



Get Richest Quickest - In the precarious hedge-fund bubble, it's either clean up-or flame out - New York Magazine, November 22, 2004, by Steve Fishman

Zachary R. George, 27, serious, square-shouldered, and wearing some kind of goo in his hair, sits at a long counter of a desk in Norwalk, Connecticut. He's got a phone and a screen, like a telemarketer. Picking up the receiver, Zachary dials into the conference call.

"Harry," begins Zachary when it's his turn. Zachary and Harry J. Phillips Jr., the 55-year-old CEO of Cornell Companies, one of Houston's top 100 businesses, use each other's first names, as if they're cordial, which they're not.

"You work for us," Zachary likes to let Harry know. Zachary represents a two-year-old hedge fund called Pirate Capital, a name that Zachary says gets people's attention. (And if that doesn't, then the 32 percent returns per year do.) For \$20 million, Pirate purchased 13 percent of Harry's company, which runs prisons. This makes Pirate Harry's largest shareholder and, as Zachary sees it, Harry's boss.

By now Harry, a distinguished member of prestigious boards, a trustee of his alma mater, Washington & Lee, is accustomed to Zachary's urgent tones, especially when it comes to, as Harry put it, his "recent acquisition of an interest in Cornell."

Zachary, for his part, doesn't really understand how people outside Wall Street can expect to not make their numbers and still have friendly relations. Zachary, who looks like he might still be the college snowboard competitor he once was, takes a different view. Cornell has missed its earnings predictions for six or seven quarters running. "Why," he'd recently asked Harry, "should anyone expect a CEO that has overseen the destruction of so much shareholder value to be able to turn things around now?"

Harry knows that Cornell, with its 4,000 employees in sixteen states, has had some disappointments. But on the conference call, he makes it sound as if that's a mere detail. "We are going to grow this company," Harry tells the analysts. Then, as if the greatest worry might be that Harry is going to throw in the towel, he adds, "We're in it for the long term."

Zachary, it turns out, has been thinking along different lines. When it's his turn, he lets Harry know that he and his four colleagues at Pirate have come to a decision: They want the company sold, and Harry replaced. He's run the numbers, which are eloquent—the effect on stock price could be a 50 percent gain. To Harry, that sounds like a "fire sale" - not to mention unemployment—and all because some out-of-town hedge fund is in a profit-taking mood. (Actually, half a dozen out-of-town hedge funds are circling Harry's company.)

One afternoon, a stock blew up, and Loeb lost \$20 million, "an inflection point" that required, he said, "intense reflection." Then he bought more.

"I'm not trying to be an asshole," Zachary explained [*SG Editorial Note: But that doesn't seem to prevent him from succeeding*], emphasis on the word trying. Still, he next tells Harry and everyone else on the phone that he's launched a search for a new CEO. Pirate has flown in candidates. Zachary has interviewed them in Pirate's conference room, with its view of the office mascot, a life-size wooden pirate.

And so, concluding, Zachary leans into the phone and says, "Next year we're going to be here, and you won't."

In the past few years, running a few hundred million dollars for a hedge fund—and taking tens of millions for yourself - has become the going Wall Street dream. And this high-risk, high-return trading game has lured plenty of dreamers. Nowadays, people like Zach - young, aggressive, impatient - seem to be all over. There are currently about 7,000 hedge funds, 95 percent of which didn't exist ten years ago. Not that anyone knows exact numbers. In addition to being arrogant and insular, they're also clandestine. "A guy can control a \$5 billion fund, and you have no idea who he is," explains one observer.

Most everyone, though, seems aware of the galling sums of money hedge-fund managers can pull in. What financial type hasn't had shoved under his nose Institutional Investor's list of the top hedge-fund earners? The bottom guy made \$65 million last year, which happens to be more than the combined pay of the CEOs of Goldman Sachs, Morgan Stanley, and JPMorgan. "Never have so few made so much," announced Institutional Investor. Even the manager of a

smaller fund, someone like Zach's boss at Pirate, which has \$200 million in capital, is in line to make more than the CEO of General Electric, the fourth-largest company in the country.

Hedge-fund money has changed New York in the past few years, as hitherto unheard-of investors suddenly snatch up trophy real estate, decorate it with imported stones they've just got to have in their living room and, of course, a Picasso, then fly off in the Gulfstream to, well, another home.

