


Who Blew Up PHOENIX?



Did a rogue trader really lose \$125 million in the Phoenix Fixed Income Arbitrage Fund without anybody catching on?

By Barclay Leib

On January 5, 2000, Phoenix Research and Trading, a Toronto-based hedge fund management group, issued a hastily prepared press release. The firm stated that one of its traders, Stephen Duthie, had lost \$7.4 million in unauthorized trading in its publicly traded Phoenix Hedge Fund LP, with the losses originating from a feeder fund called the Phoenix Fixed Income Arbitrage Limited Partnership.

Several days later, the firm clarified its earlier statement: The loss suffered by the fixed-income fund was actually \$125 million. The firm's principals, moreover, were proposing the dissolution of the partnership and hiring

Ernst & Young to undertake a "forensic investigation." The firm added that it was hiring a private investigator to locate Duthie, who was feared to have fled the country.

How could a \$150 million market-neutral arbitrage fund—a fund designed to take low-risk bets—lose \$125 million? Phoenix claims the losses were wholly the result of a rogue trader who violated the firm's investment guidelines. Since the news surfaced, however, the firm has refused to talk publicly about the scandal and has made the results of the Ernst & Young investigation available only to those who signed a strict nondisclosure statement. Duthie, on the other hand, claims that the fund collapsed because a large carry trade went sour—one in a series of such positions he claims

Phoenix carried on several occasions during his five-year career at the firm.

It's a classic "He said, she said" story that initially received a flurry of coverage in the Canadian financial press. The Ontario Securities Commission has since launched an investigation, but the mystery remains unresolved almost five months later.

FUND IN TROUBLE

According to Duthie's account, Phoenix was a small hedge fund group of 13 people with \$250 million under management at its peak. By design, the Fixed Income Arbitrage Fund was supposed to return a steady 10-plus percent return per annum from low-risk fixed-income arbitrage strategies. In 1997, however, the firm's fixed-income trading performance re-

ILLUSTRATION BY MIKHOO, PUTHORN

turned a disappointing 6.13 percent, and redemptions followed. Two traders left the firm in 1998 and a separate "directional trading program" was closed for poor performance. Duthie claims that there was talk of the firm being forced to shut down unless performance improved.

Then, in April 1998, according to Duthie, there was a conscious decision to change the style of the trading activity and the leverage the firm was using. Coincident with this alleged change in style, fixed-income returns jumped from just 76 basis points in the first quarter of 1998 to 3.71 percent in the subsequent quarter. During the previous year, the fund's average monthly return had been only 51 basis points. After April, it started averaging closer to 1.25 percent.

Duthie claims the fund was able to earn those returns in part with large carry trades on the front and back end of the yield curve. One of the first, he claims, was a large Canadian two-year note position worth several billion dollars. Later, he claims, he did other large trades on the U.S. yield curve. Still later, he established an even riskier long-directional position in 10-year U.S. government securities that he claims was effectively a firm position held "over at least five month-ends, some with gains, some with losses." Although the 10-year position grew to approximately \$3 billion, Duthie claims fund investors never saw the variability in profit and loss such an outright long position would normally deliver. Instead, investors only saw the positive carry attributes of being

long a 10-year security yielding 6-plus percent financed overnight at a lower repo rate.

Between December 10, 1999, and year-end, however, Duthie's position began to come under significant pressure. The 10-year notes moved lower on eight consecutive days, followed by a small consolidation near Christmas, and yet another plunge lower on the last trading day of the year. Worse yet, the yield curve was slowly and steadily becoming flatter. A large note position carried on a collateralized basis with major Wall Street firms would typically have triggered several margin calls. The loss on a pre-established \$3 billion note position would have reached approximately \$60 million between early December and Christmas.

By December 31, Duthie says, he was no longer willing to nurse his losing position. He claims that after some fractious words with his superiors, he simply did not come in to work after the long holiday weekend. Duthie claims that Phoenix principals Mark Kassirer and Ron Mock then "tried to throw the entire \$3 billion position on the market during one day's trading and thereby created added losses." In a document released March 9, 2000, Phoenix officials confirmed that \$3 billion in U.S. Treasury securities were liquidated in early January.

When Phoenix announced the initial losses to the public, Duthie attests he was still in Toronto—aghast at what he was reading in the newspapers, but only willing to communicate with his former employer indirectly via an intermediary. On January 6, he left a

somewhat apologetic voice-mail message at the firm, but stopped just short of admitting guilt for having done anything wrong. He then visited the Ontario Securities Commission (OSC), suggesting that it retrieve certain documents from his prior employer to help prove his innocence.

