THE MONEY MAKERS

Paulson & Co.'s John Paulson earned $2.7 billion in incentive fees in the first nine months of 2007, putting him at the top of our list of best-paid hedge fund managers. His smartest move: betting the mortgage bubble would pop.

By ANTHONY EFFINGER

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The Richest Hedge Funds

THE SUBPRIME CRISIS that's caused so much trauma for hedge funds and investment banks has brought only good news for John Paulson. He's the manager of more than $7 billion in hedge fund money keyed to mortgage credit. Paulson started warning his investors back in the middle of 2006 that the frenzy to build and sell housing was a bubble about to pop. His New York–based firm, Paulson & Co., made big bets predicting the edifice would soon come crashing down. The wager paid off in the first nine months of 2007, when Paulson's Credit Opportunities funds rose an average of 340 percent.

That gain earned Paulson an estimated $1.14 billion in performance fees for the nine months ended on Sept. 28. Fees on Paulson's other eight funds bring his total to $2.685 billion, which puts Paulson and co-manager Paolo Pellegrini at the top of Bloomberg's ranking of best-paid hedge fund managers. Next on the list is Philip Falcone, whose New York–based Harbinger Capital Partners also bet against the housing boom and collected incentive payouts of $1.3 billion for the same nine months.

In third place was Jim Simons, president of Renaissance Technologies LLC in East Setauket, N.Y. (See "The Code Breaker," page 32.) Simons made the list based solely on the performance of his $6 billion Medallion Fund, which rose more than 50 percent through Sept. 28, throwing off fees of more than $1 billion. Medallion, started in 1988, manages money almost entirely for Simons, 69, and his employees. From 1989 through 2006, Medallion returned an average of 38.5 percent a year.

Kenneth Griffin, chief executive officer of Citadel Investment Group in Chicago, was fourth. His firm manages $16 billion and returned 24 percent. Griffin has thrived by buying up distressed assets. Citadel, for example, took over the energy trades of Amaranth Advisors LLC after the Greenwich, Connecticut–based hedge fund collapsed in September 2006 under the weight of $6.6 billion in wrong-way bets on the price of natural gas.

In fifth place were Timothy Barakett and David Slager, managers of Atticus Capital LLC in New York. They reaped fees of $720 million with bets on mining and transportation. According to regulatory filings, as of August Atticus was the third-largest holder of shares of Freeport-McMoRan Copper & Gold Inc., the world's second-largest copper producer. Freeport shares almost doubled in the first nine months of 2007, driven up by worldwide demand for metals.

Hedge fund managers are usually awarded incentive fees at the end of the calendar year, so the top earners will have to keep their streaks alive to collect.

Paulson, 51, made his quick billions

Paulson's biggest extravagance is his house, for which he paid $14.7 million.

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Highest-paid Hedge Fund Managers

	Manager(s)	Firm	Performance fees, in millions
1	**John Paulson, Paolo Pellegrini**	Paulson & Co.	**$2,685.0**
2	**Philip Falcone**	Harbinger Capital Partners	**1,317.0**
3	**Jim Simons**	Renaissance Technologies	**1,012.0**
4	**Kenneth Griffin**	Citadel Investment Group	**837.1**
5	**Timothy Barakett, David Slager**	Atticus Capital	**719.5**
6	**Alan Howard**	Brevan Howard Asset Management	**488.0**
7	**Daniel Och**	Och-Ziff Capital Management Group	**276.7**
8	**Peter Doyle, Murray Stahl**	Kinetics Asset Management	**239.0**
9	**Richard Perry**	Perry Partners	**237.8**
10	**John Zwaanstra**	Penta Investment Advisers	**215.7**
11	**Joseph Oughourlian**	Amber Capital Investment Mgmt.	**208.3**
12	**Mark Kingdon, Richard Rieger**	Kingdon Capital Management	**174.8**
13	**John Horseman**	Horseman Capital Management	**165.8**
14	**Nick Allan, Jonathan Boyer**	Boyer Allan Investment Mgmt.	**146.4**
15	**Greg Coffey**	GLG Partners	**127.5**
16	**John Burbank**	Passport Capital	**124.8**
17	**Peter Davies, Stuart Roden**	Lansdowne Partners	**119.1**
18	**Alexis Habib, Claude Marion**	Spinnaker Capital	**113.4**
19	**Roger Guy, Guillaume Rambourg**	Gartmore Investment Management	**112.7**
20	**Jeffrey Altman**	Owl Creek Asset Management	**105.2**

