgage securities as hedges, Skybridge's Gayeski said.

The interest-only market has slumped as borrowers with little or no home equity continue to tap the federal Home Affordable Refinance Program for Fannie Mae and Freddie Mac loans, Midway told investors last month in a letter. Watt's nomination to head the Federal Housing Finance Agency raised concerns that new initiatives may come if he's confirmed, as well as "illiquidity" in the market, the fund said.

HARP Changes

GS Gamma, which had its biggest monthly losses in April since starting in 2005, told investors its interest-only and inverse interest-only investments were damaged by rates that had been falling, and an extension of HARP's end date.

The later deadline caused particular concern among investors with bets tied to borrowers with smaller mortgages, who are typically overlooked by lenders looking for larger loans and bigger profits, GS said. As those investors decided to "sell aggressively," the supply helped drag down other types of IOs.

Investor concern also grew that HARP and similar Federal Housing Administration rules will be tweaked to offer borrowers with loans granted after mid-2009 the opportunity to refinance. Just as home prices rising at the fastest pace since 2006 bolstered the non-agency market it also increased speculation a new group of borrowers will be able to replace high-rate mortgages with cheaper loans.

Pices rose 7.2 percent in the year through March, the biggest gain since May 2006, according to the Federal Housing Finance Agency. A report today from CoreLogic Inc. showed about 850,000 residential properties gained positive equity during the first quarter.

SkyBridge, which earlier this year reduced how much it invests with agency mortgage hedge funds, expects to raise its allocations once the market settles down, Gayeski said.

"Typically when you have a dislocation of this magnitude, it can take four, six, nine weeks before people start moving to take advantage and really make money again," he said. Compared with other fixed-income markets, "it's the only space where prices are materially lower and spreads are materially wider than they were coming into the year," he said.

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--With assistance from Christine Maurus in New York. Editors:
Pierre Paulden, Rob Urban

To contact the reporters on this story:
Kelly Bit in New York at +1-212-617-1097 or
kbit@bloomberg.net;
Jody Shenn in New York at +1-212-617-2380 or
jshenn@bloomberg.net;

To contact the editor responsible for this story:
Rob Urban at +1-212-617-5192 or
robprag@bloomberg.net.

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