Hedge funds have traditionally been open only to rich investors, those who supposedly can handle the risk. (Though Schwab will put anyone in for \$25,000 these days.) In return, they're not saddled with the kind of government oversight one expects when small investors' money is at risk in, say, mutual funds. Within the hedge-fund category, there are a dizzying array of strategies, including some identified with banks, venture capitalists, and private equity firms. In addition to trading equities, currencies, and debt, hedge funds make loans, buy companies- and occasionally even seek to control them. Though even Zach's company doesn't often try to oust management.

Hedge funds skim as much as 2 percent off the top of the asset pool: Carl Icahn, the famed corporate raider, who-him too-recently launched a hedge fund, takes 2.5 percent. If you have a \$1 billion fund, then, as one manager explains, "it's January 1st. Welcome to work. You've got \$20 million in the bank." (And hedge funds don't have many costs.) But the real money and the real defining characteristic of hedge funds, no matter their strategy, is this: They take a portion of the profits, usually 20 percent. (Icahn, of course, takes more.)

For years, the average overachieving M.B.A. could imagine nothing better than a job as investment banker-Zach had briefly been on that track. Investment bankers were the smart guys in \$2,000 suits who whispered in the CEO's ear. They cashed boat-size bonus checks from bringing tech companies public. But a sputtering economy not only hampered investment bankers (and Internet entrepreneurs) but also much of a once booming money-management business. In the past five years, the S&P index of stocks was down .6 percent. While investors licked their wounds, hedge-fund managers posted a titillating 15 percent return over that same period. No wonder they lord it over the rest.

"Investment bankers?" says one hedge-fund guy. "Their lives are miserable." He ticks off the shortcomings-he seems to have been keeping track. The punishing hours, the endless pitching, and all those dull, needy clients. What could be worse? Perhaps only a job at a sleepy mutual fund, a plain vanilla, as the hedge-fund managers sometimes call them.

By comparison, the hedge-fund manager's life seems effortless. Gloriously client-free and with reasonable hours. "I got into this business," says one hedge guy - is he stifling a yawn? - "so I could make money while I sleep." The classic hedge-fund creation story concerns a young trader at an investment bank. Opening his year-end bonus check, his jaw drops in amazement.

"We thought you'd be happy," says his supervisor. "That's the largest first-year bonus we've ever given."

"Happy?" responds the young man, confused.

He'd wrung millions out of the market, and yet the firm rewarded him as a junior team member. He quit that day, the story goes, to start a hedge fund. And here's the twist: He can. It doesn't take much. To run money, which is how managers refer to what they do, requires little more than a few computers. Zach's boss likes to say, "I could run \$100 million by myself." The theory is that they've got an almost athletic gift for investing.

They're the type who can, as one manager did, call the direction of the market correctly 22 days in a row. They don't want (or need) the kind of marketing, sales, and investor-relations apparatus that comes with, say, a mutual fund.

These days, many hedge-fund managers seem to hail from Wharton or, better yet, Goldman Sachs, lately a kind of hedge-fund farm team. (Pirate Capital founder Tom Hudson, 38, had passed through Goldman Sachs, where he earned a guaranteed \$1 million a year.) On the other hand, one independent filmmaker started a hedge fund with his father, a psychologist, and raised \$2 million. "Anyone can hang a shingle," says Jim Torrey, who runs the Torrey Funds, which invests \$500 million in hedge funds.

No one says it aloud, but the message was clear. Join a hedge fund-or, better yet, start one, Zach's ultimate goal-and, well, as one member of Hedgeworld put it, you could be a "supercapitalist," an action figure in khaki pants with a shot at "screw-you amazing money," as the saying goes. A supercapitalist roams the globe (figuratively, since mostly he's installed in his cubicle), seeking undervalued assets. He even, like Zach, occasionally gets to rail against managements that unjustly depress shareholder value. The choice is yours. An adviser nattering on in a good suit, or else "someone who has," as one hedge-fund guy asserted, "the ability to make things happen by his own will or his own checkbook."

The investment banker talks your ear off, charms you with his minor gifts. And for what? To give advice. There's a hedge-fund put-down. "We get to pull the trigger," says one manager. Just for the pleasure of illustrating the point, one hedge-fund guy sitting at a café in a burgundy golf shirt-he has no clients and thus no dress code-grabs his cell phone off the table. "Give me \$100 million of . . .," he says, and names the company. "That's how hard it is." It's that easy if-and here's the implication-you have the nerve. As one hedge manager all but snorted, "Bankers have no appetite for risk." The hedge-fund manager, by his own estimation, is made of different stuff.

