THE WALL STREET JOURNAL. ONLINE

June 17, 2008

PAGE ONE

Shakeout Roils Hedge-Fund World

Big Firms Gain Clout as Field Matures; Parking the Maserati

By GREGORY ZUCKERMAN
June 17, 2008

The hedge-fund business -- among the most reliable fortune-producing machines in recent years -- is going through a brutal shakeout.

Just a few years ago, traders found it relatively easy to quit Wall Street jobs, hang out a hedge-fund shingle and cash in. Investors beat down the doors with eagerness reminiscent of the late-1990s dot-com frenzy. It took only a decade for the industry to grow to 8,000 funds from a few hundred.

HEDGE CLIPPING

• **What's Changing:** After years of rapid growth, the hedge-fund business is maturing -- and smaller funds are taking the hit.
• **The Backstory:** Investors view larger firms as safer amid market turmoil, and more service-oriented.
• **Big Picture:** Some funds are so huge, they now behave more like traditional investment banks.

But now smaller hedge funds, including top performers, are shuttering, and even brand-name traders are finding it tougher to get new ones off the ground. Only 1,152 new funds were launched in 2007, down almost 50% from a 2005 peak, according to Hedge Fund Research Inc. Because so many funds closed last year or merged into others, the business expanded by just 589 funds overall, the smallest increase in six years.

The next test: The possibility of a wave of withdrawals at the end of this month, the next quarterly date on which many investors are permitted to pull out their money. The inflow of new money from investors has already been slowing during the past two quarters. At the same time, hedge-fund returns have been flat, adding to the pressure.

Managers of hedge funds -- private partnerships that cater to wealthy individuals and institutions and are less regulated than, say, mutual funds -- like to think of themselves as a unique breed, capable of racking up big profits from opportunities that ordinary investors overlook. But in fact their profession is tracing the path of other businesses, whether autos or computers, that enjoyed rapid growth, led by aggressive entrepreneurs, before confronting deep challenges. And just as, say, eBay Inc. and Yahoo left rivals in the dust, or Vanguard Group and Fidelity Investments came to dominate the mutual-fund world, the largest hedge funds, such as **Och-Ziff Capital Management**, D.E. Shaw & Co. and Paulson & Co. are pulling away from the pack.

By the end of last year, 87% of all the money in the business was handled by funds managing $1 billion or more, and 60% was held by managers sitting on $5 billion or more. The dominance by the largest funds has been accelerating: In the past two months alone, the world's largest public hedge-fund company, Man Group PLC, increased assets by $4 billion, to $78.5 billion.

The shift is helping the big funds play a more powerful role in shaping the business and financial landscape. Last month, for example, Carl Icahn's fund, Icahn Associates, launched a bitter fight with Yahoo Inc. to try to gain control of its board. His hope is to entice Microsoft Corp. to revive its interest in buying Yahoo. Although that looks increasingly unlikely, it would theoretically yield a payday of hundreds of millions of dollars for Mr. Icahn's firm.

The megafunds increasingly behave more like sprawling investment banks, replete with layers of management, rather than swashbuckling investment vehicles. Some funds even have started offering basic corporate loans, a field traditionally left to regular banks.

A big difference with the banks: Hedge funds make much fatter paydays. Jim Simons of Renaissance Technologies, Steven Cohen of SAC Capital and Kenneth Griffin of Citadel Investment Group all earned at least $1 billion last year.

Sterling Credentials

The transformation of the hedge-fund business caught Bertrand des Pallieres off guard. For years, Mr. des Pallieres cashed hefty paychecks as a top trader at J.P. Morgan Chase & Co. and then at Deutsche Bank AG, before leaving last year to launch a hedge fund of his own. He had sterling credentials -- and a terrific running start: Deutsche Bank indicated it would invest hundreds of millions of dollars with his new firm, SPQR Capital LLP, according to Mr. des Pallieres.

He rented swanky office space in London's upscale Mayfair district and dangled generous pay packages to staff his fund. Mr. des Pallieres got so distracted launching the business that, last summer, he forgot to pay the parking bills on his $160,000 blue Maserati Cambiocorsa. The coupe was impounded for three months before he noticed.

Mr. des Pallieres set lofty goals for his fund. "We thought a billion dollars was a good figure to count on," he says. But just over a month ago he shelved the project and fired half his staff. Deutsche Bank had second thoughts about becoming an investor, Mr. des Pallieres says, and he couldn't find other takers.

Deutsche says it never committed to making the investment.

Today, Mr. des Pallieres has a more modest goal of investing smaller sums in infrastructure assets such as ports and bridges, a longer-term play. "You benchmark yourself against the firms that started two or three years ago, and you get depressed," he says.

On the winning side are goliath funds run by money managers like Daniel Och. The 47-year-old Mr. Och, who left Goldman Sachs in 1994 to launch Och-Ziff, made $1 billion last year when his firm went public. While the general perception is that successful hedge funds post eye-popping gains, that's not his selling point. So far this year, none of his funds have gained more than 1.2%, though he is still beating the overall market.

When Mr. Och meets potential investors, he emphasizes his firm's risk-management skills, including a track record that includes only 20 losing months in its 15 years. Over the same period, the S&P 500 has had 59 losing months.

Investors like the sound of that. Och-Ziff managed $33.3 billion at the end of the first quarter, up 30% from a year earlier. Investors "particularly appreciate how we preserve their capital" in market dips, Mr. Och says.

