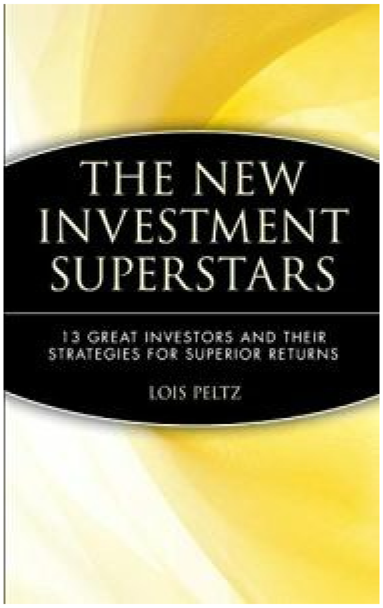

Book The New Investment Superstars

13 Great Investors and Their Strategies for Superior Returns

Lois Peltz
Wiley, 2001

Recommendation

Lois Peltz has stolen the keys to Wall Street's inner sanctum and is waving you over to take a peek inside. Her insights on the hedge fund money machine - how it works, who runs it and how - should enthrall insiders and outsiders alike. She begins with the grand old gentlemen of the game, the likes of Julian H. Robertson Jr., Michael Steinhardt and George Soros, and tells how Soros speculated his way to a $2 billion profit - in one day! She shows how the game is played, and gives an insider's perspective on the methods of the new superstar managers. The in-depth profiles include: Lee Ainslie, Leon Cooperman, Ken Griffin, John Henry, Mark Kingdon, Bruce Kovner, Daniel Och, Raj Rajartnam, Paul Singer and Brian Stark. These managers will build the vast fortunes of the future while also amassing their own. *BooksInShort* encourages investors, Wall Street players and interested spectators to hedge their bets, and buy this book.

Take-Aways

- The established gentlemen of hedge fund investing are gradually giving way to a new breed of fund managers with different characteristics.
- The new fund managers are more concerned with delivering superior performance under varying market conditions than with amassing huge assets.
- The new managers employ a more team-oriented style of decision making.
- Many superstar managers use investment committees to evaluate opportunities
- Many superstar managers use investment committees to evaluate opportunities.
- It remains to be seen how many brilliant bulls will turn into embarrassed bears.
- Sheer size of a fund is considered a potential liability, rather than an objective.
- Many managers diversify by giving money to other fund managers to invest.
- Numerous types of hedge funds are available, but superstar hedge fund managers tend to have common characteristics.
- There are now 4,500 to 6,500 hedge funds with assets of $350 billion to $450 billion.

Summary

On the Hedge-Fund Horizon

New stars are emerging on the investment horizon: hedge fund managers who consistently generate superior returns and also manage downside risks and reduce volatility. These managers share certain common traits:

- Most have Ivy League backgrounds and/or MBA degrees.
- Most view markets opportunistically.
- Most use fundamental research.
- They worry more about delivering superior performance under various market conditions.
- They worry less about amassing the largest amount of assets under management.
- Most fill the role of coordinator and overseer of the fund.
- Minimum investments are higher and the asset lock-up tends to be longer. Some funds bar new investors to maximize returns.
- Most fund managers lead balanced lives, and enjoy sports as a common free-time activity.
- They share a passion for their work.
- They have an ability to manage downside risk.
- They wish to institutionalize their firms, including having planned succession.
- They invest a lot of their own money in their funds.
- The use investment committees.
- Some allocate funds to other managers' funds to further diversify.

> "A new breed of hedge fund manager has evolved... they managed to embrace change and profit from it rather than fight it."

When the markets were robust, a lot of the managers looked like stars. Now that the markets are bearish, managing the risk and selling short become significant. The weak are being separated from the strong. Yet, some wizened survivors have seen it all before.

The Man with the Eye of the Tiger: Julian Robertson

Julian Robertson is the archetypal Southern Gentleman. He graduated from the University of North Carolina with a business degree. After the Navy, he went to work for Kidder Peabody, where he spent 20 years as a stockbroker and as the head of Webster Management, which managed the firm's money. In May 1980, he started Tiger Management, investing $2 million of his money and $6 million from investors. By 1991, the firm approached $1 billion in assets under management. It peaked - as the largest hedge fund at that time - in October 1998 at $22.8 billion.