"We are not afraid of risk," one elite manager explains. "That's what separates us from everyone else." Huge bets are the norm. One thing is certain: Lose your nerve and you'll lose your money.

Aggression is the norm. "If you're buying into the market," says one, "then by definition, you're saying the person selling to you is an idiot."

Risk, of course, is the dark side of the hedge-fund experience. Everyone in Hedgeworld knows that the market-Mr. Market, to some-can decide to show a young supercapitalist just who's boss. "You can do everything right and the share price can still go haywire," says one manager.

Some hedge funds blow up, the term for disaster. (The famous collapse of Longterm Capital in the late nineties seemed poised to unsettle the global economy.) Clearly, consolidation and failure lie ahead. (And, investment bankers point out, banks will be here in twenty years.)

As newcomers flood the field, great deals are harder to find. Suddenly, as one manager says, "it's shark versus shark." Hedge-fund returns this year are close to flat. There is talk in financial circles-tinged with hard-to-suppress Schadenfreude-that this is the top of the hedge-fund game, the moment just before everything changes. Clearly, the easy money has already been made. The federal government recently has talked about regulation. "I wouldn't want my kids going into it now," says one manager.

Nevertheless, as the stock market continues to post unimpressive returns, investor belief in hedge-fund magic shows no signs of abating. Money pours in at record rates-this is the fifth

consecutive record quarter. Eric Mindich, formerly of Goldman Sachs, just raised \$3 billion. By all accounts, money will continue to arrive - pension funds want in! - as will the sharks.

Every hedge-fund manager has a story of how, one sunny afternoon, he lost \$20 million or \$60 million or \$100 million. Losses can initiate a death spiral. The question for all the aggressive new sharks - and their hopeful investors - is this: When your time comes, will you be able to handle it? Or will you too blow up one day?

The Day Daniel S. Loeb, 42, picks his latest fight, this one a skirmish with Wilbur Ross Jr., a former investment banker (which may be part of the problem), he doesn't appear to be in the best mood. It's the end of the trading day at Loeb's Madison Avenue offices - he liked the space enough to bid the price up. (But then it comes with a 4,000-square-foot terrace, perfect for walking Biggie, his miniature pinscher.) Loeb heads down a hallway, swings by the Richard Prince photo featuring a bare-breasted girl on a Harley. He turns into the conference room with its fogging glass wall and sets up at a blue plastic-topped table. (He liked the designers so much he had them do his place in South Beach.) Loeb's going off caffeine. His assistant has a green tea waiting for him.

"A stock blew up," he offers offhandedly. The offending stock, Leap Wireless, a cell-phone company, unexpectedly gapped down five points, attention-getting since Loeb owns about 4 million shares, for a quick \$20 million loss.

Loeb is a focus guy. Each morning at 5:30, he makes his way from his West Village townhouse to a yoga center and puts his feet behind his neck, which Loeb maintains is good for concentration. Still, at the moment, Loeb seems distracted. His hair, which is starting to gray, sticks up in patches. He wears white corduroys. His shirt, with pink and purple stripes, is untucked. "Let's put it in context," he says. "It's never fun to lose a lot of money." But it's only \$20 million. "We lost a little over 1 percent of the fund," he points out. He calls for a trash can for his tea bag.

By contrast, the Ross matter seems a bit of fun, a mood elevator. Loeb places the press release on the table. It seems that Loeb and Ross, who has his own private equity fund, find themselves in the same investment. Recently, Loeb purchased \$37 million of bankrupt Horizon Natural Resources, a coal company. Ross heads the committee guiding the company through bankruptcy.

In this capacity, Loeb says, warming up, Ross has committed "an egregious example of greed and self-dealing." From Loeb's point of view, he overweights his compensation, a mistake Loeb suggests may be a reflex from "the many years you spent generating fees . . ." Loeb accuses Ross of "double-dipping," a charge that sent Loeb's jittery lawyers running for cover. "He's a bit of a blowhard," says Loeb, who knew Ross wouldn't sue. Blowhard, apparently, isn't entirely pejorative. Loeb admires Ross's success in the steel industry-"no disrespect," says Loeb.