Figures are for the nine months ended on Sept. 28. Fees are for the funds run by the managers named. Total fees are given when two managers are listed. Sources: Bloomberg, Hedge Fund Research

by buying credit default swaps—instruments that rise in value as the risk of default increases—on mortgage assets. And the hedge fund manager, who still takes the bus to work from his townhouse on East 86th Street in Manhattan, says the bleeding isn't over. "Home prices nationwide have only fallen 3 percent so far," Paulson & Co. writes in the quarterly letter to investors that was delivered in October. "We expect a peak-to-trough decline of 15–25 percent to bring home prices back in line with disposable income."

Paulson & Co. operates a total of 12 funds. As a group, they hold $23.6 billion in assets. Paulson declined to comment for this article or to confirm estimates of the incentive fees he has earned.

PAULSON'S LETTERS to Credit Opportunities investors outline his strategy: Rather than depend on evaluations of mortgage-backed assets by rating companies such as Moody's Investors Service and Standard & Poor's, he and his staff dig into the securities and look at thousands of individual loans. "Selecting individual securities in which to invest is highly complex and a virtual minefield for the uninitiated," Paulson & Co. wrote in its third-quarter report. "Investors who rely on faulty agency 'ratings,' Street research, or off-the-shelf models will invariably get burned."

Paulson didn't. Estimates of hedge fund managers' income are based on the simple formula most funds use: 2 and 20. The 2 is 2 percent of assets. It keeps the lights on and gas in the company Range Rover. Paulson charges only 1 percent, a bargain in the land of hedge funds. The 20 is 20 percent of any profits made trading investors' money. By that reckoning, the fees generated by Paulson's four Credit Opportunities funds—Paulson Credit Opportunities LP, Paulson Credit Opportunities Ltd., Paulson Credit Opportunities II LP and Paulson Credit Opportunities II Ltd.—totaled $1.14 billion.

Paulson employs 54 people and shares the money with the teams of analysts and traders who help run his funds, says a person familiar with his operation.

Paulson's profit was others' pain. The market turmoil of July and August claimed high-profile victims. Two Bear Stearns Cos. hedge funds that specialized in mortgage securities lost all of their value by the end of July and filed for bankruptcy. Bear Stearns had pumped $1.6 billion into one. Funds run by Sowood Capital Management LP in Boston lost 60 percent of their value. Sowood said it sold their remaining assets to Citadel.

A stuttering performance triggered one big fund to reduce its fees. In August, Goldman Sachs Group

World's Best-performing Hedge Funds

Fund	Firm	Strategy	Total return
1 Paulson Credit	Paulson & Co.	Event driven	435.9%
2 Paulson Credit II	Paulson & Co.	Event driven	242.9
3 Qinhan China	Qinhan Capital Management	Multistrategy	218.8
4 HFH ShortPlus	Highland Financial Holdings	Asset-backed securities	132.1
5 APS China A Share	APS Asset Management	Long biased equity	131.9
6 Balestra Capital Partners	Balestra Capital	Macro	130.5
7 Golden China	Greenwoods Asset Management	Long/short equity	127.2
8 Paulson Advantage Plus	Paulson & Co.	Event driven	123.9
9 Passport I-Global Strategy	Passport Capital	Long/short equity	122.4
10 Harbinger Capital Partners Special Situations	Harbinger Capital Partners	Distressed	107.6
11 GWI Brazil	GWI Investment Management	Long biased equity	104.3
12 Paulson Partners Enhanced	Paulson & Co.	Merger arbitrage	100.0
13 Passport Materials	Passport Capital	Sector	97.7
14 Pinpoint China	Pinpoint Asset Management	Long/short equity	92.4
15 Emperor Greater China	Emperor Investment Management	Long/short equity	90.3
16 Vault Global Opportunities	Vault Partners	Long/short equity	87.4
17 Boyer Allan Greater China	Boyer Allan Investment Mgmt.	Long biased equity	76.7
18 Everyoung Growth	Guotai Junan Asset Management	Macro	69.5
19 Harbinger Capital Partners I	Harbinger Capital Partners	Distressed	64.5
20 Skopos HG	Credit Suisse Hedging-Griffo	Long/short equity	61.3

