# U.S. Investors Face An Age of Murky Pricing

## Values of Securities Tougher to Pin Down; Discord at Dillon Read

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Since the invention of the ticker tape 140 years ago, America has been able to boast of having the world's most transparent financial markets.

The tape and its electronic descendants ensured that crystal-clear prices for stocks and many other securities were readily available to everyone, encouraging millions to entrust their money to the markets.

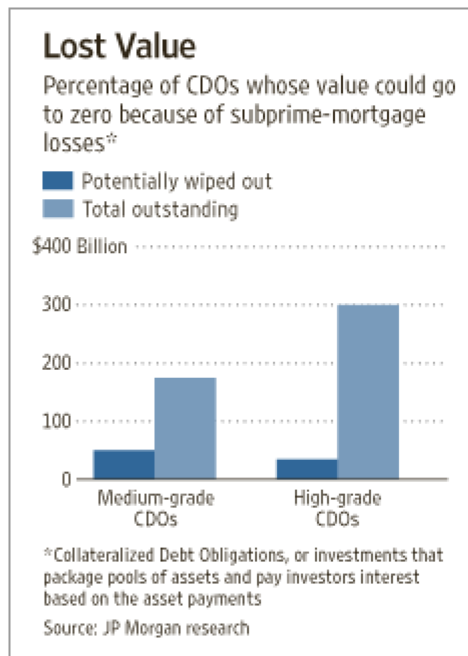
These days, after a decade of frantic growth in mortgage-backed securities and other complex investments traded off exchanges, that clarity is gone. Large parts of American financial markets have become a hall of mirrors.

The hazards of this new age of uncertainty became clear at Dillon Read in March, when rising defaults by homeowners were hammering the value of mortgage securities. John Niblo, a hedge-fund manager at the firm, acted fast. He twice slashed his fund's valuation of securities tied to "subprime" mortgages, knocking them down by about 20%, or nearly $100 million, say traders familiar with the matter.

But managers at **UBS** AG, Dillon Read's parent company, were irate. The Swiss banking giant was carrying similar securities on its books at a far higher price, the traders say. In conference calls, the UBS managers grilled Mr. Niblo on his move. "I'm marking to where I could reasonably sell them," Mr. Niblo responded during one call, according to the traders familiar with the conversations.

UBS later shut down the in-house hedge fund, and Mr. Niblo was let go in August. Last week, UBS announced a $3.7 billion write-down on $23 billion of securities with mortgage exposure, including securities from the shuttered fund.

Such pricing problems have become common in some of Wall Street's biggest markets. The burgeoning universe of complex securities based on mortgages and other assets has turned the once-simple task of getting a price quote into a confounding undertaking.




Today, "way less than half" of all securities trade on exchanges with readily available price information, according to Goldman Sachs Group Inc. analyst Daniel Harris. More and more securities are priced by dealers who don't publish quotes.

As a result, money managers can no longer gauge with certainty the value of some assets in mutual funds, hedge funds and other investment vehicles -- a process known as marking to market. An official at the Securities and Exchange Commission said recently that some bond mutual funds might be using outdated or unrealistic prices to value their portfolios.

The growing uncertainty over what assets are really worth could wreak havoc on the efforts of both individuals and money managers to invest rationally. During this summer's confusion over bond valuations, for example, it was especially difficult to know whether to buy or sell. Investors forced to fly blind sometimes resort to panic selling, which can produce wild swings in the markets.

Billionaire investor Warren Buffett advocates more transparency in pricing. "Some marks can be pretty imaginative," he says. "They call it 'marking to market,' but it's really marking to myth." He says that before funds publish financial statements, they should sell 5% of hard-to-value positions to gauge values.