Disrespect, though, is kind of a Loeb sideline. Since 1995, Loeb has run Third Point Management, a hedge fund he started with \$3.3 million from family and friends. He now has eight other investment personnel and \$1.7 billion, which to Loeb's mind isn't particularly exceptional these days. At a hedge-fund charity event, he asked for a show of hands: Anyone here not run a \$1 billion hedge fund? His fund has returned over 25 percent annually to investors.

Loeb is well known in Hedgeworld for his attacks on what he views as greedy execs who also happen to be depressing shareholder value. Of shares he owns. "The moral-indignation business," Loeb sometimes calls it.

Hedge-fund guys love to read Loeb's attacks-"he articulates what people feel," says one. Usually, the letters accompany Loeb's government filings. If you buy 5 percent of a public company, you must file with the SEC; Loeb once increased his holdings, at a cost of more than \$4 million, just so he could file a letter.

Loeb is proud of his letters, which are thorough, well argued, and filled with clever turns of phrase. (He had a batch prepared for his high-school English teacher.) In a letter to the CEO of Warnaco, he referred to the CEO's "imminent involuntary extraction." To the CEO of Bindview Corp., a software company, he wrote of "your seemingly perpetual failure." He's gone after Intercept, Potlatch, Penn Virginia. There's one where he calls the CEO "Chief Value Destroyer," which he abbreviates CVD. "I'm surprised some CEO hasn't had him shot," says one manager.

Loeb's letters are great entertainment. They also show the degree to which hedge funds play by different rules. Anyone who's consulted an investment adviser has seen the "rules of intelligent investing for the rest of us."

They're in a booklet apparently printed just for you - usually your name is on the cover. The booklet appears to prove several shocking facts. First, how stupid you are to even try to pick winning stocks. Second, how dangerous it is for you to try to time the market, to buy at a bottom or sell at a top. And so, he tells you what financial advisers tell most every hapless investor. Diversify your portfolio and your asset classes. Which is his way of letting you know he's not going to actually manage your money. Rather, he'll divide it into a few asset buckets and diversify it by industry group, and then he's going to, as Loeb says of Ross, "extract his fee," which, though he does his work up front, must be paid each year.

For most hedge-fund managers, this is insanity. "You might as well walk through Times Square with money sticking out of your pockets and yell, 'Rob me!'" says one. Hedge funds don't, as a rule, take the diversified view, an attempt, in their mind, to perform just like everyone else. They're looking for winners. Their goal is to get in near the bottom and slip out of the way when the top crests.

The pressure is on. Mutual funds live off a percentage of the money invested. "We eat what we kill," hedge-fund people like to say, a reference to the fact that they take a share of the profits. To a hedge-fund manager's mind, mutual funds, or plain vanillas, are lazy. Vanillas, so the thinking goes, make their money through their vast marketing machine. Their investment goal is simply not to lose more than the market average. "My eyes glaze over when people start talking about their performance relative to an index," says Loeb. "I'm an absolute-return guy," says another manager. After all, no profits, no bonus.

And so, for hedge-fund managers, investing is an aggressor's game. "If you're buying into the market," points out one, "then, by definition, you're saying the person selling to you is an idiot."

"Investment bankers?" says a hedge-fund guy. "Their lives are miserable." He lists the shortcomings: punishing hours, dull, needy clients.

Joseph Carvin is unlike Loeb in many ways. Carvin helps run the \$1.2 billion Altima Partners, not from Madison Avenue but from a cluttered two-person room in White Plains about the size of an SUV. (His eight other partners are in London.) Loeb focuses on U.S. stocks; Carvin on everything but. (Ask for a tip, and he suggests Argentine debt denominated in yen.) Still, like Loeb, he knows that the key to outsize returns is to make big bets on good ideas.

"Diversification is deworsification," says Carvin, then tosses his head back and laughs like

Beavis. This July, Altima Partners spun out of Deutsche Bank, where it had been for five years. Some hedge funds own dozens, even hundreds of positions. Loeb probably has over 50. Still, the point holds. Your investment adviser believes that a rising market lifts all investors, and thus, really, it doesn't matter what stocks you're in as long as you're in the market. The hedge guy believes, as Carvin explains, "you have to be right, like, 75 percent of the time."