Figures are for the nine months ended on Sept. 28. Includes funds of more than $100 million. Sources: Bloomberg, Hedge Fund Research

Inc.'s Global Equity Opportunities fund announced it would waive its 2 percent management fee and halve its 20 percent incentive fee for new investors. That came after the fund lost $1.4 billion, or 28 percent, in early August.

Bloomberg constructed its ranking of top hedge fund earners by using figures from Hedge Fund Research Inc. in Chicago and from data compiled by Bloomberg. Funds and fund managers that don't share their results weren't considered for the ranking. The large funds for which we lacked sufficient data included Citigroup Alternative Investments LLC, D.E. Shaw & Co., Farallon Capital Management LLC and SAC Capital Advisors LLC. (See "How We Crunched the Numbers," page 58.)

Paulson, the top earner, was born in New York City and graduated from New York University in 1978, summa cum laude, with a bachelor's degree in finance. He then earned a Master of Business Administration degree from Harvard Business School, where he was named a Baker Scholar for graduating in the top 5 percent of his class.

Early in his career, Paulson worked at private equity firm Odyssey Partners LP, run by Jack Nash and Leon Levy. Paulson went on to work in mergers and acquisitions at Bear Stearns and then joined Gruss Partners, an early practitioner of merger arbitrage, in which investors try to profit from the difference in the price of a security and the amount offered by a prospective acquirer. He started Paulson & Co. in 1994 to do merger arbitrage himself. Four of Paulson's 12 funds still pursue that strategy.

Pellegrini, 50, Paulson's co-manager on the Credit Opportunities funds, is a veteran of investment bank Lazard Ltd., where he worked from 1986 to '95, according to Paulson & Co. marketing material. Like Paulson, he has a Harvard MBA. Pellegrini, who declined to be interviewed, is from Milan, Italy, according to a 1996 wedding announcement in the *New York Times.* He married Beth Rudin De Woody, daughter of the late Lewis Rudin, a New York real estate developer.

IN 2006, PAULSON and Pellegrini became convinced the credit markets were stuffed with securities whose risk had not been recognized by investors or the rating companies, according to investor letters obtained by Bloomberg News. In July 2006, Paulson opened the first of his Credit Opportunities funds. Their strategy of betting against mortgage debt by buying credit default swaps earned the funds a 71 percent return in the first quarter of 2007 alone. (Returns for 2006 are not available.)

"We expect credit performance of subprime mortgages to continue to deteriorate," Paulson told investors in his first-quarter report, sent out in April. By the U.S. summer, mortgage securities were in full retreat. Paulson's Credit Opportunities funds soared in value, rising 75.7 percent in July and 26.5 percent in August.

People who know Paulson, none of whom wished to be named, describe him as modest and reserved. His greatest extravagance may be his house. In April

2004, he bought a 28,000-square-foot (2,600-square-meter) building on East 86th Street, just off Fifth Avenue in Manhattan. He paid $14.7 million, according to property records. The five-story mansion was built in 1916 for banker and horse breeder William Woodward Sr., whose family inspired Truman Capote's *Answered Prayers* after William Jr. was shot to death by his wife at the family estate on Long Island in 1955.

Other wealthy buyers covet Paulson's home because it's twice as wide as most New York townhouses. "Everyone says, 'Get me one like that,'" says Paula Del Nunzio, the broker at Brown Harris Stevens who sold it to him.

Paulson is a family man. He has two daughters under 5, and he once invited his wife on a mostly male ski trip to Utah sponsored by a brokerage firm, according to a person who also took the trip. He sails, and he likes to run in Central Park.

