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Hedge Fund Glory Days Fading Fast

By LOUISE STORY

Making millions — or even a few billion — by managing a hedge fund has been a running dream on Wall Street in recent years. But suddenly even the masters of this $2 trillion universe are falling on hard times, at least by their own gilded standards.

Hedge funds, those secretive investment vehicles for the rich and, increasingly, the not-so-rich, are supposed to make money whether markets go up or down. But many of them are being swept up in the turmoil in the financial world.

The funds' investment returns are sinking, and so are those big paydays for their managers, whose riches have helped redefine modern notions of wealth and helped drive up the price of everything from Picassos to Manhattan penthouses.

Several big funds have faltered in recent weeks, some of them spectacularly so. While many funds are still flying high, the average hedge fund has lost more than 4 percent this year, according to Hedge Fund Research, putting the industry on course for its worst year on record.

The dimming fortunes of the industry have implications far beyond the rarefied world of hedge funds. Over the last decade, the size of this industry grew fivefold, as public pension funds, corporate pension funds and university endowments poured billions of dollars into these vehicles, in hopes of market-beating returns.

A prolonged downturn might prompt some investors to rethink these investments or demand lower fees from managers, who typically collect annual management fees of 2 percent and then take a 20 percent cut of any profits. Trouble at hedge funds also might draw government scrutiny, given the amount of pension money sitting within these unregulated firms.

"Everyone is looking for a panacea, everyone is looking for a quick way to make money fast, and everyone is pinning their dreams on the backs of these hedge funds," said Dan McAllister, the treasurer and tax collector of San Diego County, whose pension fund lost money when a hedge fund called Amaranth collapsed two years ago. "But maybe it's time to be a little cautious, and it's time to look at things with a more discreet eye."

While big hedge funds have blown up in the past, and many small ones fail every year, the current problems are more far-reaching than in the past.

Fund after fund is warning investors that the markets have become increasingly difficult to predict. They are having a tougher time making money now that Wall Street banks like Lehman Brothers, which is in an all-out fight for survival, have reduced the amount of money they are willing to lend to the funds in order to safeguard themselves.

It is now 5 to 10 percent more expensive for hedge funds to borrow from banks than it was a year ago, and banks are increasingly hesitant to lend to hedge funds for long periods.

In recent weeks, several funds have closed, most notably a fund run by Ospraie Management. Rumors about troubled hedge funds like Atticus Capital have unsettled the broader markets.

"I think we're seeing what these hedge fund managers really, truly are," said Robert Discolo, head of hedge fund strategies for A.I.G. Investments, an asset manager within the insurance giant A.I.G. "And some of them really can't make money in a difficult environment."

Already, hedge funds are planning for harder times ahead. Fund managers are planning to slash employee bonuses in December, according to study to be released this week by Glocap, a hedge fund recruiting firm.

"This is probably one of the worst years for performance of hedge funds — it's been a bloodbath," said Adam Zoia, chief executive of Glocap, which began tracking hedge fund compensation in 2001 and has never recorded a down year until now.

The worst hit are funds that bet on events like mergers, companies' stock prices, bonds and those that missed the turn in the price of oil. Only a few strategies are up, like macroeconomic funds and funds that short — or bet against — stocks, according to Hedge Fund Research.

Granted, hedge fund managers are still making a lot of money compared with average Americans. People who have worked at hedge funds for two to four years are expected to receive bonuses of $174,583, Glocap's study found. Employees with a few more years of experience are likely to receive $393,333.

Those figures are down 16 percent and 19 percent, respectively, from last year.

Things could get worse. Some recruiters are keeping watch lists of troubled hedge funds. Heidrick & Struggle, a recruiting firm, has 100 hedge funds on its watch list and expects 50 to 80 to fail in the coming months, said Tim Holt, the partner who oversees the firm's Wall Street recruiting.

The longer the industry as a whole stumbles, the more investors are questioning some of its rules of the road. The term “hedge funds” is really a catch-all for investment firms that employ a wide variety of strategies with varying levels of experience and risk management.

Most large pension funds and institutional investors have put the brakes on their hedge fund investments this year. New money invested in hedge funds in the first half of this year was just under $30 billion, a far cry from the $118 billion raised in the first half of 2007, according to Hedge Fund Research.

Some of the young people who flocked to the hedge fund industry have begun to doubt its future.

Jonathan Weiss quit his job at Glenview Capital, a large hedge fund in New York, in January, despite earning a large bonus last year. He said he did not like the way the industry was moving away from its entrepreneurial roots.

His friends called him crazy. “They called me up wondering why was I walking away from this supposed golden ticket,” Mr. Weiss, 28, said. “It’s because I knew it wasn’t a golden ticket.”