And so, what hedge managers need is not a pie chart that divvies up a portfolio into offsetting slices. For the hedge manager, the trick is coming up with the right ideas. As one mournful manager asks, "How many good ideas do you get a year?" Carvin expects his fund to find four or maybe five a year (which, incidentally, means his "biggest challenge is to sit and do nothing"). The trick is to gain, as citizens of Hedgeworld like to say, "conviction," an almost mystical thing. "If you have to run the numbers, it's too late," says Carvin, only half-joking. Really, the hedge guy believes you ought to be able to, as one put it, "smell a good deal."

You're after an informational edge-"something that someone else doesn't know," says one hedge-fund guy-the more inside, the better. "I have to know things about a company before the company does," says Zach. (Sometimes he'd tweak a company by calling an exec to let him know what's going on with his company.) Some hire private investigators. Loeb's letters bristle with insider details, the result, he says, of "The Investigation," which he likes to capitalize. He learned that one company leased a private jet from a firm controlled by the CEO, and that the CEO's son-in-law was on the payroll and, as Loeb's Investigation further determined, on the golf course during the workday.

Information in hand, hedge-fund managers tend to be high on their own analytic powers. One manager started an online chat room where he liked to hold forth in the guise of stock-market lord. "In His divine wisdom," he began one entry, then laid out his analysis for buying an inexpensive telecom stock.

Loeb's background is in bankruptcies - "investment's black art," according to a fellow practitioner. When Drexel Burnham went bust in 1990, 10,000 people lost jobs, which was terrible. It was also, Loeb recalls, "one of the most successful bankruptcy investments ever." As a hedge-fund manager, Loeb has a preferred strategy: to buy into troubled companies-this, not the letter-writing, is the key to his success. It's a terrific way to catch a company at the bottom. Most emerge from bankruptcy having shed millions of dollars of debt. (For companies, bankruptcy is like fat camp.) He bought Warnaco in bankruptcy, paying, as he couldn't resist writing to the CEO, the equivalent of \$6.50 a share-a 59 percent discount, he calculated, over the then-trading price. Eventually he'd sell his stake for about \$16.50 a share.

Once the hedge fund spots an opportunity, the trick is to throw \$50 million or \$100 million or more at it, sometimes borrowing if he has to. Loeb calls it "concentrating my positions." He'll put as much as 10 percent of his assets-\$170 million-into a single idea. Judging by Loeb's letters, there have been nine ideas good enough to prompt a 5 percent stake in a company so far this year. Pirate's \$20 million stake in Cornell was 10 percent of its assets.

Smaller bets don't make any sense. "If you have \$10 million in a position and it doubles, which is spectacular, okay, so you make \$10 million," explains Carvin. "But \$10 million over \$1 billion! Who cares?" In fact, in that case, the only possible conclusion is that you're a moron. "You should've had \$50 million in it," says Carvin. "Then it has an impact." The frustration occurs when the bet, the one you are convinced will come good, is stacked high, if only the stock price would move. Waiting isn't easy. Every dollar ticks with pressure. You report to investors every month. You earn bonuses every year. "I have to make money every day," says one hedge-fund guy.

You'd like a catalyst, or you'd like to create one. Carvin says, "We can create the event," the

one that will unlock shareholder value. That's the supercapitalist spirit. Few hedge funds would make that claim so boldly (though, clearly, that's what Loeb, with his green tea and his scorching letters, tries to do). Carvin once bought a Brazilian telephone company, then arranged to have its stock listed on an American exchange. Word of the move leaked out; the stock jumped. It took another year to actually get the stock listed, and then, as Carvin says, "it was a dud." By that time, though, Carvin was on to other opportunities.

Even young Zachary may have successfully given events a nudge. Harry Phillips announced last week that after one year as CEO of Cornell Companies, he was stepping down, not that he credited Pirate's initiative, which frosted Zach. Harry is staying on as chairman. "Ridiculous," says Zach, who's thinking of running for the board of directors himself.

Of course, as every hedge manager knows, the more you load up, the greater the risk. That means that some percentage of the time, things go wrong. "Inevitable," says Loeb. Indeed, hedge-fund managers like to say that losses are significant mostly as a test. You have to be able to handle it, which mainly means handling the pain. "You have to forget how good your education is and how well you did in finance," says Loeb. "You have to take it." If you can survive, fund and will intact, then you get to remark, in a nonchalant tone, how losing a fortune in a few hours is really good for the character.