Paulson gave some of his profits back to ravaged mortgage borrowers in October, when he donated $15 million to the Institute for Foreclosure Legal Assistance, a new nonprofit formed that month by the Center for Responsible Lending, a borrowers' advocacy organization in Durham, North Carolina. The center is run by the National Association of Consumer Advocates, a Washington-based group of lawyers. "Given the success of our funds, we feel it is important to help those who have suffered the most as a result of predatory subprime lending practices," Paulson wrote to investors after the third quarter.

Falcone, who ranked second on the Bloomberg list, also profited from the mortgage meltdown by buying credit default swaps that rose in value as subprime loans went bad. His $11.5 billion Harbinger Capital Partners fund rose 64.5 percent in the nine months ended on Sept. 28, earning him fees of $1.04 billion. Harbinger's $2.5 billion Special Situations fund doubled in value, adding $280 million more in fees.

Falcone, a 1984 Harvard grad, started Harbinger in 2001. Before that, he ran distressed-debt trading at Barclays Capital, the investment banking unit of London-based Barclays Plc. Falcone, 45, declined to comment on his performance or fees.

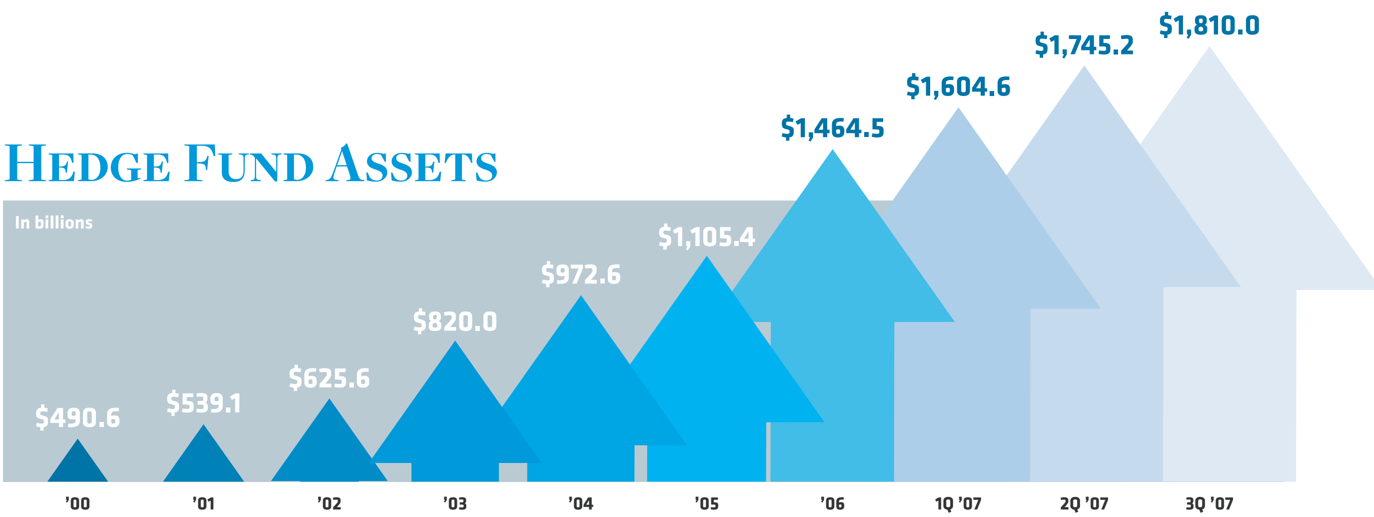
Beyond subprime, several of the top 20 managers made money in emerging markets. Hedge funds focused on the developing world have led the pack since 2005, when they returned 21.04 percent compared with 9.3 percent for all funds, according to Hedge Fund Research. In the first three quarters of 2007, they were up 20.38 percent compared with 8.77 percent for all funds.

OWL CREEK ASSET MANAGEMENT rounded out the top 20 by investing in Asia, particularly China. Founder Jeffrey Altman took in performance fees of $105 million in the nine months ended on Sept. 30. His two funds, totaling $2.4 billion, rose about 35 percent, driven by Asian stocks.

Altman, 41, graduated from Tulane University in New Orleans in 1988 with a degree in finance. Owl Creek, named for the back road between Aspen and Snowmass, Colorado, is a bottom-up fund, meaning it looks for companies to buy and sell, not economic trends to bet on, according to a person familiar with the New York firm's operations.

