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A Golden Touch Turns Leaden

By JAMES B. STEWART

No wonder Occupy Wall Street took its protest this week to East 86th Street and the 28,500-square-foot limestone mansion owned by the billionaire hedge fund manager John A. Paulson. What better symbol of the excesses of Wall Street than Mr. Paulson, who made billions betting on the real estate collapse and whose opulent surroundings stand in such contrast to the million of Americans who have lost their homes?

Mr. Paulson made more than $15 billion for his hedge funds by betting on the collapse of the mortgage-backed securities market in 2007 and 2008, then followed up with an equally well-timed bet that large banks would survive the financial crisis and that the price of gold would soar. Last year he personally earned what has been estimated as the largest single payday in Wall Street history: $4.9 billion.

The media branded him the man with the Midas touch. Institutional and individual investors rushed to give him their money, eagerly paying management fees of 2 percent plus 20 percent of any gains, and pushed his funds' assets earlier this year to $38 billion. In September, Forbes ranked him 17th on its list of the 400 richest Americans, with an estimated net worth of $15.5 billion. The man-who-could-do-no-wrong embarked on 2011 with confident predictions that a global economic recovery would strengthen, inflationary pressures would push gold to new highs and financial institutions would prosper.

This week Mr. Paulson reported his results through the third quarter, which ended Sept. 30. His flagship Advantage Plus and Advantage funds were down 47 percent and 32 percent. His Recovery Fund was down 31 percent. His once high-flying gold fund lost 16 percent in September, cutting its gains this year to just 1 percent. HSBC ranked Mr. Paulson's Advantage Plus fund the fourth-worst-performing hedge fund in its entire universe, and that was before it recorded September's dismal results.

It's hard to feel all that bad for Mr. Paulson. For one thing, he remains fabulously wealthy despite his recent setbacks, and his management fees alone — 2 percent of roughly $30 billion— which depend only on the amount under management, and not performance, would amount to $600 million. His ability to stand back from the real estate mania and recognize it for the bubble it was offered the trade of a lifetime, one that few others had the courage or conviction to embrace.

At the same time, Mr. Paulson has suffered the fate of most short-sellers, investors who typically make bets on the misfortunes of others. Markets arguably need such speculators to provide liquidity and price discovery. But to many if not most people, there's something distasteful, even offensive, about profiting from the suffering of others, especially so for the protesters occupying Zuccotti Park.

It's not as if Mr. Paulson gained his wealth by creating new technology that transformed lives, like Steve Jobs (net worth $7 billion, according to Forbes) or Mark Zuckerberg ($17.5 billion), or by entertaining people (Oprah Winfrey, $2.7 billion) or clothing them (Ralph Lauren, $6.1 billion). No one's protesting against them.

Even among billionaire hedge fund managers, Mr. Paulson is distinctive, and not only because he appears to be the richest. He was the only one of them targeted by the protesters on their march through the Upper East Side, and he displayed a tin ear when he lectured them (in a news release) about how much he pays in taxes, adding: "Instead of vilifying our most successful businesses, we should be supporting them and encouraging them to remain in New York City and continue to grow."

More fundamentally, allegations made last year by the Securities and Exchange Commission in its civil fraud suit against Goldman Sachs & Company, which Goldman settled by paying a record $550 million, made clear that Mr. Paulson didn't earn his billions purely because of his shrewd market insights. He helped select the mortgages he was betting against, the ones most likely to default, something Goldman failed to tell the party on the other side of the bet. This wasn't a level playing field, which contributed to the protesters' allegations that Wall Street is a game rigged to benefit the wealthy and powerful.

That isn't to say Mr. Paulson did anything illegal. He wasn't charged by the S.E.C. or accused of any wrongdoing, and it's hard to fault him for taking advantage of a perk Goldman offered him. Others did it too; JPMorgan Chase recently settled similar charges, suggesting the practice was widespread. But Mr. Paulson's was the first and most visible case, and fairly or not, it indelibly linked his name to what the S.E.C. labeled fraud. (Through a spokesman, Mr. Paulson declined comment on all aspects of this column.)