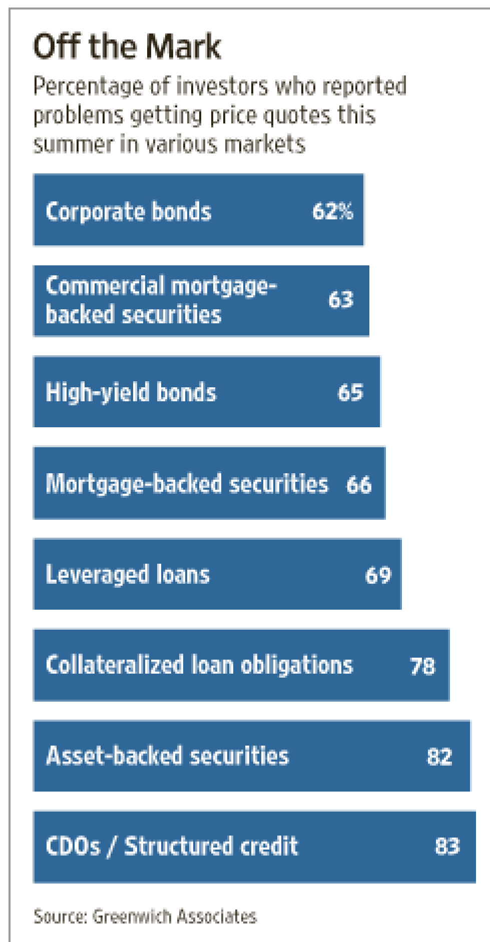
For years, one of the bedrocks of U.S. financial markets had been that clear prices were available to all. When prices went up or down, investors knew it right away, and they could usually figure out why. The credit crunch that struck earlier this year highlighted a danger lurking in markets for newfangled securities: When buyers pull back and nothing trades, investors can be in for unpleasant surprises.

During this summer's credit crunch, more than 80% of investors in bonds tied to the mortgage market said they had trouble obtaining price quotes from their bond dealers, according to a survey of 251 institutional investors by Greenwich Associates, a Connecticut consulting firm.

Sheets listing prices for bonds -- known on Wall Street as the "daily axe" or "daily run" -- are being produced much less frequently these days, even for the most actively traded debt securities. "There is a general reluctance on the part of dealers to be publishing

prices, because it is so uncertain and there is not a lot of liquidity," or ease of trading without large price swings, says Greenwich consultant Timothy Sangston.

Over the years, nonexchange-traded investments have produced plenty of pain for investors. Some go-go mutual funds dabbled disastrously in illiquid investments in the late 1960s and early 1970s; a 19 94 meltdown in the mortgage-securities market toppled Wall Street titan Kidder Peabody; and giant hedge fund Long-Term Capital Management collapsed in 1998 after bad bets on opaque bond markets.




But investing in securities that are difficult to price is far more widespread today. Between 2000 and the end of last year, the market value of bonds outstanding, most of which don't trade on exchanges with readily available prices, rose 75% to $25.2 trillion, according to Citigroup Inc. That's more than triple the 23% growth rate over that period of the DowJones Wilshire 5000 index, which tracks all U.S.-listed stocks. The stocks in that index carried a $17.7 trillion market value at year end.

Losses connected to hard-to-value securities have been piling up. In the past month, eight major financial firms -- UBS, Merrill Lynch & Co., Citigroup Inc., Deutsche Bank AG, Morgan Stanley, Goldman Sachs, Lehman Brothers Holdings Inc., and Bear Stearns Cos. -- disclosed a total of more than $20 billion in write-downs for mortgages, leveraged loans and other assets that have plunged in value. Some said their assets had become harder to value.

Merrill announced last week the largest recent Wall Street write-down -- $4.5 billion for exposure to mortgage-related securities. Two top bond executives were ousted after the firm concluded they had been valuing the firm's holdings too highly.

Michael Vranos, a veteran mortgage-bond trader, recently told investors in his large hedge-fund company, Ellington Management Group, that he was suspending investor redemptions at the end of September because he couldn't figure out values for some of the fund's mortgage-related investments. "There is no way to determine [values] that would be simultaneously fair both to investors redeeming from these funds and to investors remaining in the funds," he wrote in a Sept. 30 letter. A spokesman for Mr. Vranos declined to comment.

J.P. Morgan Chase & Co. analyst Kedran Panageas estimates that 29% of lower-quality "collateralized debt obligations" -- thinly traded investments that package pools of loans -- will eventually lose all of their value due to the recent mortgage shakeout. In the case of quality CDOs, she estimated, 12% will be reduced to zero. The lost value, she says, represents roughly $85 billion of the $475 billion of such securities outstanding. So far, she believes investors have recognized only a fraction of those losses.

Some Wall Streeters have a motive to inflate marks: Their bonuses often are tied to the value of their holdings. A Lipper & Co. hedge-fund manager, Edward Strafaci, earned bonuses of $3.9 million between 1998 and 2001 based on improperly marked convertible bonds, according to the SEC. Mr. Strafaci overstated the value of the bonds he managed, despite warnings from his traders, according to a civil complaint charging securities fraud. The value of a $722 million Lipper hedge fund later was cut in half, and Mr. Strafaci pleaded guilty to criminal securities fraud.