> "Hedge funds are not designed to outperform the stock market in a roaring bull market but rather to shine in flat, negative, choppy markets."

Robertson was renowned for picking U.S. stocks, but he was not as effective globally. When Russia defaulted on its debt, Tiger lost $600 million, and it later lost a cool $2 billion betting on the Japanese yen in 1998. Robertson was a value investor, buying stocks with good earnings prospects at low prices, including airlines, automobiles and paper stocks - old economy stalwarts that had become undervalued. Tiger owned Microsoft and Samsung Electronics, but avoided the highflying Internet stocks that had no earnings. By the end of 1999, Tiger owned 24.8% of US Airways, 14.8% of United Asset Management, 7.2% of Sealed Air and 3.7% of Bear Stearns. During this period, his performance naturally lagged behind that of younger managers who pursued technology stocks.

> "Some analytical studies show that many hedge funds generate their best performance in the early years when there are fewer assets under management and the fund is more nimble."

When a hedge fund under-performs, investors redeem their equity to invest it elsewhere. Robertson had to sell holdings from his portfolio to meet these calls, during the downward spiral. Between August 1998 and April 2000, $7.65 billion of assets left the company.

With 180 workers, Tiger had a net loss of about 25 analysts in 1999-2000. In October of 1999, Robertson revealed that he had lowered the amount of borrowed stock from 2.8 times capital to 1.4 times. In March 31 of 2000, he announced his retirement at age 67. Assets in his hedge funds were now $6 billion - $1.5 billion of that was his own money. He wrote to his investors: "There is no point in subjecting our investors to risk in a market, which I frankly do not understand." He announced he would return investors' capital. Although Robertson's Tiger funds dropped about 19% for 1999, its annual performance since 1980 was about 29%.

George Soros' Quantum Leap

George Soros, born in 1930 in Budapest, graduated from the London School of Economics in 1952. He came to the U.S. in 1956 and worked as an arbitrageur at F. M. Mayer in New York. Soros had an important edge - he understood European financial markets, and quickly became known as an expert in that growing field. Soros convinced the management of Arnhold & Bleichroder to let him run two offshore funds: First Eagle, a long-only fund, began in 1967, and Double Eagle Fund, a hedge fund, began in 1969. He poured $250,000 of his own money into the hedge fund and attracted another $6 million from Europeans who knew him. In 1973, Soros moved on to start his own fund, Soros Fund Management. The Double Eagle Fund became The Soros Fund in 1973 and the Quantum Fund in 1979. By 1980, Soros' 80% of the fund was valued at $56 million.

> "The bull market in stocks helped many managers post excellent returns. Now that the markets are choppier and more difficult, risk management and hedging plays a larger role. The short side of the equation becomes more important."

Soros believed that the key to his investment success was the art of survival. Weathering the business cycles is critical. Soros' Quantum empire began to slip into entropy in 2000. His company was still loaded with high tech and bio-tech stocks when the sell-off began in mid-March 2000.

In his book, The Alchemy of Finance, Soros says reflexivity is crucial to understanding market behavior. Soros says financial markets are characterized by a discrepancy between reality and the participants' perceptions. When the difference between the two is small, it is a near-equilibrium condition. When the difference is great, it is a far-from equilibrium condition. When the gap between the prevailing bias and reality are too wide, a reflex, catastrophic collapse ensues. Soros states that reflexivity isn't very important when things are in a near-equilibrium state, but is very important during a boom/bust sequence. He looks for telltale signs that a trend has been exhausted, knowing that if he picks correctly against the trend he will profit, but that if he goes against the trend too early, he won't.

> "As a fund becomes very large, it also gets so closely watched on Wall Street that it hurts; its footprint makes it too visible in the market. Other investors watch and copy."

If this sounds overly theoretical, consider that on Wednesday, September 16, 1992, Soros made close to $2 billion by shorting the British pound, against the prevailing wisdom. The Financial Times dubbed Soros "the man who broke the pound." Soros is a noted philanthropist who has doled out $2 billion during his career. His funds earn an average annual return of more than 36%.

Hedge-Fund Phylum

The major types of hedge funds are:

- Global emerging funds involve investments in regions such as Russia, China, India and Latin America. Because emerging markets do not permit short selling, emerging markets use long-only strategies.
- Long/short equities seek to be directional. Managers shift from growth to value or from medium cap to small to large, or from a net long to a net short position.
- Managed futures involve financial, commodity and currency market investments. Managers use either a systematic strategy or a discretionary strategy based on judgment.
- Market neutral funds try to lock out or neutralize market risk, while earning a monthly return of 1% to 1.5%. This is a conservative strategy.
- Fixed-income strategies depend on public and private debt instruments, with fixed rates and maturities.

