January 18, 2009
Hedge Funds, Unhinged

By LOUISE STORY
Chicago

LAST summer, Kenneth C. Griffin and his wife, Anne, hedge fund managers both, were so rich that they did something most wealthy couples don't do until much later in life.

Still in their 30s, they hired a Ph.D. student in economics to help dole out their money to charities.

Fast-forward six months, and Mr. Griffin, who built the Citadel Investment Group into one of the largest hedge funds in the world, has seen the value of his funds plunge by roughly $10 billion — one of the biggest amounts lost in the hedge fund carnage last year.

He was down 55 percent while the average fund was down 18 percent. For Mr. Griffin, it is a failing as personal as they come. Sitting back in his chair, gazing uneasily at the skyline here, he points to a new patch of gray hair when asked about the toll of his losses.

"Last year was a dramatic year for the world's largest financial institutions," he says. "We were not immune."

Mr. Griffin has basked in praise — whiz kid, wunderkind, the next Warren Buffett — ever since he began trading from his Harvard dorm room 20 years ago and then moved to Chicago to start his hedge fund. In recent years, his firm handily took in more than $1 billion annually.

But now, the whiz kid has lost so much money that it is unclear whether he can make it all back. That reality is playing out among thousands of troubled hedge funds drowning in losses.

Two out of three hedge funds lost money last year, and according to agreements with investors, their managers are supposed to recoup all losses before they start skimming fees from their profits again. That could take years.

And it's unclear whether these traders, so accustomed to flush times, will stick it out long enough to make investors whole again.

Their decisions will reverberate beyond Greenwich, Conn., the New York suburb that is a haven for hedge fund honchos. Pension funds, endowments and charities — not just wealthy individuals — all invest in hedge funds.

Assets held by hedge funds surged to nearly $2 trillion as of the start of last year, from $375 billion in 1998, according to estimates from Hedge Fund Research, a Chicago firm. Along the way, hedge funds — once so few in number that they represented a boutique industry populated by a rarefied group of specialists — sprang up like kudzu.

Today, there are around 10,000 hedge funds, compared with around 3,000 a decade ago and just a few hundred two decades ago.

Little other than money unites hedge funds, which invest in areas as varied as bonds, aircraft and small-business loans. They even make bets on the weather.

What they have in common are lucrative fees: managers typically charge 20 percent of profits and 2 percent of total funds under management — the latter of which they earn regardless of performance.

The wealth and power of hedge funds, and those handsome fees, were predicated on what now sounds like a hollow promise: to make money year in and year out.

But the years of easy money are over.

Banks, pinioned by their own enormous mistakes and the economic slump, have cut back on hedge fund lending — essentially turning off a financial spigot that the funds relied upon to goose their returns.

Economic uncertainty makes it harder to predict market movements. And investors, burned by big losses in 2008, are either questioning hedge fund fees or simply avoiding putting more money into the funds.

The regulatory vise, meanwhile, is tightening around an industry that long enjoyed the freedom to trade and operate without the constraints imposed on more traditional firms.

On Thursday, Mary L. Schapiro, Barack Obama's nominee to head the Securities and Exchange Commission, said during a confirmation hearing that she plans to more tightly regulate hedge funds as part of an effort to "bring transparency and accountability to all corners of the marketplace."

Lawmakers are already considering new taxes and regulations that would require hedge funds to disclose more information about their secretive trading strategies.

Add it all up, and managing a hedge fund looks much less attractive than it used to.

"The magnitude of this current crisis and its effect on their business was a real shock for hedge fund managers," said William N. Goetzmann, a professor who studies hedge funds at the Yale School of Management. "It will be a long-lasting effect because it's caused customers to question the basic model."

Mr. Griffin, fiercely competitive, says he is firmly in the camp of those trying to stay open. But he acknowledges that for several years, he will be working mostly for "psychic income."

NOT everyone is rooting for Citadel. Call up nearly any hedge fund manager, and you will hear the stories about Mr. Griffin, now 40, poaching workers, landing a trade on the cheap and stalking wounded peers for deals. Mr. Griffin declined to comment on such stories.

