

# THE PERILS OF PAULSON

Hedge fund manager John Paulson's big bet on a U.S. recovery is going up in smoke and causing pain for many of his wealthy investors



John Paulson testifies before a House committee hearing on the regulation of hedge funds in Washington, November 13, 2008. REUTERS/JONATHAN ERNST

**BY MATTHEW GOLDSTEIN, JENNIFER ABLAN AND SVEA HERBST-BAYLISS**  
NEW YORK/BOSTON, AUG 10

**T**HE CROWN MAY BE slipping fast from billionaire trader John Paulson's head.

The hedge fund manager became an overnight sensation in 2007 by betting big and early on the collapse of the U.S. housing market, and then doing much of

the same on a surge in gold prices. But he is now emerging as one of this year's big losers in the \$2 trillion hedge fund industry.

His Paulson & Co. hedge fund firm, which managed \$38 billion as recently as this past March, is down to about \$35 billion as of the first week of August, and it shrinks a little bit more with every big drop in the U.S. stock market.

One of Paulson's two main funds is now

down more than 30 percent this year, the firm has reported to clients, compared to a much smaller 6.1 percent decline for the average hedge fund, according to Hedge Fund Research.

The problem for the 55-year-old manager: His equally daring bet that the U.S. economy and housing market would rebound strongly from the financial crisis -- a big wager that looked prescient a year ago



**STOCK TUMULT:** Wild trading, including many down days, is wreaking havoc with Paulson's long bets on financial stocks. Above, a board at the New York Stock Exchange showed another big decline on Wednesday, August 10, 2011. **REUTERS/BRENDAN MCDERMID**

-- isn't panning out as planned.

Paulson's funds have amassed huge, mutual fund-style stakes in shares of financial institutions like Bank of America, Citigroup, Hartford Financial, Popular Inc. and American Capital. But these are ringing up hefty losses.

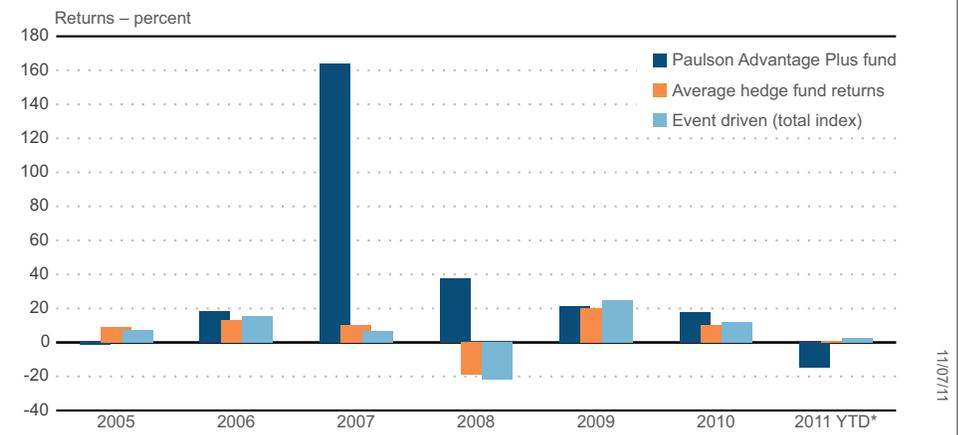
And with fears of a double-dip recession in the United States mounting, coupled with this month's 13 percent plunge in the S&P 500, the talk is growing on Wall Street that unless Paulson can quickly turn things around, the hedge fund king could be hit with a wave of year-end investor redemptions.

"There are many investors who have experienced great gains with John Paulson, but a lot of the money has come into his funds after those great gains were achieved, and the relative newcomers are seeing a lot of heavy losses," said Daryl Jones, director of research at Hedgeye Risk Management, which sells investment research to institutional investors. "I would imagine it would lessen their appetite to stay with someone who is supposed to be a big superstar but is down double digits right now."

Paulson, through a firm spokesman, declined to comment. But people close to

## Market beater until now

John Paulson's \$18 billion event driven funds – Advantage Fund and Advantage Plus Fund – have been solid market beaters and industry leaders until this year.



\* Through June  
Source: Company, Hedge Fund Research

Reuters graphic/Stephen Culp



Paulson point out that other than hedge fund guru George Soros, no one has consistently made more money for clients than the man referred to by his friends and associates as "J.P."