"Everyone has an incentive in the short run to put the best face" on valuations, says Peter J. Solomon, a former Lehman vice chairman who now heads an investment bank. "Their compensation is totally based on it. In securities that don't have ready markets, particularly when the markets are troubled, it makes one totally suspicious."

The SEC is examining how accurately mutual funds and other investors "value their hard-to-value" securities, according to Douglas Scheidt, an associate director in the SEC's division of investment management. The commission is asking funds that get price quotes from Wall Street dealers what they're doing "to satisfy themselves that the quotes they're getting reflect what they could get in a current sale," he says.

Investment funds are supposed to adjust their price marks if they sell assets at a different price level, says Mr. Scheidt. But when turmoil hit the market for subprime-mortgage securities, some funds were either "obtaining quotes that didn't seem to reflect what was going on in the market, or the dealer they had been using stopped providing quotes, yet the funds continued using stale quotes for several weeks," he says. Investors could be misled or harmed if the practice resulted in inaccurate fund values or performance claims, Mr. Scheidt says.

Some investment funds find that the price marks they get from brokers don't match what they get when they sell. In September, Balestra Capital Partners, a New York hedge fund, made a profit of $6.7 million when it sold an investment in credit-default swaps, says Norman Cerk, a Balestra portfolio manager. Yet before the sale, one of Balestra's brokers had provided a much more pessimistic valuation of $2.3 million, he says. "Everything we've sold has been higher than the brokers' marks," he says. Mr. Cerk declined to identify the broker or to speculate on why the discrepancy was so wide.

Methods for gauging shifts in values vary greatly. A bond trader at J.P. Morgan Chase says that bonds he trades are marked sometimes based on an estimate from a third party, particularly if the bonds are actively traded. Harder-to-value securities are marked to "model," he says, which can refer to any number of methodologies, depending on the

security. Other municipal bonds he trades are marked differently if they are considered long-term investments.

Hedge funds, which largely are unregulated, can conduct private sales to each other of hard-to-value securities, just to set prices.

"Even selling a portion of a position can be gamed by getting four or five investors involved to buy each others' positions" at beneficial prices, says Janet Tavakoli, a former trader and now a consultant. Since the recent market turmoil, some traders seem to be trying to set prices simply by offering them for sale, according to some investors who say they've talked to traders. The position is then marked at the "offer" price, these investors say. That's akin to a homeowner valuing a house based on how much he wants for it -- not how much a buyer is willing to pay.

Some financial firms have sought in recent weeks to avoid write-downs by selling mortgage positions to hedge funds, with an agreement that allows the hedge fund to sell them back after a set period. A hedge-fund trader says his firm recently bought $1 billion of risky subprime mortgage loans from Bear Stearns with a one-year pact, known as a "mandatory auction call," under which Bear agrees to participate in an auction for the loans that will provide the hedge fund with a minimum rate of return, according to a person familiar with the situation. "They didn't want the mortgages on their books," the hedge-fund manager says.

Such financial arrangements typically are considered proper if there's an economic purpose to the trade and if risk is taken on by both parties. Legal problems could arise if such trades are part of an attempt to conceal a company's financial picture, regulators say.

Securities regulators also are examining whether financial firms are valuing assets consistently and fairly. Differing valuations have been accepted at some Wall Street firms in some circumstances. For example, some dealers provide "valuation marks" to investors who own bonds outright, and different "collateral marks" on bonds that dealers accept as collateral on loans to investors, traders and investors say. But dealers aren't allowed to assign higher values to securities they themselves own than to the same securities owned by clients.

As the value of some debt securities has collapsed, financial players have struggled to keep pace with the markdowns necessary to reflect plunging prices. When Wachovia Corp. took onto its books this summer a risky slug of a CDO with a $600,000 underlying value, it initially marked the value at $297,000 to reflect the meltdown in the CDO market, according to one person familiar with the matter.

When Wachovia tried to sell the position, which was difficult because of its small size, it reduced the mark even more, to $138,000, this person says. Yet in an email to a potential buyer on Sept. 5, a Wachovia salesman indicated that the bank was willing to sell the position for $30,000 -- just five cents on the dollar. "The head of the group just told me they will hit a 5 cent bid just to move it," the email said.