Indeed, simply racking up top returns isn't enough in the current mood. Xerion Capital Partners LLC scored compounded annual returns averaging 21%, after fees, in its five years of existence. Nevertheless, last year its founder, Daniel Arbess, saw that large institutions such as pension funds and endowments were getting reluctant to put in new money. They told Mr. Arbess they wanted to see a bigger client-service team and that Xerion, with several hundred million in assets, was simply too small.

So in October, Mr. Arbess sold his firm to much bigger Perella Weinberg Partners, a $3 billion firm formed by banker Joseph Perella. Now, institutional investors are once again showing interest.

"The bar has gone up, it's tough to manage $250 million to $500 million," says David McCarthy, a 20-year hedge-fund pro. He recently shuttered his own fund, which invested in other hedge funds, even though its returns topped the market last year. The reason: Investors kept telling him the $300 million firm was too small.

Pressures like these reflect the changing nature of hedge-fund investors themselves. Traditionally, the investors were wealthy individuals seeking the hottest funds with the biggest returns. Pension funds often were wary, viewing hedge funds as risky.

Now, however, institutional investors are changing that view. Pensions, charities and endowments increasingly are investing in hedge funds in part because of the potential to make money even in a down market. (The funds attempt to do that by making bets on both rising and falling prices.) However, institutional investors tend to prefer larger funds with brand-name recognition, and avoid scrappy upstarts.

"We used to be more hesitant to give money to large funds, the fear was they wouldn't perform as well as others, but that hasn't been the case lately," says Brett Barth, who helps run BBR Partners LLC, a $4 billion New York firm that invests in hedge funds. That said, the larger the hedge funds get, the tougher it likely will be to stay nimble and generate outsized returns.

Despite the tougher environment, hedge funds remain an extremely lucrative business. Most charge investors a management fee of least 1% of assets invested, then 20% of any gains.

Overall, the $1.9 trillion hedge-fund industry is holding up. The average fund is flat this year, through May, according to Hedge Fund Research. That beats the decline of 3.80% in the Standard & Poor's 500 in that period, though it's below the gain of 0.94% in the Lehman Brothers bond index. Last year, the average hedge fund gained 10%, compared with returns of 5.5% for the S&P 500 and 7.8% for the Lehman index.

But because of their fee structure -- which includes a percentage of gains -- many funds find it hard to pay their employees if they can't generate gains.

At the same time, the debt-market turmoil of the past year has undermined a key hedge-fund investing strategy. Until recently, funds routinely amplified their returns by investing lots of borrowed money. However, as bank lending has tightened, that strategy has taken a serious hit. Smaller and newer funds are having the most trouble arranging this kind of borrowing.

Widening Gap

The more challenging market conditions mean the gap between winning and losing funds is widening. Last year saw the widest divergence between top-performing funds and bottom-performing funds in more than five years, according to Hedge Fund Research. The top 10% of funds scored gains averaging 62% last year, while the bottom 10% had losses of 14%.

Brad Alford, who once picked hedge funds for Duke University's endowment and now runs Alpha Capital Management, LLC, an Atlanta financial-services company that caters to wealthy individuals, says he is placing fewer clients in hedge funds. That is partly because there has been a rush of competitive products, such as low-cost mutual funds that try to act like hedge funds.

"We used to invest in hedge funds because we got stocklike returns with bondlike volatility," Mr. Alford says. "Now we're getting bondlike returns with stocklike volatility." Another reason he's turning away from hedge funds is tax-related: Short-term profits from hedge funds are taxed at a 40% rate, which is higher than taxes on long-term trading gains from other kinds of investments.

Pushback From Investors

Mr. des Pallieres, the founder of SPQR Capital, didn't expect so much pushback from investors. He had been in a division at Deutsche Bank that had anticipated -- and therefore profited from -- last year's mortgage-market crisis, and imagined there would be rich investment opportunities in the aftermath. So last year he rushed to launch his own hedge fund.

Deutsche Bank's interest in his firm gave him confidence, he says. Early meetings with other potential investors also seemed positive.

By last fall, however, the outlook darkened. He read a news report that the Deutsche Bank executive he was negotiating with had left the bank. It soon became clear that the big German bank wasn't going to ante up.

"Deutsche Bank invests in hedge funds and other investment vehicles whenever we think the opportunity is attractive," a bank spokeswoman said.

Executives at other banks still seemed interested in investing in his fund. Until, that is, Mr. des Pallieres realized that some of them were suddenly fighting to keep their own jobs, rather than focusing on his hedge fund.

"People kept getting fired" in the middle of negotiations, Mr. des Pallieres recalls.

To boost morale of his staff, he told employees he was confident investors would turn up. But Mr. des Pallieres was spending as much as $1 million a month keeping the firm operating. Then, in January, when fellow London-based hedge fund Peloton Advisors suffered billions of dollars of losses in a matter of days, his remaining investors backed out.

Mr. des Pallieres and his girlfriend went to a resort on the Maldives for a week's vacation, trying to figure out what to do. When he returned, he called a meeting for the firm's employees, telling them he wasn't willing to fund the business anymore.

Mr. des Pallieres is refocusing the firm on the narrower business of investing in infrastructure assets such as bridges. He's also cutting his expenses. But he's hanging on to the Maserati. "It's not that bad," Mr. des Pallieres says.

Write to Gregory Zuckerman at gregory.zuckerman@wsj.com[1]

URL for this article:
http://online.wsj.com/article/SB121364877315978651.html

Hyperlinks in this Article:
(1) mailto:gregory.zuckerman@wsj.com