### LOYALTY TEST

THIS YEAR, HOWEVER, his investors' loyalty is being put to the test.

Maybe no one single trade has come to symbolize Paulson's bullishness on the U.S.

economy more than Bank of America. By Aug. 9, the troubled lender's shares were down 43 percent this year, reducing the value of the 124 million shares Paulson owned as of March 31 by \$784 million. Paulson is believed to have sold some of his Bank of America shares as the stock has plunged toward the \$7 mark, but the firm has refused to comment on its current position.

The picture isn't much prettier for Paulson's large share holdings in Citigroup, Popular (formerly Banco Popular) and SunTrust Banks. The value of Paulson's equity stake in those three banks, assuming the funds haven't sold any shares since March 31, would have declined by more than \$800 million over the past four months.

And then there is Sino-Forest, the troubled Chinese forestry company. Paulson absorbed a \$500 million loss on the stock in June after allegations of accounting irregularities at the Hong Kong-based company surfaced earlier in the month.

The series of missteps is tarnishing the near god-like status the former Bear Stearns trader has earned over the past few years.

Much of the \$20 billion in outside investor money Paulson manages has come from pension funds and clients who bought in after he made \$15 billion for the firm in 2007 on his well-chronicled subprime mortgage trade. Paulson raised that money by making his hedge fund one of the most widely available to wealthy customers of dozens of large and small brokerage firms.

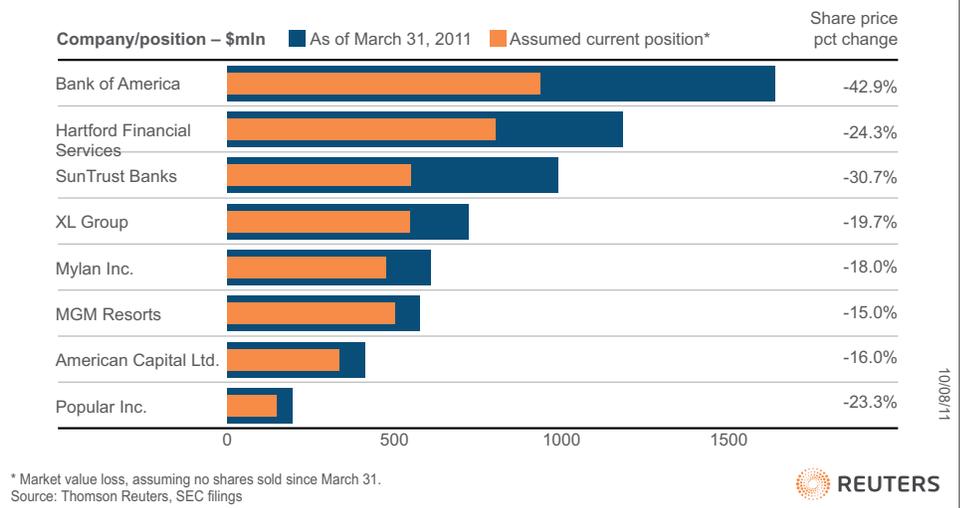
Now some investors who got in after Paulson's so-called Alpha moment are getting out this fall, or are seriously considering doing so at year's end. Some in the industry are wondering whether Paulson's flagship Advantage funds, with \$15 billion in assets, are too large and thus not nimble enough to navigate increasingly choppy markets for stocks.

Francis Bielli, executive director of the Philadelphia Board of Pensions and Retirement, said on June 30 that the board voted to submit a redemption for its entire \$12.4 million investment in the Paulson Advantage fund. The Philadelphia municipal pension, which manages \$3.7 billion, had originally invested \$15 million with Paulson in December 2008. In June 2010, it withdrew \$4 million of that money.

Joelle Mevi, of the Public Employees Retirement Association of New Mexico, invested with Paulson Advantage fund in March 2010. She is holding tight for the moment. But she says the \$11.8 billion public

## Paulson's clunkers

John Paulson's flagship Advantage funds are both down over 25 pct this year. Much of that loss, which has reduced the funds' assets under management by nearly \$4 bln, has come in just the past few months. Below are some of the Advantage funds' biggest stock bets, which have backfired since the beginning of the second quarter.