In October 2002, Loeb watched \$60 million disappear in one swing. He was shorting technology, hoping for a final sell-off. He had visions of the legendary hedge-fund manager Paul Tudor Jones II, who was said to have perfectly timed the crash of 1987. Unfortunately, Loeb's timing was off. He'd caught the bottom. "Fuck! Idiot!" he'd yelled at himself.

The stock market is rational, every hedge-fund guy believes, but only in the long term. Short term, you'd better get a grip. "I have trained myself to not get emotional about making or losing money," says one manager. Emotion can be your undoing. Especially fear. Fear mobilizes ordinary investors, whom hedge-fund managers sometimes think of as tourists. A tourist caught in a falling stock has only one goal: pain relief. He runs for the exits, puking up his holdings. To make himself feel better.

Loeb knew what it was to be "sick to my stomach from losses." The \$60 million swing would cause his only negative year, down 7 percent. Still, of lasting importance was that he'd unwound the position, made it out. And, having endured that test, he could face others. When, last month, the emotional sellers puked up Leap, Loeb lost a quick \$20 million in an afternoon. "An inflection point," he called it, almost medically. It required "intense reflection," he said, but not panic. He thought about why he'd bought the stock in the first place. He looked at the company's competitors. He saw nothing but upside. Loeb bought more shares-bought them on the puke, as the expression goes.

In Loeb's lobby one day, an incongruous visitor appears. It's Loeb's rabbi. He's the one with the velvet yarmulke and the cell phone to his ear. He motions at the Richard Prince photo of the bare-breasted girl. "You should cover her up a little," he says, then follows Loeb into his office for a weekly Torah lesson.

"Money isn't everything," Loeb says by way of explanation. Fifty million, sadly, leaves one flying commercial. Hedge-fund money can put you into exhilarating conversations about the virtues of Gulfstreams versus Falcons.

Still, it's quite a lot. In fact, what else is there? Investment bankers report that they, you know, "create industries." "Hedge funds are just about the money," says one investment banker, channeling, momentarily, a Peace Corps volunteer. "Not everybody, believe it or not, is totally driven by the money."

Hedge funds, though, don't have any other product. Loeb knew he wasn't in the moral-indignation business. "The only thing I care about," he says, "is making money for my investors." And, not incidentally, himself. "Hedge funds are the best way to make a fortune today," says one manager succinctly. And what a fortune it is!

The financial implications of the hedge-fund fee structure aren't complicated. The hedge-fund industry approaches, in round numbers, \$1 trillion in assets. Last year, according to one hedge-fund index, hedge funds returned almost 20 percent. Thus, last year alone, something like \$40 billion flowed into the hands of hedge-fund managers-which is, on average, close to \$6 million for every single person who opened a hedge fund. And that's not the top. The top is staggering. Institutional Investor reported that George Soros, perhaps the most famous hedge-fund manager, earned \$750 million last year-and that's real money, not stock options. That one-year take would have made him one of Forbes's 400 richest Americans, tied for 389 with Teresa Heinz Kerry. (Soros, not limited to just one year, is the 24th richest American, worth \$7.2 billion.)

In a letter to one CEO, Loeb pointed out that his fund made \$600 million in profits through 2003. (A hedge-fund manager couldn't help himself-bumbling CEOs ought to know who really makes the money!) That's \$120 million for bonuses, the bulk of it for Loeb. So far this year, his fund is up almost 20 percent. If gains hold, that's about \$60 million for Loeb to distribute, mostly to himself.

Of course, investment-banking money is nothing to sneeze at. And yet, a very presentable net worth of \$10 million, \$20 million, or even \$50 million, sadly, leaves one flying commercial. Hedge-fund money, by contrast, can put you into exhilarating conversations about the advantages of owning a Gulfstream versus a Falcon. There are other distinctions. Like the ability, as a possessor of hedge-fund wealth, to truly appreciate art, especially brand-name art. A net worth of \$50 million is not going to get you your pick of Impressionist art. Says one art consultant who guides hedge-fund managers, "If one year they make a lot of money, they'll spend \$50 million [on art]." There's your Picasso.

Spend hedge-fund money on art and you might get a listing as one of the top ten art collectors in the world, which was how Steven A. Cohen, manager of SAC Capital (take last year: \$350 million), was identified by ArtNews, in part for his Picasso and his Van Gogh.

