TIPS v Treasuries: What a wild ride it was!

The TIPS v Treasuries trade has run its course. Our last bonds are coming off of repo on May 20th. Barring a major market move, the trade will be terminated at that point. We held the trade for about five years. What a wild ride it was!

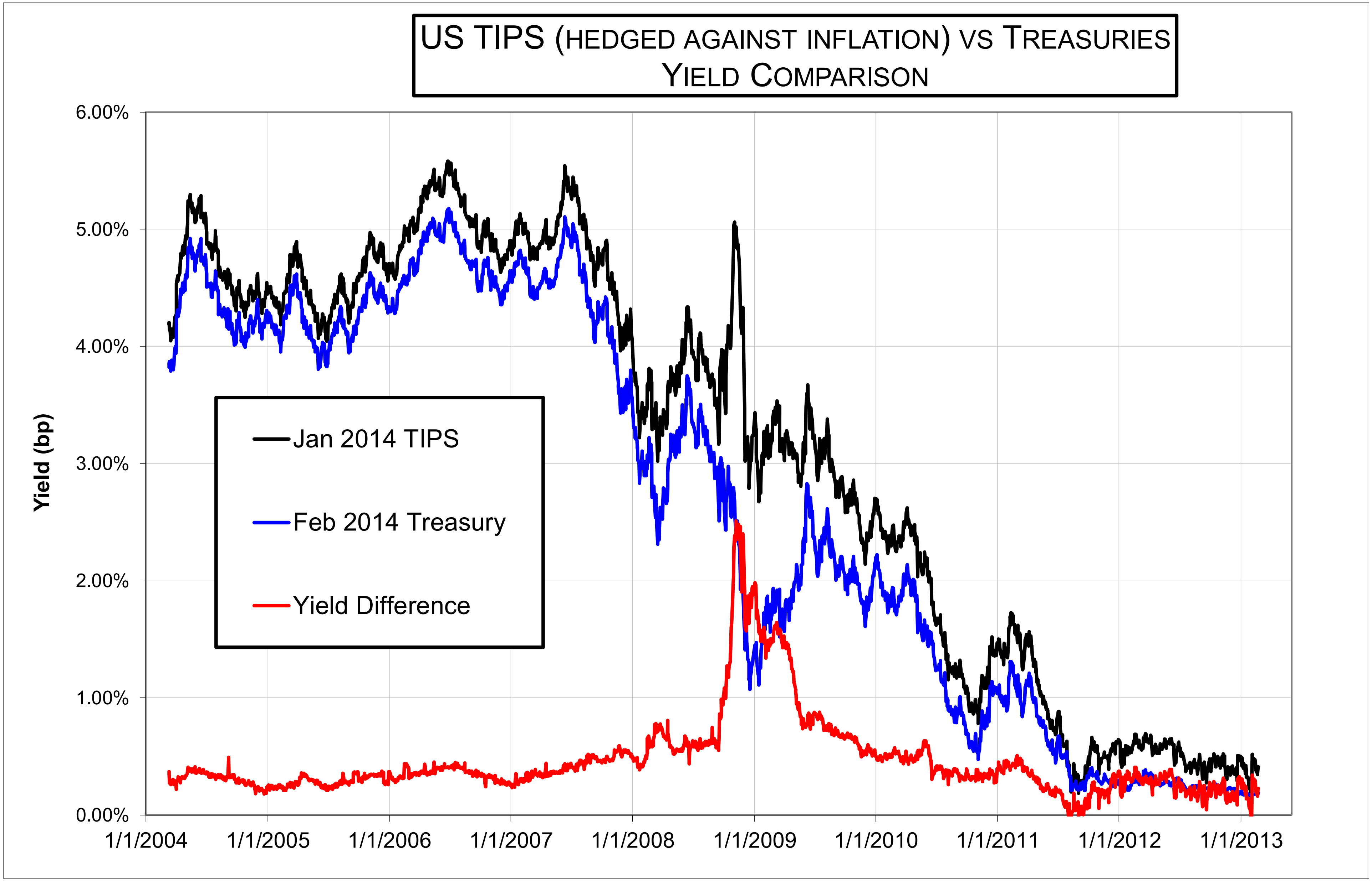
This anomaly was probably our greatest trade ever. At its peak, it was about 250 basis points mispriced (see next page). On a price basis, some of the bonds were mispriced by 20%.

The Financial Times wrote a quartet of articles on this trade highlighting Barnegat and the anomaly
Sept 14, 2010: The Largest Arbitrage ever documented
Sept 14, 2010: Who played the largest ever arbitrage?
Sept 15, 2010: Hedge Funds reap rewards from Treasuries
Sept 16, 2010: Bond Strategy led to big win after Lehman

About two years after the anomaly, some academics wrote a paper about it and termed it "The Largest Arbitrage Ever"

The trade was pretty straightforward. TIPS, once you hedged out their inflation exposure, yielded more than Treasuries. Despite having the same issuer, same credit rating and same maturity, TIPS yielded ~5% and Treasuries yielded ~2.5%

November 7th, 2008	Fixed Rate	Inflation Rate	Cost
Buy Jan 2014 TIPS (Based off of CPURNSA Inflation Index)	Receive 3.74%	Receive Inflation (CPURNSA Index)	-$1,000,000
Receive on Inflation Swap Fixed Rate, Pay Inflation Index	Receive 1.36%	Pay Inflation (CPURNSA Index)	$0
Short Feb 2014 Treasury	Pay 2.56%	N/A	+$1,000,000
Net of 3 Trades	Receive 2.54%	-	$0


US TIPS (HEDGED AGAINST INFLATION) VS TREASURIES
YIELD COMPARISON
Yield (bp)
6.00%
5.00%
4.00%
3.00%
2.00%
1.00%
0.00%
1/1/2004
1/1/2005
1/1/2006
1/1/2007
1/1/2008
1/1/2009
1/1/2010
1/1/2011
1/1/2012
1/1/2013
Jan 2014 TIPS
Feb 2014 Treasury
Yield Difference

TIPS v Treasuries represented all that is Good & Bad about Barnegat

Despite this trade seeming obvious now, it was a scary time after the Lehman Bankruptcy during the Global Financial Crisis. This trade represented all that is good and bad about investing in Barnegat.