His aggression has earned him admirers but has also created enemies. In the low-profile hedge fund industry, people shuddered at his brash claims that Citadel would become as powerful as investment banks like Morgan Stanley and Goldman Sachs.

His firm has become the fortress that many would love to see broken. Mr. Griffin knows that, but he chalks it up to his success. “Over the last 10 years we have been innovative and bold,” he says.

But in July, his magic touch deserted him. After reviewing the trading books at Kensington and Wellington, the two largest funds that Citadel manages, he decided to trim some holdings while bolstering an asset class he had traded since his early days: convertible bonds.

But the value of convertibles plummeted as banks, large issuers of such shares, went into a tailspin after the collapse of Lehman Brothers, the venerable investment bank.

Citadel made another large bet that the gap between corporate bonds and insurance bought on those bonds, known as credit-default swaps, would narrow. In essence, Mr. Griffin was betting that the economy would strengthen and that the price of insurance on debt would cheapen.

Others in the industry backed away from that particular gambit. Paul Touradji, who runs a fund associated with the veteran trader Julian Robertson, said his own digging indicated that more people would need to sell their bond positions than the number that were likely to buy in.

Still, Mr. Griffin stuck to his guns, even as his funds fell 16 percent in September. The loss put Citadel in the spotlight and generated speculation about its survival.

One day, the rumor was that Federal Reserve officials were trolling his Chicago headquarters; the next, that his funds were selling off troubled assets, or that banks were pulling credit. (Federal Reserve officials did in fact check up on Citadel. But since last spring, such inquiries have become routine at all large financial institutions. The other rumors were unfounded.)

Mr. Griffin says Citadel came under attack because it was a large and easy target — not because it was about to collapse.

By late October, Citadel was fighting for its life. At the end of the month, its funds were down an additional 20 percent and nearing 40 percent losses for the year. Mr. Griffin met with all of his employees and held a public conference call to reassure the world about Citadel’s financial footing.

Mr. Griffin calls that period “surreal” but says he never went to bed worried that Lehman’s fate would become his own. The difference with Citadel, Mr. Griffin says, is financing. He says he has arranged for credit lines at dozens of banks with durations as long as a year, buying him time. “Any firm that is a lasting, permanent institution goes through rough times,” he says. “In three years, they’ll write the story about how we came back, much like Goldman Sachs came back after 1929.”

Citadel, in fact, is different from many hedge funds that specialize only in trading. Mr. Griffin reinvested profits over the years into new service-based businesses. The management company, which is controlled solely by Mr. Griffin, also owns a firm that provides administrative services to other hedge funds, as well as the Citadel Derivatives Group, a major player in the options and stock markets. And Citadel recently hired a former Merrill Lynch executive to build a capital markets business, a mainstay of investment banking.

“Citadel is a diverse platform,” says Matt Andresen, who runs the Derivatives Group. “Our clients do not interact with the asset management side of the firm, and they’ve come to know us in an entirely different capacity.”

Mr. Griffin has full discretion over how much money he uses to subsidize his struggling funds. Last year, Citadel shouldered some of the funds’ operating costs, which are known to be among the largest in the industry.

At the same time, though, Citadel blocked investors in its two troubled hedge funds from withdrawing money at the end of last year. The company has told investors that they might be allowed to withdraw money at the end of March.

Mr. Griffin explains these decisions by saying that “it was the right thing to do,” because withdrawals by some investors might have disadvantaged other investors who remained in the funds. Citadel also canceled its holiday gathering because it was not “right,” he says, to celebrate last year.

But right and wrong in hedge fund land is a matter of debate. Industry veterans have been loudly criticizing fund managers who blocked investors from retrieving money. Leon Cooperman, for instance, who runs Omega Advisors, is suing another hedge fund, contending that it didn’t allow him to make withdrawals; he said his own fund would never block redemptions.

“You’d have to lower me into the ground before I’d put up a gate,” Mr. Cooperman says. “Clients deserve to be able to withdraw their money.”

Orin Kramer, another hedge fund manager, who also helps oversee the New Jersey pension fund, says that what bothers him most is that managers who are freezing their funds are still charging 2 percent management fees on money they have trapped.

“It’s like telling someone at a hotel that they can’t check out and then charging them for the privilege of staying,” Mr. Kramer says.

