Hedge funds, CDOs and the financial crisis: An empirical investigation of the “Magnetar trade”

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ABSTRACT

The so called Magnetar trade (a kind of capital structure arbitrage on the US housing market, using CDS and synthetic CDOs, and exploiting rating-dependent mispricing of risk) has gained a high publicity due to a Pulitzer Prize awarded media story from two journalists of ProPublica (an online news outlet). The story essentially claimed that the mortgage investment strategy of the hedge fund Magnetar during the period between 2006 and mid 2007 was based on a desire to construct CDO deals with riskier assets so that they could place bets that portions of their own deals would fail. This paper provides several pieces of evidence in line with the argument that tranches from Magnetar-sponsored CDOs present overly risky investments. However, investors and rating agencies appear to have adjusted their required spread levels and ratings to reflect this higher riskiness, at least to some extent.

Keywords: Hedge funds, Arbitrage, Collateralized debt obligation, Credit default swap, Synthetic CDOs

1. Introduction

Structured finance products like collateralized debt obligations backed by asset-backed securities (i.e., ABS-CDOs) have been heavily criticized for being, at least partly, responsible for the origin and intensification of the financial crisis 2007–2009. ABS-CDOs from the 2006–2007 vintage indeed showed particularly high collateral default rates and are commonly named toxic assets (Mählmann, 2012a). The ABS-CDO market experienced a fundamental change during the year 2005, characterized by the introduction of standardized forms for credit default swap (CDS) contracts on ABS (ABCDS) and for CDS on CDOs later in June 2006.

This change boosted the origination of synthetic deals which could be executed much more quickly than cash deals and could be much bigger. However, the advent of synthetic CDOs produced potential conflicts for CDO collateral asset managers in trying to serve the interests of one type of customers (long investors) who were betting mortgage borrowers would continue to make their payments and of other customers (short investors) who were betting the housing market would collapse. Even the incentives of long investors could become conflicted. Synthetic CDOs enabled sophisticated investors to place bets against the housing market or pursue more complex trading strategies, like capital structure arbitrage. In this type of strategy, investors, usually hedge funds, often used CDS to take offsetting positions in different tranches of the same CDO security (i.e., going long the equity tranche and shorting mezzanine and senior tranches). That way, they could make some money as long as the CDOs performed, but they stood to make more money if the entire market crashed. Synthetic ABS-CDOs were a particular promising vehicle for capital structure arbitrage, due to a general mispricing of risk observed in the CDO market, with equity tranches being undervalued and more senior