*"INVESTORS WHO WISH TO MAXIMIZE RETURN SHOULD START THEIR SEARCH BY LOOKING FOR YOUNGER FUNDS."*

pensions administrator is keeping a close eye on Paulson's performance and is concerned about his "exposure to financials."

Paulson won't comment on investor redemptions, but he is trying to put his clients at ease. On Aug. 5, the firm took the unusual step of sending out a letter to investors, informing them that for the period ending Sept. 30, investors were seeking to withdraw \$420 million from the firm. The letter says that's "less than the average quarterly redemptions over the past 2 years." But the firm was silent about potential year-end redemptions.

### PARTY CRASHES

HEDGE FUND INDUSTRY watchers say what's gone on at Paulson this year is indicative of what often happens with hot managers as they get big and take larger and larger bets.

A study last year by research firm PerTrac Financial Solutions, which looked at the performance of thousands of hedge funds over a period of years, found that "investors

who wish to maximize return should start their search by looking for younger funds." The report also found that except for 2008 - one of the worst years ever for the hedge fund industry - smaller funds have tended to outperform large hedge funds over the long haul.

Patrick Adelsbach, a partner and director of event-driven research at hedge fund consulting firm Aksia, says whenever a hedge fund gets too large, there is a concern about a manager getting "boxed in" by taking outsized stock positions. He says the irony is that the more assets a manager has to deploy, the more ordinary the trades can become.

When analyzing hedge funds for pension fund clients, Adelsbach says he keeps an eye out to make sure a manager isn't starting to emulate a "mutual fund strategy" in its stock trades.

In some respects, Paulson's \$15 billion Advantage funds have come to resemble a mutual fund - except that they charge the much larger fees of a hedge fund.

As of March 31, Paulson was listed as one of the largest institutional shareholders in at least eight companies, including Hartford Financial, MGM Resorts International, Mylan Inc., SunTrust, Popular, XL Group and American Capital.

In the case of MGM Resorts, Paulson's firm had 43.8 million shares as of March 31, nearly three times as many shares as four separate Vanguard funds had invested in the

10/08/11





**GOLD RUSH:** The \$1 billion Paulson Gold Fund, launched last year, is soaring ever higher. Above, a seller displays gold jewelry for sale in Civitavecchia, north of Rome, August 10, 2011. **REUTERS/GIAMPIERO SPOSITO**

gambling and resort company.

Alan Gold, a Chicago resident who invests in hedge funds and real estate, says he has shied away from Paulson, although he's been pitched a number of times. Gold says he tends to avoid large hedge funds because they can be "unwieldy" to manage, which makes it harder "to find good quality investments."

Paulson's enormous 124-million-share bet on Bank of America is a classic example of a bold thematic play on a beaten-down stock.

The move can look brilliant when the shares rise -- which initially happened for Paulson when he first bought nearly 168 million shares of Bank of America in summer 2009. At the time the stock was selling for around \$11 and briefly traded as high as \$19 in April 2010. But when things go the other way and the stock is falling like a knife, it's hard to quickly get out of that position.

In a July conference call with investors, Paulson conceded he had too much exposure to financial stocks and was reducing holdings in bank stocks with problematic mortgages such as Bank of America. But he has not offered any firm guidance on what his funds have been selling.

The issue of size has been raised before. In a 2008 year-end investor letter, the manager wrote investors often "ask if our large asset base impedes our ability to maintain high levels of performance." He continued: "Although that may be the case in the future, we have not reached that point yet."

### GOLDEN DAYS

SOME OF PAULSON'S MOST attractive investment opportunities are concentrated in some of the smallest funds he manages.

His \$1 billion Paulson Gold Fund, launched last year, is soaring ever higher, with the price of the precious metal reaching new heights every day. With gold now selling for around \$1,792 an ounce, the Gold Fund, which had been up 2.7 percent through July could be up as much as 6 percent for the year, an investor said.

The \$3 billion Paulson Recovery Fund, which is flat for the year, is booking a whopping 200 percent paper gain on its \$150 million investment in OneWest, a California-based bank that emerged from the wreckage of failed savings-and-loan IndyMac. The bank, which Paulson and other deep-pocketed investors bought with help from the Federal Deposit Insurance Corp., is potentially eyeing an initial public offering next year.