In the end, the position sold for $60,000, or 10 cents on the dollar, according to the person familiar with the matter, leading the bank to lose $237,000 on the position. The transaction "involved a small position and a very small loss," says a bank spokeswoman.

In August, Thornburg Mortgage Inc. also discovered how unstable pricing had become when it had to liquidate $22 billion worth of high-quality mortgage securities, at a loss of $1.1 billion, to reduce its short-term debt.

Larry Goldstone, the mortgage lender's president and chief operating officer, complains that some Wall Street dealers that were financing his company's activities sold his firm's mortgage securities at fire-sale prices to make sure they were repaid. In some cases, he says, dealers sold AAA-rated mortgage-backed securities at a much lower price than he was able to get for comparable securities at the same time, worsening his company's losses by tens of millions of dollars. "It was panic," he says. "Completely irrational."

For Mr. Niblo, the Dillon Read hedge-fund manager, the problems began early this year. Mr. Niblo managed a portfolio of about $1 billion in CDOs and mortgage-backed securities. By February, rising mortgage defaults by homeowners with poor credit were taking a toll on the mortgage-backed market.

Seeing the turmoil, Mr. Niblo, 47 years old, sought prices from more than a dozen Wall Street dealers, and in April marked down the portfolio of subprime mortgages by about $20 million, according to the traders with knowledge of the situation. Ramesh Singh, a UBS executive, scoured trading positions and asked Mr. Niblo how he was coming up with the prices to re-mark his portfolio, these traders say.

The mortgage-backed market continued to deteriorate. Again, Mr. Niblo sought prices from dealers and marked his portfolio down -- this time by $75 million, the traders say.

A series of tense conference calls followed. Ramesh Chari, another UBS manager, complained about Mr. Niblo's valuations; they were lower than UBS's marks on similar securities, the traders say. He asked Mr. Niblo to explain his decision.

In response, Mr. Niblo asked how UBS could value the securities at a higher level "if we can't sell them at these prices?" according to traders.

Messrs. Singh and Chari declined to comment, referring questions about the matter to a UBS spokesman. The spokesman says UBS doesn't discuss "specifics of the valuation of individual trading books and positions. Obviously the characteristics of securities and the make up of portfolios differ from book to book and there is no single standard valuation model for all securities."

In June, Mr. Niblo was put on administrative leave as UBS sorted out the losses and valuation issues at Dillon Read. Mr. Niblo had priced many of the mortgage-backed securities in the range of 50 to 80 cents on the dollar, while UBS valued similar securities in the 80s, the traders say.

Last week, when UBS announced its write-down, Chief Executive Marcel Rohner said the firm had done the best it could. "We feel that we have applied a prudent valuation" that "reflects the current expectation of what's going to happen."

Still, Mr. Rohner himself highlighted the bigger issue clouding the financial markets. The trouble, he said, arose because UBS had to mark a price on mortgage-related securities "where there is no market price, where there is no trading."

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## What's It Worth?

A new accounting standard adopted this year by most big Wall Street firms gives investors a better idea of which securities can be priced based on readily available quotes and which may be harder to value. Statement 157 of the Financial Accounting Standards Board sets three levels of precision.

### Level 1

Sometimes called "**marking to market.**" The most precise.

**Valuations** are based on "quoted prices in active markets for identical assets or liabilities." Prices appear on computer screens.

**Assets in this category:** Publicly traded stocks, listed futures and options, government and agency bonds, and mutual funds.

### Level 2

Called "**marking to matrix**" by some. Less precise.

**Valuations** are based on "observable market data" for similar or comparable assets, such as dealer-pricing services based on surveys or other market bids and offers. Fewer screen prices.

**Assets in this category:** Emerging-market government bonds, some infrequently traded corporate and municipal bonds, structured notes, some mortgage and asset-backed securities, and some derivatives that don't trade publicly.

### Level 3

Called "**marking to model.**" Involves the most guesswork.

**Valuations** are based on management's best judgment, and involve management's "own assumptions about the assumptions market participants would use in pricing the asset." The process can employ pricing models based on estimates of future cash flows or other formulas.

**Assets in this category:** Some real-estate and private-equity investments, certain loan commitments, some long-term options, and less easily tradable asset-backed bonds.