- Funds of funds divvy assets up among several different funds, to achieve diversification.
- Sector funds specialize in specific sectors such as healthcare, technology and finance.
- Short sellers position themselves to take advantage of stocks that go down. They simply buy stock and sell it short, hoping to repurchase it later at a lower price.

Death of a Hedge Fund

A hedge fund might be retired or diluted for several reasons, including:

- The incentive fee - The hedge fund manager doesn't get an incentive fee until he has made up any losses, and the fee is the bulk of the manager's compensation. So after a bad year, the manager has a disincentive to fight back to even since there is no pay for getting back to the so-called "high water mark." Hedge funds attract the best and the brightest because managers receive a 1% management fee plus a 20% incentive fee. This compares to half of 1% for the mutual fund manager, who receives no incentive fee.
- Assets hit a ceiling - The more assets a manager has, the harder it becomes to deliver excellent returns. A fund is more nimble when it manages fewer assets. The return is often greater when investing in smaller companies, and as a fund becomes bloated it becomes difficult for managers to find market opportunities with the right return/risk criteria. Few managers want to hold more than 10% equity in any one company, as it becomes hard to trade out from under a company in which you own too much stock. So the total universe of investment opportunities begins to decline. Also, as the asset level increases, decision making is delegated to subordinate managers who probably have less skill. Finally, the larger the asset base, the more the fund attracts "turnstile investors" who buy in and then insist on high quarterly returns, lest they bug out.
- Succession - The elite fund manager traditionally has been unable to satisfactorily groom an heir. A talented young manager is more likely to leave the firm and start anew than to wait for an opportunity to succeed the principal manager.

Hedge Fund Implications

Ironically, the more problems that the large hedge fund managers have, the more new hedge funds spring forth. Like the Hydra that sprouts two heads for every one lopped off, sub-managers eagerly wait for chances to start their own funds. When manager Michael Steinhardt retired in 1995, for example, six of his associates formed their own funds.

> "Soros viewed himself not just as a speculator but as a philosopher - and a failed one at that."

Younger managers learn from their mentors that funds need structure, team-orientation and succession. Cumberland Associates is the only large hedge fund management firm that has successfully created continuity from one generation to the next. The teams' specialists are rewarded, in part, on their performance, to avoid the perception that managers are motivated only by large portfolios and incentive fees.

> "The more assets a manager has under management, the harder it is to deliver excellent returns."

When Alfred Winslow Jones created the first hedge fund in 1949, the idea was to hedge one's position on securities. Jones would invest in 70% long and 30% short positions. With today's different strategies, no uniform definition exists for a hedge fund - hence funds are also known as hybrid products, alternative securities, absolute return funds or private investment partnerships.

> "And as a hedge fund manager gets very large, the percentage of hot money investors also grows in proportion, i.e., investors who are quick to come in and quick to go out, (that is) turnstile investors."

Presently, some 4,500 to 6,500 hedge funds hold assets between $350 million to $450 million. Europe alone has an estimated 300 managers. Hedge funds are supposed to be non-correlated to stocks and bonds. Thus, stocks could go down, and hedge funds - an important tool for diversification - might stay the same, or even go up. During the stock run up, most hedge funds lagged a few percentage points behind the overall stock market, since some of their resources are used to hedge, by buying options or futures.

> "Most of the managers seemed to lead balanced lives and talked passionately about some outside interest. Sports was a common theme. The challenge of winning and/or the mastering of a technique were exhibited in what managers did in their free time.&q

Among the top ranks of emerging hedge fund managers are the thirty-something Lee Ainslie and Ken Griffin, as well as Leon Cooperman, John Henry, Mark Kingdon, Bruce Kovner, Daniel Och, Raj Rajartnam, Paul Singer and Brian Stark. A few of these men are a good bet to replace the likes of Robertson and Soros as the kings of investment finance.

About the Author

Lois Peltz was editor-in-chief of MAR/Hedge Funds, an investment performance reporting service, for eight years. She is now President and CEO of Investment Information Providers, which supplies investment information services to the professional investment community.