Also up is the Paulson Real Estate Recovery Fund. The small, \$350 million private-equity-style fund is buying vacant land with approval rights to build hundreds of single-family homes. It targets failed complexes in Colorado, Arizona, Florida and California. The fund gained 22 percent last year.

Paulson believes that in five years time, the housing market will have recovered enough to enable the small fund to make a bundle from reselling the properties, which it acquired at bargain basement prices. In

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the meantime, Paulson is earning income as a landlord by renting out some of the luxury homes that were previously built before the developers went bust.

But the majority of Paulson investors aren't in any of these funds, and have their money in the beleaguered Advantage funds.

Paulson, who Forbes says has an estimated net worth of \$16 billion, has pointed out that he and his employees are co-investors along with his customers. So the manager and his employees are sharing in some of the suffering his clients are enduring.

It's true that about 40 percent of the firm's \$35 billion in assets is either Paulson's money or that of his employees. But the firm does not require its employees to pay the typical 1.5 percent asset management fee and the 20 percent performance fee the fund collects from outside investors.

Also, a good deal of the money invested by Paulson and his employees in the Advantage funds is committed to a so-called gold-denominated share class, which is performing far better than the plain vanilla version of the funds. But many of the Wall Street brokerage houses that sell access to Paulson funds don't offer the gold-denominated alternative, which Paulson introduced in 2009. About a third of the \$35 billion Paulson manages is committed to the gold-share class.

For many investors, the inability to access smaller funds or the gold-share class of the Advantage funds didn't matter when Paulson was posting high double-digit returns. But with the Advantage funds losing ground, more on Wall Street are starting to wonder about why Paulson moved so actively to rake in outside money the past few years.

Paulson was largely an unknown figure before the subprime bet paid off. He toiled in relative obscurity and managed just several billion dollars for wealthy investors and small endowments from his mid-town Manhattan office. Until recently, he took the bus to work, say investors who know him.

But the subprime bet, chronicled in the book "The Greatest Trade Ever" by Wall Street Journal reporter Gregory Zuckerman, catapulted him to rock star status and made



**THE GAMBLER:** In April, Paulson held one of his investor conferences in Las Vegas. REUTERS/RICHARD BRIAN

many millionaires want to invest with him.

### COME ON IN

PAULSON DID MUCH TO open the doors. He made his funds - in most cases just the Advantage funds - available to wealthy customers of Wall Street brokerages and small investment advisory firms.

These distribution channels, or "platforms" in hedge-fund jargon, are a cheaper way for wealthy individual investors to access Paulson. The manager normally has a \$10 million investment requirement. But for as little as \$100,000, an investor with several million dollars in assets can put money into a Paulson fund through these brokerage firms.

An increasing number of hedge funds, like D.E. Shaw & Co., Israel Englander's Millennium Management and Daniel Loeb's Third Point, are available to wealthy clients of UBS, Morgan Stanley and Bank of America's Merrill Lynch. But few funds are on as many of these platforms as Paulson.

In the United States, wealthy individuals can also turn to smaller firms like Mount Yale Capital Group, Luminous Capital, Krusen Capital, Altegris Investments and CAIS Capital. In Europe, Paulson funds are sold through Lyxor and Deutsche Bank. In Australia and New Zealand, a small firm called Ashton Funds sells access to Paulson.

To tap into these large brokerage and smaller investment advisory firms, a few years ago Paulson hired Claudio Macchetto from Citigroup's alternative investments group to serve as director of global platform

operations. Macchetto, who reports to Paulson investor relations head James Wong, heads his own team of a half dozen employees.

Overall, nearly two-dozen of Paulson's 120 employees are involved in either investor relations or marketing. That's considerably more than other leading funds.

Dan Loeb's Third Point, with about \$8 billion under management, has just four people in investor relations and marketing. Steven Cohen's SAC Capital Advisors, with \$14 billion under management and more than 800 employees, has about a dozen people in marketing and investor relations.

Och Ziff, founded by Dan Och in 1994, the same year Paulson went out on his own, has about 20 investor relations and marketing people, out of more than 420 employees.

Paulson's large marketing team has enabled the firm to maintain a consistent flow of new investor money coming into the firm, even as it regularly sees several hundred million dollars in redemption each quarter, according to the Aug. 5 memo from Wong, Paulson's investor-relations director. Paulson loyalists point out the fund's assets have largely held stable the last few years and more of its growth has come from performance than taking in net new money.

