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Magnetar: What's in a Name?

by: John Lounsbury

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Jesse Eisinger and Jake Bernstein have a lengthy expose at *ProPublica.org* of alleged fraud in mortgage securitization. The allegations involve a hedge fund named Magnetar, which was formed in 2005 to apply some new creative financial engineering to a flagging sub-prime mortgage market. As a result, according to Eisinger and Bernstein, the sub-prime mortgage business was pumped to new heights, delaying the deflation of the housing bubble and making the collapse much worse.

New Garbage for an Overflowing Landfill

The *ProPublica.org* report includes the following:

> According to bankers and others involved, the Magnetar Trade worked this way: The hedge fund bought the riskiest portion of a kind of securities known as collateralized debt obligations -- CDOs. If housing prices kept rising, this would provide a solid return for many years. But that's not what hedge funds are after. They want outsized gains, the sooner the better, and Magnetar set itself up for a huge win: It placed bets that portions of its own deals would fail.

Eisinger and Bernstein allege Magnetar pressed CDO issuers to include riskier assets in their CDOs that would make the investments more vulnerable to failure. They report that dozens of Wall Street professionals saw the Magnetar program as an effort to profit by betting against the sub-prime securities market. The authors support their claims by citing an independent study (that they funded) that concluded 96 percent of the Magnetar deals were in default by the end of 2008, compared with 68 percent for comparable CDOs.

There is, of course, an alternative interpretation of the above facts. This may not have been fraud but simply incompetence. See the Magnetar response in the next section.

Denial by Magnetar

Magnetar has responded to the Eisinger and Bernstein report with a letter that states:

1. Denial that the firm entered into any transactions where default was calculated to be a significant risk.

2. Denial that they were net short on any of their transactions and securities involved.

3. Short positions were simply used for selective shorting in situations designed to be market neutral.

4. When there were net imbalances, the firm was net long securities with which they had exposure.

5. It is a false allegation that Magnetar designed any CDOs to fail.

The Arrogance of the Name

The apparent arrogance involved in this situation is evident in the name, Magnetar. This is the noun describing a dying star with intense magnetic field emanations after a supernova collapses. One of the parallel outcomes of such a collapse is a black hole, a point of extremely high mass with gravity sufficient to suck in matter from the surrounding space.

The lifetime of a Magnetar is extremely short in terms of galactic time. I have not read enough to know the following phase after the momentary flash of a Magnetar. It could continue to decay toward an ultimate cinder or, possibly, progress to become a black hole. I'll defer further discussion to an astrophysicist. The important factor is that a Magnetar is an intense event that occupies a time span of the order of 0.0000007% of the life of the universe. The same ratio applied to 100 years yields a relative life span of 23 seconds. And after that brief lifetime the residue is at best worthless. At the worst, the residue is a black hole, sucking all related activity (read this as financial system) into destruction.

The choice of name by Magnetar implies that the promulgators understood the opportunistic and destructive nature of their venture and had the arrogance to announce that understanding to the world. It seems the world had no understanding of astrophysics so the arrogant "warning" went unrecognized.

After writing the above, I read an article by John Gapper at *ft.com*. John has a thorough review of the entire story and makes some additional points:

> The question is whether the banks disclosed everything they should have to other investors, putting them on equal terms. ProPublica notes that the CDO deal prospectuses did not disclose Magnetar's equity role, or detail its other positions. The second reason is that ProPublica says Magnetar helped to keep the CDO machine humming despite, at the least, having a cynical view of housing. It was acting differently from Mr Burry, or John Paulson of Paulson & Co, who were simply going short. Magnetar, however, was operating in an arcane part of the CDO market and the forces driving the housing boom were far bigger than a wily Chicago hedge fund. Had Magnetar not existed, things would probably have ended up as they did.

Hat tip to granger.

Disclosure: No stocks mentioned.

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