Mr. Paulson's recent performance has already cost him his Midas reputation, and investors are questioning his strategy. "I can't say I expected this, but it doesn't surprise me," said one hedge fund adviser who, like the others I spoke to, didn't want to be identified. "The way he runs a portfolio is going to come with volatility."

Several advisers noted that Mr. Paulson had been in business for many years before emerging as a star, both on his own and at another firm, and while his returns were respectable, no one claimed he was a genius. A review of his S.E.C. disclosures this year suggests that much of his losses have come not only from being wrong about broad issues, like the direction of the stock market or global economy, but from bad judgments about individual stocks. Mr. Paulson stayed bullish on Bank of America and Wells Fargo long after other investors fled, though he reduced his positions somewhat. Another singularly ill-timed position was his 23.5 million shares in Hewlett-Packard as of June 30. H.P. shares have since been rocked by management turmoil and strategic miscalculations. A Chinese timber company in his portfolio was accused of fraudulent accounting. Shares in gold producers and a gold exchange-traded

fund, one of Mr. Paulson's largest holdings, whose gains had helped mitigate his losses earlier this year, plunged in September.

Investors in Mr. Paulson's funds now face the unpleasant task of deciding what to do now that their funds have lost, in some cases, nearly half their value. Some benefited from his spectacular returns during the financial crisis, but many others, like the Public Employees Retirement Association of New Mexico, invested only within the last year.

Nothing short of a spectacular rebound can redeem Mr. Paulson's performance this year. In a conference call with investors this week, he conceded that "we made a mistake" about the direction of the United States economy and said he would be reducing leverage and risk in his most aggressive fund. But investors said he largely stood by his previous predictions.

I've been speaking periodically with Joelle Mevi, chief investment officer for New Mexico PERA (as the pension fund is known), who manages more than $12 billion in assets and had $24.6 million invested in Mr. Paulson's Advantage Fund as of mid-August. Back then, she said the hedge fund portfolio over all had been performing as anticipated, and as for Mr. Paulson, "We have to expect volatility."

By September, with the Advantage Fund down about 23 percent for the year, she said, "I'm more concerned about the underperformance and especially our losses from inception to date. Granted, these are hedge funds, and we're in for the long term. But it's very hard to overcome those performance numbers. I'm sure the board will recognize that it's a very large loss on a single investment."

This week, with the Advantage Fund down another 9 percent, Ms. Mevi said the board would vote by the end of the month whether to liquidate its Paulson position. Like other Advantage investors, PERA faces an Oct. 31 deadline if it wants to withdraw funds on Dec. 31. "We'll be taking a close, hard look this month," Ms. Mevi said. "I've asked our consultants to monitor this very closely, and we remain very concerned." She reiterated that PERA was a long-term investor, adding "that doesn't mean some managers won't have to be replaced."

Mr. Paulson has assured investors he will have no trouble meeting withdrawal requests, and so far they have been modest. Many longtime investors appear to be standing by him. But the next weeks will be critical, as others like the New Mexico board make their decisions. In the meantime, many investors are steering clear of stocks in Mr. Paulson's portfolios out of concern he will be forced to sell by the end of the year, further driving down prices.

More broadly, Mr. Paulson's recent performance raises questions about the high fee structure charged by hedge funds, the seemingly indiscriminate rush to invest in them and the ability of anyone — even so celebrated a trader as Mr. Paulson — to consistently beat broad market averages.

What's surprising isn't that Mr. Paulson's returns have crashed to earth, or even that his reasoning this year has so far proved so spectacularly and consistently wrong. It's that in lionizing Mr. Paulson and handing their money over to him, so many people succumbed to the enduring myth of the financial genius, ignoring the boilerplate that appears on every prospectus: "Past results are no guarantee of future returns."

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