Not everyone is into art. George Hall-his hedge fund is the Clinton Group-went another direction. He bought a megayacht. It's 115 feet long. For a time he kept it at Chelsea Piers. Parking cost \$12,000 a month, but then it was so handy if, say, he wanted to throw an impromptu dinner for 80, which he occasionally did. Or maybe cruise to the private island Paul Tudor Jones II (last year's income: \$300 million) owns in the Bahamas.

Real estate is another hedge-fund collectible. It may be true, as one manager asserted, that hedge funds relaunched New York's superluxury market, which is \$10 million and up. "And they pay cash!" exclaimed one Realtor. As if one needed another example of who the top dog is now, hedge-fund manager James Dinan snapped up the apartment of fallen Tyco CEO Dennis Kozlowski, paying \$21 million. Loeb made his real-estate splurge in East Hampton, buying a house on two and a half acres big enough to be nicknamed the "TWA terminal." He paid \$15 million, for which he got pools-indoors it's a wave pool, outdoors it's a 75-foot lap pool-and 125 feet of beachfront.

Still, the most impressive purchase was probably that Time Warner pied-à-terre that David Martinez, manager of Fintech, snapped up. He paid \$45 million and-this was the galling part-considered it a complete fixer-upper. Martinez expects to put \$10 million to \$15 million into

the redesign, which includes the cost to create a seascape look from rare blue stones, but not of furniture.

Every hedge-fund manager talks of the risk-reward ratio. The reward was that you'd be the richest cat on Wall Street. The risk, on the other hand, was bottomless. And recently, the risk has been growing. "It feels like a top," said one manager. Meaning, possibly, there's nowhere to go but down. And down can be a long way.

"Let me take you into my hell," says David Marcus.

Like many hedge-fund managers, Marcus began trading early. At 13, he sank his bar mitzvah money into the market. In college, he played options between classes, using advances against student loans. After college, Marcus went to work for mutual-fund king Michael Price. Eventually, he managed a \$1 billion European fund for Price's Franklin Mutual. "I discovered Sweden," says Marcus. "I'd never seen stocks so cheap."

As portfolio manager, Marcus had a ball. Swedes are polite, well behaved. In a jaunty tone, Marcus said whatever he wanted. One chairman, he noted, was "a bag of hot air." Why shouldn't he? In 1999, Marcus's fund returned 47 percent. Barron's labeled him a "European-stock ace."

After Price sold the company, to Marcus's mind, the new owners didn't treat him like an ace. He earned over \$1 million a year, much of it, though, in deferred compensation. Plus, he considered the alternative. If he'd been ahead 47 percent while running a \$1 billion hedge fund, he'd have earned close to \$90 million. I'd never have to work again, he thought.

So Marcus started a hedge fund. Perhaps the most challenging task for new hedge-fund managers is raising money. With money pouring in, though, the manager with good results may have the upper hand. "We have a manager that is no longer willing to wear shoes at investor meetings," says Robert Schulman, CEO of Tremont Capital, which invests in hedge funds. Marcus raised \$400 million in khaki pants and blue button-down shirts-that's all he owns. He launched MarcStone (from Marcus and Flintstone) in 2000.

Marcus took big positions in several solid companies - he particularly liked a French construction company. Overall, though, he believed Europe was in for a tumble. He bet most of his money on a declining market. In his view, European telecommunication companies - in particular Marconi, which is British - were overpriced; some, Marcus believed, ought to be worth a big fat zero. He bet on them to go down, selling big short positions.

To sell short, you borrow the stock, sell it, and then later buy it back when, if all goes according to plan, the price is lower. Hedge funds claim they can make money whether the market is up or down. The short is why. Jim Chanos, who runs Kynikos Associates, shorted Enron at about 60. Others lost their shirts; Chanos rode it into the single digits, making money all the way.

The real trick, though, is the paired trade. To believe strongly in one thing and strongly against another, and have those things counterbalance, is a kind of hedgie bliss. It is what permits the manager to tell investors that he can hedge out the risk, which sounds magical and mostly isn't true. As one extremely successful manager says, "I don't know how you can really make money if you're not willing to lose money."

Still, at one point tourists made paired trading easy. The public, for instance, pushed the IPO for Palm through the roof, not noticing that its parent company, 3Com, owned 94 percent of Palm. Hedge managers bought 3Com and shorted Palm. Much of the risk was hedged out-by

owning 3Com, you had a huge stake in Palm's upside, and by shorting Palm, you also owned its downside. "We made a fortune on Palm," says one manager.