One of Owl Creek's big winners was China Everbright Ltd., a Hong Kong company with stakes in a Chinese bank and a brokerage. Its shares tripled in

Hedge Fund Assets



Figures are for the end of each period. Source: Hedge Fund Research the nine months ended on Sept. 30, gaining as investors bet that its brokerage unit would become the Charles Schwab Corp. of China, selling stocks to a billion investors.

Owl Creek also raked in returns with USJ Co., the operator of Universal Studios Japan, a theme park in Osaka. USJ did an initial public offering in March, and by Sept. 30, its shares had jumped 33 percent. Owl Creek was the third-biggest holder of USJ stock as of April, according to regulatory filings.

Funds like Owl Creek and Paulson notched their gains against the biggest-ever field of competitors. In the past decade, the number of hedge funds worldwide has more than tripled, to 9,917 as of September from 2,990 in 1997. Assets under management at those funds have grown to $1.81 trillion from $367.6 billion, according to Hedge Fund Research.

HEDGE FUNDS FOCUSING ON EMERGING MARKETS LED THE PACK AND WERE UP 20 PERCENT IN THE FIRST NINE MONTHS OF 2007.

All of the competition could be bad news for returns, says Lars Jaeger, 38, a principal at Partners Group, a money management firm in Zug, Switzerland, that invests in hedge funds. With so many managers out there, it's harder to produce "alpha"—returns significantly above what an investor would earn by putting his money in a conventional index fund. "As more and more players come in, the average alpha goes down," Jaeger says. "It's a zero-sum game."

Fees could fall along with returns, says Bill Berg, president of Sigma Investment Management Co., an investment advisor in Portland, Oregon. Without alpha, hedge funds lose their luster, Berg says, and the crowding is likely to continue to drive down returns. "Ten years from now, you're not going to be able to tell the difference between mutual funds and hedge funds," Berg, 53, says.

The fund companies that top Bloomberg's ranking aren't likely to cut their fees anytime soon. When you quintuple their investment, as Paulson did in the first nine months of the year, clients will keep throwing money at you, no matter how big a cut you take. **B**

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HOW WE CRUNCHED THE NUMBERS

OUR RANKING OF hedge fund managers is based on Bloomberg data and on data supplied by Chicago-based Hedge Fund Research. We also obtained information from investors and from the funds themselves. On a spreadsheet, we compiled the names of about 2,000 U.S. and non-U.S. hedge funds with assets of at least $100 million as of the end of September. We recorded their total returns for the nine months ended on Sept. 28, the names of their fund managers, their investment style and their management and incentive fees.

Since hedge fund firms typically don't pay a bonus to a manager who gets below-average results, we sorted the funds by strategy and deleted those whose return lagged the comparable HFRI Monthly Performance Index. For example, an equity market-neutral fund returning 5 percent for the nine months ended on Sept. 28 was not considered because the HFRI Equity Market Neutral Index had a return of 5.14 percent for that period.

The returns we obtained were net of fees. We derived gross returns for each fund by dividing the net figure by 100 percent minus the sum of the fees. If a fund didn't report its fees, we used the average of all of the funds in our universe: a 1.5 percent management fee and a 20 percent incentive fee. Using the gross returns, we were able to reconstruct approximately what the assets were at the start of the year. (Since we didn't have inflows or outflows, the asset numbers we derived didn't take asset flows into account.) We subtracted original assets from current assets and multiplied the result by each firm's performance fee to derive the manager's share of the profits. Management fees aren't included; we assumed they were used for the day-to-day operations of the fund.

We aggregated fees by manager to determine which manager had the funds that threw off the most in incentive fees. In cases where there were co-managers, we awarded total fees to both managers rather than divide them up.

Hedge funds typically keep a low profile. We didn't have fund data from four of the biggest hedge fund firms by assets. (See table, page 54.) The firms are D.E. Shaw, Farallon Capital Management, Citigroup Alternative Investments and SAC Capital Advisors. Unless the information came from Bloomberg, HFR or the hedge fund firm itself, we tried to verify it with two other sources, including investors and other fund databases. Our final list of the 20 best-paid managers came from a universe of 620 individuals at 700 firms.

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