Where the Money's Really Made

Hedge funds are raking in hundreds of billions while you're losing your shirt. Is this the next bubble?

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Across this quiet, snowy field, through the trees and over the fence, lurks a Wall Street monster. The locale is Westport, Conn., about a mile inland from Long Island Sound across I-95. The beast within those stark walls is Pequot Capital, a superpowerful $7 billion hedge fund that along with a dozen or so other mega--hedge funds--many sprinkled among towns nearby--is rocking mainstream Wall Street to its core. Here in Fairfield County, the richest county in the richest state in the richest country in the world, vast fortunes are being created, and rules of finance are being rewritten.

Don't for a minute think that this doesn't apply to you. The hedge fund boom has sweeping implications not just for Wall Street traders and a few thousand well-heeled investors, but increasingly for every American businessperson, investor, and retiree.

You know the $7 trillion--plus of stock market value that has evaporated over the past three miserable years? Well, guess what: The money didn't simply disappear. Some folks, often short-sellers at hedge funds, profited mightily from the decline. Nothing wrong with that. A hedge fund is supposed to make money in markets bull and bear. Some of the best did exactly that, first riding the bucking-bronco bull of the 1990s and then shorting the market on its steep, treacherous descent. By some guesstimates (as Carol Loomis writes in the story that follows, the data can be sketchy), hedge funds have outperformed the S&P 500 as well as the average equity mutual fund by substantial margins over the past five years. One hedge fund monitor says the group has beaten the S&P by an astounding seven percentage points per year on average since 1998.

Such tantalizing performances have made even cynical investors salivate. Today, with stocks so weak and bond yields so low, hedge funds are Wall Street's last great game, it seems. Even so, the major players are people you've never heard of, who work for firms that few people know, who run billions of dollars in the utmost secrecy. At a time most of Wall Street is under fire (or getting fired), the top hedge fund managers have become its stealth power brokers, celebrities of a clandestine, moneyed world.

We'll meet some of these people in a minute, but first a few disclaimers. Contrary to what you might expect, this story will not tell you that the $675 billion hedge fund bubble is about to burst, though it might. You will also not hear from us that hedge funds-- even the most aggressively short-selling kind--have become dangerous to the functioning of markets or that they unfairly "gang up" on worthwhile companies (a complaint that appears often enough in the press). You won't even get a blanket warning to stay away from these barely regulated entities, lest you lose your homestead. The industry is too sprawling, too complex, too multifaceted to support any such claims ... at least on the basis of the evidence out there so far.

What you will get, rather, is a peek inside this strange, cloistered realm--a place where everybody who's anybody hails from the same colleges, earns their spurs at the same Wall Street firms (Goldman Sachs and Morgan Stanley, naturally), congregates in the same insular circles, and hobnobs at the same charity dinners. Members of the true hedge fund elite are so publicity-shy that few agreed to an on-the-record interview, and fewer still to pose for a photo. When we called the only photographer with stock photos of Ken Griffin, the 34-year-old manager of the $8 billion Citadel Investment Group in Chicago, Griffin quickly made arrangements with the photographer to buy the film. Likewise, we were unable to get a single recent picture of Steven Cohen of SAC Capital, one of the biggest and most controversial power brokers on Wall Street. Still, what we have discovered about these players and other major hedgers is likely to surprise you. And you can be sure of one thing: They don't want you to know about any of it.

More than any other sector of the economy, Wall Street is a place where trends are carried to excess: The Nifty Fifty bull market of the 1960s. The LBO--junk bond boom of the 1980s. The great period of irrational exuberance for technology stocks that ended so calamitously. Says Warren Buffett: "Hedge funds have become the latest Holy Grail."

The hundreds of billions of dollars that have poured into hedge funds in recent years have come in large part from the rich. For decades--going back to fabled investor Ben Graham's partnership in the 1920s and even earlier--hedge funds have marketed themselves to so-called accredited investors. Today that generally means people with $1 million or more in investable assets or an annual income north of $200,000, according to Tremont Advisers. The presumption is that such individuals are financially sophisticated enough to take care of themselves.

These days, though, funds that make investments in hedge funds are peddling themselves to less accredited investors as well-- dentists, school principals, and the like--for minimum stakes as low as $25,000. What's more, a huge group of shareholders may be in hedge funds and not even know it: America's retirees. The state of California's $133 billion Calpers fund, for instance, has plunked $550 million into hedge funds, including $50 million into Andor Capital of Stamford, Conn. The $21 billion Pennsylvania State Employees' Retirement System, or PennSERS, made an even bigger bet, recently investing some $2.5 billion, or roughly 12% of its assets, into hedge funds. (A spokesman says the investment is in funds of funds.)