BLAME GAME

The case raises a number of unanswered questions. How much, if anything, did Duthie's superiors know about the fund's trading strategy? Phoenix says it was completely unaware of Duthie's large carry trading. Duthie says it knew everything. "This was a position size in excess of \$3 billion that we were rolling mostly by overnight repo," he explains. "There is no way, in a small office of just 13 people—with the principals of the firm sitting three feet from me—that they did not know the manner in which I was trading."

Another question that emerges is, How could a hedge fund with only \$225 million in total assets ever carry a position of \$3 billion of anything? That kind of massive leverage is well beyond what banks would typically loan to a relatively small hedge fund. Industry sources say, however, that it would have been possible for Phoenix to acquire that kind of leverage if the firm quietly spread its exposures across several different counterparties. If this was the case, the fund would still have had to meet occasional margin calls. Collateral would need to have been moved around or replenished. How would a firm have done

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this if its principals did not know about the position? Were these principals simply not paying attention when Duthie directed these potentially elaborate margin reallocations?

Of course, it is possible to turn Duthie's assertions around. If he was trading in such a large-scale and dangerously leveraged directional manner (counter to the professed tenets of the fund's offering document), how likely would it have been to get all 12 other members of the firm to risk their careers, reputations and invested personal capital on the back of such a trading style?

Another mystery involves the way the firm recorded its profits. How could Phoenix report consistent profits month after month when Duthie himself admits that his large 10-year note bet was held over multiple month-ends—"some with gains, some with losses"? Duthie explains a bit obliquely that although positions were shipped monthly to the Bank of Bermuda for calculation of the fund's net asset value—a process he claims not to have been directly involved in—"the pricing components used were basically inaccurate."

The inadequacies of Phoenix's risk management system that allowed all of this to transpire have also never been fully revealed. According to Duthie, Phoenix used an in-house risk-management system that showed a value-at-risk for all securities, but was "not an all-encompassing snapshot of true exposure." Other sources say that Phoenix's system could handle fixed-date repos of government securities, but could not handle an "open repo" in

which the far-dated tenure of a repo is left without a definitive maturity date. Manual adjustments to the system may have been required to handle these latter types of trades, and an outright purchase of bonds might potentially have been confused with an "open-repo" trade if a trader so represented it. Duthie steadfastly maintains, however, that he had no access to operational systems, and that the daily trading blotter was freely available for review by one of the firm's principals, Ron Mock, at the end of each trading session.

In retrospect, it's not surprising that Duthie ran into trouble at year-end, when repo-trading lines receive more intense scrutiny. "What banks may allow intra-month is different of course from what they would allow on any given month-end or quarter-end," explains one treasury market expert. Banks have long been known to expand their balance sheets between quarterly reporting periods only to reshrink them for cosmetic purposes. Duthie's problems culminated on December 31, 1999, the last day of the quarter and of the trading year—a day when the 10-year note happened to reach its low for the year. Although trade entries or accounting can potentially be fudged, meeting an added margin call without further access to capital cannot.

"Follow the repo," advises one salesman close to the situation, referring to the advice offered Watergate reporters Woodward and Bernstein. "Whoever was doing the repo with Phoenix is likely to know the inside story." Other counterparties may not have been

alarmed by the size of Duthie's trading because they were only seeing one side of a spread or intraday trade. Only in the rollover process might the true size of Duthie's holdings potentially set off alarm bells.

QUIET LIMBO

No lawsuits are currently pending over the matter, and both Duthie and the spokesman for Phoenix Research and Trading say none is currently anticipated between the two parties. While Duthie is reserving a final decision on this until after the OSC report, he claims that "seven different groups of lawyers have all told me that it is very hard to sue anyone for libel in Canada, and the risk/reward will probably not make it worth my while to pursue." On the other side of the equation, Phoenix spokesman Jim Deeks says that Duthie's personal net worth doesn't merit a lawsuit being launched by the fund group, and that Kassirer and Mock simply "want to put the whole affair behind them."

Meanwhile, the OSC is proceeding with its investigation, albeit somewhat slowly. It has requested further information from the firm, and private investors in the collapsed fund are apparently waiting for this OSC report before launching potential lawsuits. The Bermuda domicile of the fund appears to be complicating matters, with the entire situation slowly slipping into a oddly quiet limbo.

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