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OFF THE SHELF

## Sit Down for a Chat With Hedge Fund Movers

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JOHN MAYNARD KEYNES was a day trader. Besides his own fortune, he invested the money of his employer, King's College of Cambridge University. From 1928 to 1945, when British equities shrank 0.5 percent a year on average, Keynes earned the college an annualized return of 13.2 percent, wagering on stocks and bonds, but also currencies and commodities, using insight into global events.



We are all Keynesians now.

Sure, after the 1945 Bretton Woods agreement on a regulated international financial regime (of sorts), domestic stock investing predominated. Innovators like A. W. Jones picked equities both to rise (long) and to fall (short), hedging his bets — hence his term “hedge fund.”

But when Bretton Woods broke down for good in 1971, currencies floated freely, and the era of foreign exchange and commodities “speculators” like George Soros and Julian H. Robertson Jr. ensued. During the three decades up to 1999, Mr. Soros’s fund returned more than 30 percent a year on average. Clients who invested \$100,000 with him in 1969 would have had \$420 million by 2000.

The tech crash in the spring of 2000 seemed to end the party, but like all financial carnage it just multiplied the vultures.

What Keynes pioneered in so-called alternative investments has become an industry of some 12,000 diverse hedge funds, managing — if that’s the right word — not just the private wealth of the rich, but

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also institutional endowments and public pension funds, along with a saturnalia of borrowed capital that draws in the global banking system.

“Inside the House of Money” by Steven Drobny (Wiley, \$29.95) pulls back the curtain, slightly. This is less a book of sustained narration or explanation than a notebook of interviews developed from exclusive confabs sponsored by the author’s consulting firm, Drobny Global Advisors. Still, the ruminations of supposedly hush-hush hedge fund operators are richly illuminating, and much less expensive than the fees they charge.

Nowadays, “hedge fund” signifies a legal and performance compensation structure, not an investment strategy. Mr. Drobny focuses on the style of “global macro,” which he defines as investing in any asset class anywhere in the world. He dwells little on crucial differences in investment time horizons.

But today, he says, all investments, even mutual funds, “are subject to changes in the world economy, the U.S. dollar, global equities, global interest rates” and other factors, not to mention wars. “Global macro,” Yra Harris, the Chicago-based trader, tells Mr. Drobny, “used to be called ‘geopolitics.’ ”

The author shows us human beings, not forces of darkness. Many of the 13 interviewees reveal getting a head start from friends of friends and fellow alumni. Some draw inspiration from “Reminiscences of a Stock Operator” by Edwin Lefèvre (1923). Several acknowledge harvesting ideas from The Economist. Most now run their own funds, but few enjoy managing people or even portfolios. They love managing risk.

A number of themes emerge. First, despite prodigious research, their brilliant ideas can go awry.

“If I’ve gotten better at it,” the industry legend Jim Rogers tells Mr. Drobny, echoing others, “it’s because I’ve made enough mistakes.”

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Another says that “my favorite trades are when I’m wrong and I get out without losing too much money.”

Second, trading and analysis entail different mojo. Mr. Drobny’s business partner, the analyst Andres Drobny — no relation — says the crucial skill is not just reading a crystal ball on the world, but translating an insight into a trade.

Third, incentives have become perverse. In a \$10 billion hedge fund, one purist complains, the 2 percent management fee amounts to \$200 million, whatever the performance, and as soon as the fund goes up 10 percent, that’s another \$200 million (20 percent of the \$1 billion profit), meaning that the manager can “close out positions and take the rest of the year off.” So much for absolute return.

Full-blooded characters enliven the text. Jim Leitner, a former graduate student in international finance and Russian studies who grew up in Germany and Turkey, bounced from one trainee position to another before landing at Bankers Trust in 1985. In 1997, he founded Falcon Management, behind a gas pump in Wyckoff, N.J., where he apparently amassed 10 percent of the international market in Turkish lira.

In 1999, when an earthquake caused Turkey’s stock market to collapse, Mr. Leitner bought shares in Turkish glass companies, anticipating replacement demand. He still follows megatrends and aggregated country data, but he also bores deeply into specific companies abroad. Good global macro has become global micro.

Dwight Anderson, a commodities specialist and an alumnus of Princeton’s history department (where this reviewer teaches), started as a manufacturing consultant, visiting factories. Then he was hired by Tiger Management, Julian Robertson’s firm, to help run a commodities desk. After crunching the numbers on palladium, Mr. Anderson staked out mines in Arctic Siberia and subtropical South

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Africa, confirming what the data indicated — a looming supply deficit. Tiger bet that prices would climb. Prices fell.

“Julian would always ask, ‘Are we right in this situation?’ ” Mr. Anderson recalls. “ ‘If so, we should be bigger. It doesn’t matter that prices moved against us.’ ” They doubled down. Eventually, the price of palladium exploded to more than \$1,000 an ounce, from \$120.

Successes like that allow you to be wrong a lot and still trounce the Street. But, Mr. Anderson says, “as Tiger got to be upwards of \$25 billion, positions had to be massive to be meaningful.” Size helps until it hurts.

What is this select group’s collective prognosis? Shakeout.

Peter Thiel, whose Clarium Capital charges no annual fee but takes 25 percent of any profits, maintains that “we are living in a world distorted by the biggest financial bubble ever seen,” adding that “there has to be a deleveraging of the world’s financial system.”

Scott Bessent, who ran Mr. Soros’s London office when it “broke” the Bank of England, shorting the pound in 1992, suggests that what has changed is that now “your biggest risk can be how your competitor is positioned.” Welcome to game theory.

Yra Harris concurs that “global risk is way out of line right now” and that “there’s not enough liquidity to absorb a blowup.” But he also says that it can be costly anticipating that something ugly is bound to happen, because it may not happen for a while. “If you’re right at the wrong time,” Mr. Harris says, “you’re wrong.” So they’re all in.

Whatever may befall us, many hedge fund types will be O.K. After all, Keynes invented their profession during the Great Depression.

“One of these days,” concludes Sushil Wadhvani, a Keynes devotee and former Bank of England analyst, “the chickens will come home to roost, and when they do, there’ll be huge opportunity.”