The motivation is no mystery: Pension funds are looking to goose their feeble returns with a little of hedge funds' magic sauce. The basic ingredient of this sauce is hardly exotic. It's hedging-- making one investment to protect against downside risk in another investment. That's what the first hedge funds did and what many still do today. (Many also use leverage or borrow to enhance their returns.) An example would be to buy Pepsi and short Coke, or buy Merck and short an index of drug stocks. Or go long on the dollar and short the pound. "It really is the best way to invest," says legendary hedge fund manager Julian Robertson. "You buy the ten best stocks in the world and short the ten worst, and you should do pretty well, unless something goes wrong."

Many funds today, however, do no hedging at all. In fact, the term "hedge fund" is a catchall that applies to thousands and thousands of investment funds of all strategies. As my colleague Carol Loomis wrote in a seminal FORTUNE article in 1970, a hedge fund can be any limited partnership that's constructed "in such a way as to give the general partners--the managers of the fund--a share of the profits earned on the limited partners' money."

And what a share it is. In exchange for the lure of outsized returns, many funds impose an arrangement known as "one and 20." It means that the manager's take is 1% of the fund's assets and 20% of profits. So the aforementioned Chicago star Ken Griffin could make $215 million in 2001, according to Institutional Investor magazine- -though, to be fair, his fund was up an eye-popping 20% in a down market. (For more on how this business model works and what investors can expect, see the following story.)

Buffett, who many years ago managed a hedge fund himself before running Berkshire Hathaway, is quick to point out that the term "hedge fund" is "nothing but a name." Nor is there anything inherently glamorous or mystical about it. "A fund is only as good as the person who runs it," he says. Buffett is right, of course. But the mounds of cash help explain why hedge funds are suddenly upsetting Wall Street's apple cart. The old-fashioned elite down at Wall and Broad accuse hedgies of sucking up capital, muscling trading desks with outsized commissions, and luring away the best traders, analysts, and money managers with promises of $100 million paydays. The most successful hedge fund managers--a few are now billionaires--are far wealthier than the CEOs of Wall Street's biggest firms.

Everything seductive and controversial about hedge funds can be summed up in three little letters: SAC. That's the $4 billion fund run by Steven Cohen, which has generated spectacular returns over the past decade. About half that kitty is said to be Cohen's personal wealth. Cherubic, balding, and about 5-foot-7, Cohen--or Stevie to his compadres--somewhat resembles the character George Costanza of Seinfeld. He is also said to be self-deprecating and a great dad. But Cohen, who started his career at the brokerage Gruntal & Co. (see "The Shabby Side of the Street" in the fortune.com archive), is also one of the world's most aggressive traders. He is security-conscious and secretive, and declined numerous requests for an interview. Getting anyone to speak about him on the record is next to impossible as well. One recent afternoon I called a former SACer named Scott Lederman, who sounded positively skittish. "I'd love to help you, but I can't," he said. "I've signed a confidentiality agreement. I just can't answer your questions."

Though Cohen, like many other big-league players, operates out of southwestern Connecticut, he is considered something of an outlier because of his controversial trading strategies. He is a practitioner of what he has termed "information arbitrage." As best we can tell, that means trading in part on the thousands of bits and pieces of information that flash across Wall Street trading desks every day. Trouble is, many in the business say that in the pursuit of that information, SAC employs tactics to gain a competitive advantage. How so? Cohen's firm is said to generate as much as 1% of the average trading volume of the NYSE every day and therefore produces mammoth commissions for investment banks. For that, sources say, SAC traders expect the best information possible from the banks, including what is known on Wall Street as the first call. If a salesperson, for instance, has a large block of stock for sale, he may be strongly urged to offer it to SAC before any of its rivals. The practice isn't illegal, but it can lead to abuses. (Cohen declined to comment.) "Does Steve expect the first call?" asks a close associate. "Absolutely. And he would scream and yell if he didn't get it. I don't know of anything illegal going on. There aren't a lot of rules."

Actually that's not quite right. There are rules. In fact, the Securities and Exchange Commission is investigating whether one of SAC's employees, Michael Zimmerman, received insider information about a possible downgrade of Amazon.com from his wife, Lehman Brothers analyst Holly Becker.

Cohen's no-holds-barred style ruffles not only big institutional traders (who get beaten on trades) but also others in his industry. Says a manager of a large, successful hedge fund: "If I see on a resume that the person worked at SAC, I won't even interview them." Cohen's defenders say that kind of talk is envy. Last year SAC was up some 11%, while the market declined 22%. Unlike most other fund managers, Cohen passes on expenses to his limited partners-- between 2% and 3% of assets--and takes a whopping 25% to 50% of the profits for himself. (SAC is closed to new investors.)