Marcus didn't have much experience with shorts. Mutual funds don't short. If the market declines, they head to the sidelines-if they can lumber out of the way. "They're fighting with one hand tied behind their backs," says Carvin. Maybe so. But Marcus had done pretty well without shorts. As a hedge-fund manager, he spent lots of time worrying whether he'd calculated the hedge right.

Marcus figured that shorting the telecoms, hair-trigger stocks that should exaggerate market movements, would hedge against a collapse in his long positions, his buys. They should, if things worked right, crash faster than the broad market.

At hedge funds, market news comes at you constantly. They all watch CNBC all day. With TV commentators dizzily rattling off losses, a hedgie who bucks the market and makes money feels close to indomitable. "You're a genius, you've got a big dick, you're a superstar," explains Carvin. For Marcus, March 2001 was a genius month, his best ever. Marconi was cut in half. Over the years, Marcus's weight had bulged. He was a Krispy Kreme guy. As a hedge manager, he'd broken 250 pounds. At five ten, he was by his own estimation a "fat pig." Still, what a month! Marcus had a doughnut, and added to his short positions.

The spiral, sometimes called the death spiral, is what every hedge-fund manager fears. What's striking is how innocuously it begins.

On April 18, 2001, in an unscheduled move, the Federal Reserve cut interest rates by a half-point. Stocks around the world shot up.

In one day, Marconi was up 9 percent, and it, Marcus reminded himself, was a piece of crap. Within a short time, his shorts had gone in his face, 25, 30 percent. Marcus's long positions might have bailed him out by shooting up as well. Instead, they idled on their butts. "I made a basic hedge-fund mistake," Marcus says glumly. The market took revenge, squeezing his shorts. By April 2001, Marcus was down 15 percent, close to \$65 million.

Hedge-fund managers make investors a promise: I won't take a bonus again until I earn back your losses. Many believe an unestablished fund simply can't have a negative year. "One down year and you're gone-poof-screwed," says Carvin. Investors will hit the fax, redeem their money. One group of Marcus's investors redeemed \$45 million.

Once investors make for the exits, the death spiral accelerates. To return their cash, you have to sell into a market that's against you, which further erodes your returns. Losing a lot of money is a crucible, and not just for the fund. As one manager said, "My very worth as a human being depended on my continually making money." Confidence is a threshold-sensitive state. Cross the line, you might not return. Carvin knew two guys who, after big losses, were afraid to pull the trigger.

Marcus has four children. At home in New Jersey, he didn't mention his losses - "It wasn't my family's fault," he reasoned. Still, he couldn't bear it when he saw his wife flipping through a catalogue. "Why are you buying all that stuff?" he snapped. She couldn't understand. She was spending \$50. "It was the worst period of my life," he says.

Marcus felt fogged by his \$60 million loss. He got up earlier and earlier. At home he'd usually plug into his computer from about 10 to midnight - trading is a kind of addiction. (At a yoga retreat in India, Loeb had a high-speed Internet connection installed.) When the market went

in his face, Marcus decided he had to trade the opening - the opening in Europe. He was at his desk in the Citicorp building at 4 A.M.

Most of the market, needless to say, was elated by the run-up. CNBC seemed giddy, relentlessly so. Marcus watched the Cartoon Network. He thought of a hedge friend down 9 percent. In a week, he'd have to report to investors. "He swung for the fences," says Marcus. It worked. This friend finished the year up 7 percent. Marcus couldn't bring himself to risk his investors' capital that way.

"I needed to stop," he says. "You can't think when you're fucked up like that." Marcus went to all-cash. Between losses and redemptions, his \$400 million fund was soon worth \$180 million. A few months later, the telecoms Marcus so disliked had fallen to almost zero. If only he'd been able to hold on or, he sometimes thought, go on vacation. A friend called: "How does it feel to be 100 percent right and 100 percent wrong?"

I want to kill you, Marcus thought.

Marcus couldn't bear his results. He was a European ace. He vowed to come back. (And now, two years later, he's lost 45 pounds, and has a new hedge fund, running \$100 million. Hardly any shorts. He's up 22 percent. Which is why the hedge-fund moment may be nowhere near its top.) But back then, he'd had to face it, come to grips with his own limitations. The risk was too scary. He closed the fund. "I tried hedge fund, and it didn't work," Marcus said soberly. "I'm a plain vanilla."