As you can see from the graph on the previous page, TIPS always yielded slightly more than Treasuries. Complicated bonds always seem to yield slightly more than simple bonds and that was the case here. Additionally, TIPS are a bit of a tax disaster for tax-paying Americans so that also hindered their demand to some extent. However, the initial mispricing of about 25bp was not sufficient for a trade. When 2008 came around and the world began to look more precarious, the trade started to become more mispriced. With Lehman's bankruptcy on September 15th, 2008, the trade went crazy. Lehman held a lot of TIPS themselves and as a result of Lehman's collapse, all those TIPS had to be sold. However, an even greater factor was the worldwide panic and rush to the safety of Treasuries.

We make money from the non-economic decisions of others

Barnegat profits from the non-economic decisions of others. That can come from panics, manias, government regulation, government interventions, tax problems or any other situation where investors are making decisions based on factors that are not entirely based on the economics of a trade. Barnegat, by its nature, focuses purely on the economics of our trades. In the TIPS v Treasury chaos, the world panicked and despite TIPS and Treasuries being the same product once you hedged out the inflation portion of TIPS, the demand for the perceived safety of Treasuries trumped all other considerations. We were able to monetize that panic.

Timing our trades is not our strength. The path can be brutal.

Despite this trade probably being our greatest trade ever, this has not been our most profitable trade ever. Our average entry point on this trade was a 1.25% yield difference between the TIPS and the Treasuries. As you can see from the graph on the previous page, the mispricing went all the way to a difference of 2.50%. We lost a lot of money initially. I told investors that we had "great opportunities" in the summer of 2008 and that eventually proved to be correct (our share price in the summer of 2008 was just under 3, our current share price is about 9), but the path was a brutal one. We lost a lot of money in the 45 days after the Lehman bankruptcy before we were able to enjoy all those profits.

We had sufficient safeguards to hold the trade

Fixed Income Arbitrage is great over the long haul, but it is also most famous for going bankrupt (Long-Term Capital, Park Central, etc). The big caveat to Fixed Income Arbitrage is always- You can find the trade, but can you hold the trade? Receiving 5% on one US Government Bond and paying 2.5% on another US Government Bond with the same maturity is an obvious winner, but many hedge funds went bust in 2008 because they were unable to hold their trades to fruition.

Safeguard 1: We hold about 50% of our fund as unencumbered collateral, precisely for situations like this. At our low point (end of October 2008), we still held 36% of our fund as excess collateral. We were able to hold this trade through the chaos. Despite entering the trade way too early and suffering initial losses as well as losses from other trades around the world, our collateral was sufficient to maintain our positions.

Safeguard 2: By 2008, Barnegat had been in business for eight years. At every possible opening (just as I am trying to achieve here), Barnegat took the opportunity to try and educate our investors, describe the positions, and be clear on the nature of Fixed Income Arbitrage. We gave money back to investors three separate times from 2005 to 2007 as opportunities lessened. When the world imploded in 2008, I was worried how our investors would react, but it worked out perfectly. This is one of the items I am most proud of. I went to investors and told them that we had 'great opportunities' and they were interested in investing more. Barnegat had net investments in 2008.

Safeguard 3: When you negotiate an ISDA (the governing document for derivatives) with a counterparty, they begin by sending you a proposal that says if you lose 15% in 1 month, 25% in 3 months or 35% in a year, they have the right to close you out of your position. Our documents have clauses of 20% in 1 month, 30% in 3 months or 40% in a year. That is a slight improvement, but not a huge factor. The big advantage we had over our competition was that if the counterparty wanted to terminate us, it would have to be at mid. Standard ISDAs detail how the counterparty can unwind your trades at their side of the market. This is an invitation for profit for the market maker. They can declare where the "bid" is and sell to themselves at insane levels. Most of our hedge fund competition got destroyed in this fashion in 2008. We hit the triggers, just as most others did in 2008, but no one wanted to close us out at mid. In a perfect example, a huge American bank came to us in 2008 and said that they had looked through all of their ISDAs and they had only given this clause away twice in their history. Barnegat had a huge advantage over the market in that sense.

Long-Term Outlook-Not much competition for trades that take years to sort themselves out.

When we initiated the TIPS v Treasuries trade, some people would ask, "What is going to be the catalyst that turns this around? Treasuries will always be viewed as the safer security". When Barnegat trades, we are not looking for a catalyst or a trigger for the trade to snap back. We were perfectly happy receiving 5% and paying 2.5% on our notional for no cost upfront. We were content to hold this trade until maturity. I think this is a large competitive advantage over our competition. We are not the only ones who find these trades, but I think we have almost no competition for these trades that take years to sort themselves out.

The Barnegat Fund

I am very proud of what The Barnegat Fund has done for the last thirteen years. Bloomberg ranks us as the #1 Fixed Income Arbitrage/Relative Value fund on the planet for that time period. We have a compound rate of return of 19.6%/year as our share price has gone from 1 to 9. However, Fixed Income Arbitrage is not for everyone. We need smart, long-term investors that understand fixed income trading. The 45 days after Lehman's bankruptcy in 2008 were the toughest 45 days of my life, but with sufficient safeguards in place, Barnegat was able to thrive and profit as the competition departed and opportunities remained.