There are perhaps a dozen-and-a-half funds in this universe of nearly 6,000 investment partnerships that have more than 50 employees, says Phil Duff, former No. 2 man at Julian Robertson's Tiger fund and onetime CFO of Morgan Stanley. "The ones with a billion-plus--they are in the big leagues," says Duff, who has since co-founded a hedge fund operation called FrontPoint.

Ah, yes, the big leagues. That's the very top of the hedge fund pecking order, where a score or so of managers have amassed fortunes of hundreds of millions and in some cases billions. Mostly unknown to even the nation's top CEOs, publicity-allergic men like Moore Capital's Louis Bacon, Tudor Group's Paul Tudor Jones, and Stanley Druckenmiller of Duquesne Capital, as well as up-and- comers including Griffin and Steve Mandel lord over $5 billion and $10 billion pools of capital. In the business they are known as the legends.

Many of the legends worked at or have connections to Robertson's Tiger fund (see chart), which was a star performer before it closed in March 2000, a value fund victim of the tech-stock boom. The grandees' charity of choice is the Robin Hood Foundation, founded by Paul Jones, which, yes, takes from the rich and gives to New York City's poor.

Even hedge funds with squeaky-clean reputations are notoriously secretive. No interviews. No pictures. No disclosure to anyone other than limited partners. Some of that is to protect trading positions. Some of it borders on the ludicrous. "My client called up this hedge fund he had a big chunk of money in to ask generally about its positions," says a fund-of-funds manager, "and they basically told him, 'None of your business.' And it was his money!" While that particular anecdote may sound indefensible, the recent kidnapping in Greenwich, Conn., of hedge fund manager Eddie Lampert has helped reinforce the group's craving for privacy. In case you haven't heard, Eddie Lampert, 40, one of the most successful hedge managers and according to some estimates worth some $800 million, recently spent nearly 30 hours handcuffed and bound with duct tape in a cheap hotel bathtub before he was freed. (The kidnappers were caught.)

For most hedge fund managers, building a business is a monumental and thankless task, involving dozens of dog-and-pony shows and endless handholding. For a tiny minority, those who can put together a stunning track record, it's a breeze. Such was the case with wunderkind Ken Griffin of Chicago's Citadel. Griffin grew up in Boca Raton and began trading out of his dorm room at Harvard in 1987. He was discovered by Frank Meyer of Glenwood Capital, a Chicago fund-of-funds operator, who bankrolled Griffin's first fund. Griffin started out trading convertible bonds but has since expanded into arbitrage and other investments.

Citadel is also a stealth operator, though it is one of the few hedge funds to have a website. But not long ago the fund's name popped up in a very public spat, which surely made Griffin uncomfortable. It was March 2002, just days before Hewlett-Packard shareholders were set to vote on whether to approve the company's acquisition of Compaq. As you may remember, HP board member Walter Hewlett was bitterly against the deal, while CEO Carly Fiorina lobbied furiously for it. Two days before the vote, someone passed on a voicemail from Fiorina to HP's CFO, Bob Wayman, to the San Jose Mercury News, which included this tidbit about lining up support for the deal. Fiorina said, "We're getting information from some of our arbs--you may remember the guys at Citadel who have been very helpful." The implication being that arbitrageurs at Citadel were telling Fiorina how shareholders were going to cast their votes. Citadel later acknowledged its arbitrage fund held shares of HP stock but denied that anything improper was going on. Still, apparently it's not a bad thing to have friends in Chi- town.

Griffin has said that he has a strategy that works in all markets. So far it seems to. His funds were up some 11% last year. "Some people are good at one thing," says Meyer. "Ken is very good at all parts of this business." Says another associate: "This is a guy who prides himself on researching subjects thoroughly. Whether it's building his business or looking to buy million-dollar paintings, Ken really studies." Besides Chicago, Citadel now has offices in San Francisco, Tokyo, London, and, you guessed it, Greenwich, Conn. In fact Griffin is deeply enmeshed in the Connecticut "matrix," befriending fellow hedgie Paul Jones and ponying up big bucks to the Robin Hood Foundation. After dating several bombshells, Griffin is now engaged to Ann Dias, who recently shared office space with Julian Robertson.

One of the most vexing issues for Griffin, and indeed for all hedge fund moguls, is sustainability. The simple fact is that giant hedge funds have a way of blowing up. It can be the kind of atomic blast that Long-Term Capital created in 1998--which forced the Fed to intervene to prevent a market meltdown--or the more prosaic closing of Robertson's famed Tiger fund in 2000. Running one of those Goliaths is like being the head of the old Soviet Union. You're on top for a while, but often it ends badly.