IN November, five of the country’s richest hedge fund managers filed solemnly into a Congressional hearing room to be grilled by lawmakers.

They made up a Who's Who of their industry. In addition to Mr. Griffin, the group included James Simons, of Renaissance Technologies; Philip A. Falcone, an activist investor who has bought a large stake in The New York Times; John Paulson, who earned billions of dollars betting against mortgages before the crisis; and George Soros, the Hungarian trader who rode to fame on prescient currency trades in the early 1990s.

Unlike banks or brokerages, hedge funds do not have to reveal information on their financial condition to the government. That means the government has no way to know the value of funds' assets, how much money they borrow, or even how many funds there are.

For years, the industry has argued that hedge funds should be allowed to operate under the radar because they serve sophisticated investors.

But by November, it had become apparent that too many hedge funds, crammed into too many of the same trades, had been forced to sell — and that they did not operate in some distant universe. Like mutual funds, they can roil the markets.

At the hearing, four of the managers surprised lawmakers and their peers by saying that more regulation of their business was needed.

Mr. Griffin was the lone holdout. He argued for private market solutions, but as the hearing proceeded, he conceded that he would "not be averse" to greater disclosure to the government, provided that it was not made public. He says now that he is working on providing more transparency to his investors.

Lawmakers proclaimed the day a victory.

"I believe there's been a near-consensus that hedge funds can cause systemic risk," said Representative Carolyn B. Maloney, a Democrat from New York and a member of the House Financial Services Committee.

Even without government intervention, the days of working behind a curtain may be ending. Investors are already demanding more information about hedge funds' operations.

Eiichiro Kuwana, president of Cook Pine Capital, a firm in Greenwich, Conn., that helps wealthy people invest in hedge funds, says that investors once had so much money to invest that they became less circumspect — with many of them investing in hedge funds that refused to provide much information.

No longer.

"Why would I trust a fund with my money if they won't trust me with information?" Mr. Kuwana says.

HEDGE FUNDS tend to close by choice; outright collapses are less common. Sometimes banks pull funds' credit lines and managers are forced to shut down. But by and large, the end comes when a manager no longer sees a financial upside for himself or herself.

Few funds have actually shut their doors. The number of funds peaked early last year at 10,233, according to Hedge Fund Research, and fell just 4 percent during the year. And they still manage $1.6 trillion.

Of the funds that lost money last year, the average loss was 29 percent, according to estimates from HedgeFund.net, a research firm. It will take a few years of fairly robust gains — no easy feat in these markets — for funds to simply recoup those losses.

Until then, managers would earn only their 2 percent fee, chump change to most hedge funds. Some managers are already paying talented employees out of their own pockets to persuade them to stay, but it's apparent that surviving this turbulence isn't in the cards for scores of funds.

Mr. Touradji of Touradji Capital was one of the few managers to make money last year, up 13 percent. He says that most firms that call themselves hedge funds never really deserved the title.

"There's any number of good violinists, but how many people are good enough to be considered to conduct the Philharmonic?" he says. "The whole concept of hedge funds was always and still is this very high bar, that you were never allowed to say it was a tough market. Come rain or shine, you were supposed to do well — even in tough markets."

But he predicts a slow death for the poseurs. Hedge fund managers, he says, may behave like restaurateurs who keep the doors open long after losses mount, largely because they don't want to work in someone else's kitchen.

For his part, Mr. Griffin is not likely to be job-hunting any time soon.

While there is no way to calculate his net worth, it is thought to be at least hundreds of millions of dollars. In May, a monument to his riches will be unveiled at the Art Institute of Chicago. He and his wife donated $19 million for Griffin Court, part of a new modern wing that connects the museum to Millennium Park. And they are hoping they will have plenty of money for their Ph.D. graduate to give out by 2010.

As for Mr. Griffin's troubled hedge funds, their survival will pivot on successful trading — they are up 6 percent this year — and on his willingness to use Citadel's other units as a safety net.

Whatever happens, Mr. Griffin says he can handle the shakeout in the hedge fund industry. "It's going to be fairly significant, " he says, then pauses and grins. "It's part of capitalism."