For a large fund, amassing money to manage - what's called "asset gathering" in the industry - can be lucrative in and of itself.

Using a back of the envelope calculation, Paulson is taking in about \$300 million a year in asset management fees from his

outside investors.

"I completely understand why Paulson would want to build out exposure to independent firm platforms like ours, because it allows funds to access a different advisor and client base," says David King, a partner with U.S. Capital Advisors in Dallas, a firm that manages \$1.5 billion and offers customers an opportunity to invest in the Advantage funds through an arrangement it has with CAIS Capital.

"But I am puzzled why the Paulson funds are offered on so many of the large bank and wirehouse platforms," says King.

Earlier this year, Paulson showed up at an event sponsored by UBS, which began selling Paulson's Advantage fund to its high-net worth customers last year. At that meeting, Paulson talked about why he was so bullish on shares of casino company MGM Resorts. In March, Paulson reported owning 43.8 million shares. But the stock has been a bust this year. MGM Resorts is down about 25 percent as of Aug. 9.

Not everyone sees all this marketing by Paulson as a bad thing. It may have helped him develop a loyal investor base. He's known for throwing lavish investor gatherings in Las Vegas and Paris. Such attention may be one reason redemptions for the third quarter are running relatively low, despite the poor performance of the Advantage funds.

In fact, new money is still coming in. In the Aug. 5 letter on redemptions, Wong hinted at that, saying: "redemptions may be offset by subscriptions."

The \$2.1 billion Houston Municipal Employees Pension System put \$10 million into the Advantage fund in March. And a spokesman for the \$18 billion Texas County & District Retirement System, which last year invested \$40 million with Paulson, says the public pension has no plans to redeem.

Dr. Lewis Feder, a Manhattan plastic surgeon with a list of celebrity patients, says he has no plans to bolt from Paulson, with whom he has invested for nearly a decade. Feder says he has money in six Paulson funds, including the small real estate recovery fund.

"He has a remarkable team employed around him," said Feder. "He doesn't go out looking for money as much as it comes to him."

A big test for investors, even Paulson's most loyal ones, comes in December, when the next opportunity to exit the fund comes up.

(Editing by Michael Williams and Claudia Parsons)



**OPEN SPACES:** Paulson is betting that vacant lots such as this one on South Robertsdale Way in Aurora, Colorado, can turn a profit in the long term.  
**REUTERS/RICK WILKING**

## PAULSON'S SEARCH FOR GREENER PASTURES

BY MATTHEW GOLDSTEIN  
NEW YORK, AUG 10

**I**N APRIL, JOHN PAULSON told some of his investors during a conference he held at the Aria hotel and casino in Las Vegas that he had been too optimistic about the timing of a rebound in the U.S. housing market.

He said it might be another year before the housing market began to roust itself from a long multi-year funk.

The famed hedge fund manager's call on housing is proving costly for investors in his flagship \$15 billion Advantage funds, which have taken a series of large bullish bets on housing and bank stocks. As of Aug. 5, the two Advantage funds were down more than 20 percent with one down roughly 30

percent, investors say.

But Paulson's poor sense of timing probably won't have much impact on the much smaller group of investors who have committed money to the manager's \$350 million Real Estate Recovery Fund, which operates under a much longer investing horizon. That two-year-old fund is focused on buying vacant land where local governments have approved the construction of residential homes but the developers have walked away.

To date, the real estate fund has acquired more than a half-dozen unbuilt housing developments in Colorado, Arizona, Florida and California on which some 20,000 homes can be built.

The fund, which often is paying as little 20 cents on the dollar for these suburban

wastelands, operates with no borrowed money and expects to reap a windfall in four to seven years. By that time, Paulson is certain a housing rebound will be under way and there will be rich demand for so-called shovel ready housing complexes in suburban Denver or just outside of San Diego, California.

It's Paulson most pure play on a revival in housing. But it's a relatively low-risk one given the fund doesn't invest in potentially volatile stocks in the way his ailing Advantage funds do.

And the real estate fund isn't using borrowed money to pay dirt cheap prices for land in relatively attractive locales. Right now, however, it's an investment opportunity that most of Paulson's wealthy patrons are missing out on.

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