Could it be that Louis Bacon is worrying about just that? At the top of his game and in the prime of his life at 46 years of age, the strikingly handsome Bacon runs Moore Capital, which with some $8 billion under management is one of the biggest hedge funds in the world. Bacon is fabulously wealthy and owns remarkable real estate properties in the U.S. and England. But he has a problem. Even though Moore Capital has racked up spectacular gains over much of its 14-year history, Bacon is reporting to his limited partners that his fund--and their capital--was down 4% last year. "Louis doesn't want to become the next Julian Robertson," says a source. That would be deeply painful for Bacon, who is incidentally Robertson's step-nephew.

Why is it that big funds implode? Simple burnout is one factor; running billions of dollars every day is grueling. Lack of flexibility is another: sticking to a strategy that worked in a bull market but doesn't in a bear market. The fickleness of hedge fund investors plays a big role too. Unlike Joe and Jane Mainstreet in a mutual fund, investors in hedge funds, who after all pay huge fees, are quick to yank their money out of a losing fund. Those redemptions may require the fund to sell some of its positions, and if that selling is done at a loss, it further depresses results, which creates a snowball.

Another issue is compensation for the manager when a hedge fund drops. If a fund is down 10% in year one--say, from $1 billion to $900 million--the hedgie doesn't get his 20% cut. The following year the fund must climb more than 11% just to get back to even, with the hedge fund manager getting no cut of that gain. If a fund drops two years in a row, many managers simply opt to close up shop and start afresh from zero with a new fund rather than try to pull up the old fund from deep in the hole.

Size itself works against these giant hedge funds. Everybody understands the difficulty that the manager of a big mutual fund like Fidelity Magellan has finding enough big ideas to move a multibillion-dollar fund. But for many giant hedge funds, that problem is exacerbated by the fact that they short stocks, which means they have to find shares to borrow. Shorting these days "is really, really hard," says a prominent hedge fund manager. "There are so many more hedge funds out there doing it, the supply of available shares is tight."

Looming above all those problems is the issue of managing. Most hedge fund managers are infatuated with investing and much less interested in running a business. As such, the hedgie is like any other entrepreneur. "A hedge fund business may grow great guns at first, but if it is successful the manager needs to delegate and maybe do some outsourcing," says David "Tiger" Williams, who runs a trading operation that serves some of the funds. Plus, a growing hedge fund will need systems, and a CFO, and back-office people, and compliance, and risk management. Some hedgies see the need for this, some don't. "When I am looking at a hedge fund to invest in, yes, I look at the track record, but I also look at the infrastructure," says Glenwood's Meyer. "The track record is looking backward. The systems in place help look forward."

No one is more aware of those facts than Paul Tudor Jones, 48, who heads up the $7 billion Tudor Group in Greenwich. Jones, who declined to speak to FORTUNE, has been in the game of hedge fund management for 20 years and is said to be fixated on maintaining a lasting business model. Instead of controlling all trading personally, the Memphis-born former cotton trader has farmed out some money management to top-end semiautonomous partners within Tudor. He has invested heavily in his office, and even though he is a true old-school macro investor (buying and selling all sorts of financial instruments all over the globe), he likes to view his fund as a sustainable company. Who knows? He might make it work.

Will the hedge fund business keep growing willy-nilly? Should you pour your money in-to hedge funds? Will hedge funds save the world? The answer to all those questions is almost certainly no. In fact, you probably could have asked the same questions 30 years ago and gotten the same answer. Harking back to that 1970 FORTUNE story, you get the feeling that for all the recent mania of late, there really is a plus ca change to this world of hedge funds. In that piece Carol Loomis wrote of some hedge funds having a very tough go of it, including Fairfield Partners. One of the men running Fairfield was Barton Biggs, who would leave the hedge fund business in 1973 and accept what turned out to be a very lucrative deal to join Morgan Stanley.

Biggs built Morgan Stanley's asset-management business over the next several decades and also became one of the Street's leading investment strategists. Along the way he became well-known for his pointed weekly research commentary on the markets. (Also along the way his niece, Fiona, married hedgie Stan Druckenmiller.) Biggs has been known as a sharp-eyed observer, quick to steer clients clear of manias. A year ago Biggs warned of a "hedge fund bubble" that was sweeping across Wall Street. That apparently was then, and this is now. In January, Biggs, 70, announced that he was leaving Morgan Stanley after nearly three decades at the firm. Was Biggs, now a very wealthy man, departing full-time to Lyford Cay? Actually no, he is leaving to start a hedge fund. It's called Traxis, if you ever get the call.