

Adapt or die

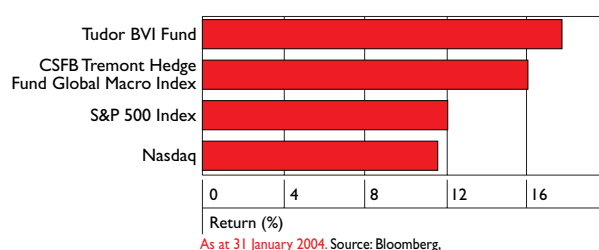
Hedge fund founder Paul Tudor Jones wants to extend a two-decade run of returning 26% annually by stepping up investment in China

BY KATHERINE BURTON

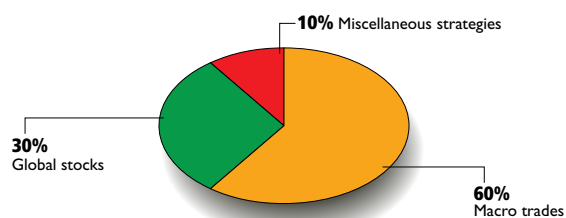
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PAUL TUDOR-JONES

COMPOUND AVERAGE ANNUAL RETURN



FUND ALLOCATION



In the first year that Jim Pallotta joined Tudor Investment Corporation, the \$9.4bn hedge fund firm founded by Paul Tudor Jones, he learned how his boss managed to rack up one of the best performance records of any hedge fund manager.

Pallotta, 46, says he was talking to Jones one day in 1994 at around 6pm, when Jones told him he had made a large bet that the US dollar would rise against the yen. "It's my favourite position," Pallotta remembers him saying.

When Pallotta woke up the next day he looked on Bloomberg and saw that the dollar had been crushed. He called Jones expecting the worst. Instead Jones told him he had woken up in the middle of the night, seen something that changed his mind and reversed his wager so he would make money if the dollar tumbled. "He made a killing," Pallotta says.

Jones, a blue-eyed, Memphis, Tennessee-born trader who looks younger than his 49 years has posted an annualised return of about 26% since opening his flagship Tudor BVI Fund in 1986, investors say.

Few managers of hedge funds can boast as strong or as steady a performance.

Now Jones is set to expand his business into Asia, with plans to open a trading office in China, and he's looking to add other seasoned fund managers in the US and Europe to the 45 who trade such things as commodities, US and European equities, global bonds and the yen.

"You adapt, evolve, compete or die," says Jones, who hunts pheasant, fishes for trout and bass and owns property in the Florida Keys; along Maryland's Chesapeake Bay; in Pawling, New York; and in Zimbabwe.

By following that rule, Tudor has managed to increase its assets more than 30,000-fold since Jones opened his first fund with \$300,000 two decades ago. The one-man trading office he started in Manhattan now has about 300 employees with headquarters in Greenwich, Con-

necticut, and offices in Boston, Washington, and London and Epsom in England. Tudor, the world's seventh largest hedge fund group has 35 equity partners.

As Tudor grows, so does the need to generate profit to keep the organisation running and the traders happy. In 1985, Tudor's first full year of trading, Jones returned 136%, followed by 99% in 1986 and 200% in 1987. As funds get larger, the ability to make such outsized returns diminishes because with bigger investments it's more difficult to get in and out of positions.

Since 1995, when Tudor BVI became a multi-strategy fund – expanding beyond futures contracts to include such investments as stocks and private equity – the fund's returns have averaged about 18% a year, investors say.

Jones says China is the next place to look for profits. "China is set to overtake the US in GDP supremacy in our lifetime," Jones says, pointing out that Chinese GDP growth has an effect on everything from commodities prices, because China is a huge manufacturer, to US interest rates because the country buys US bonds.

Some money managers, including George Soros, are not as confident about making money in China, even while the country's economy grew by 7%-9% in each of the past three years.

"China is in an incipient asset bubble and it's very difficult to find vehicles for investing," Soros, 73 and founder of the \$8.3bn Quantum Endowment Fund, said in a *Bloomberg News* interview in January.

Jones says Tudor has already turned a profit in China, where it has made private equity investments since 1993.

Some of the investments have been through or with Cathay Investment Fund Ltd, a private equity pool run by an affiliate of Greenwich-based hedge fund firm Paloma Partners LLC. In the 1990s, Cathay and Tudor invested in China Yuchai International Ltd, one of China's largest

diesel engine makers, and held stakes in a food company and a drugmaker. Tudor president Mark Dalton, who joined the firm in 1988, declined to name the companies or comment on performance numbers.

In 1994, Tudor opened a Shanghai office run by Kyle Shaw. That lasted until Shaw left for Hong Kong in 1997 to open his own fund. Through Shaw, Tudor successfully invested in a Shenzhen-based construction products company in 1997, says Dalton, who declined to provide additional details. "For the last 10 years, we've gone through a crawl, walk and run process [in China] and now it's time to act," Jones says.

Chief operating officer John MacFarlane, 49; Dalton, 53, and Jones are each planning trips to Asia, including stops in Taipei, Singapore, Beijing and Shanghai to find an executive who can lead their expansion there, Dalton says.

Jones, who wears two braided African bracelets on his wrist next to a Rolex, says he feels more pressure to perform well now than when he started the fund, because he has almost three dozen partners whose net worth and annual pay are tied to the performance of the funds.

Partners and employees are the largest investors in Tudor investment pools, he says. That isn't unusual for large funds that have been in existence for a long time. "It is really easy in this company to beat yourself up if you're doing poorly, because we have so many people taking risks successfully," he says.

During Tudor BVI's 18-year history, Jones has more than doubled the average annual return of the Standard & Poor's 500 Index. His track record is similar to that of Bruce Kovner, who runs Caxton Associates LLC, which controlled \$12bn in assets at the end of 2003, making it the largest hedge fund management firm in the world.

Kovner has returned about 25% a year since 1986 in his so-called macro funds which try to chase macroeconomic trends in interest rates, international trade and production by betting on stocks, bonds, currencies and commodities. James Simons has produced returns of about 35% a year since 1988 in his \$5.2bn Medallion Fund. He trades futures contracts, which Jones traded exclusively when he first started.

Within a decade of opening Tudor, Jones decided he needed to surround himself with other traders who had complementary skills to share the burden of managing his clients' money.

That approach differed from the management style of Julian Robertson and Soros, the hedge fund giants of the 1980s and 1990s, who tended to give their employees less responsibility for investment decisions.

Dwight Anderson, 37, spent five years at Robertson's Tiger Management LLC before joining Tudor. "At Tiger, nothing material went into the portfolio unless it went through Julian," Anderson says. His next job was at Tudor where he managed the Ospraie commodities fund from July 1999 through 2003.

"At Tudor, you are pulling the trigger," he says. Anderson left Tudor because he wanted to run Ospraie as a stand-alone fund. Tudor remains his last investor.

Even Soros, who left day-to-day management of his flagship Quantum fund in 1989, weighed in regularly with his investment views. By the late 1990s, Soros and Robertson, 71, ran the world's largest hedge fund management firms with more than \$20bn in assets each. By 2000, both men had lost billions of dollars from bad debts and client defections.

Soros scaled back the risk level in his trades for several years. Today, he is again near the top of the hedge fund heap. Robertson closed Tiger.

Giving traders autonomy and responsibility may be the key to Tudor's longevity, says David Smith, a Tudor client. "The people who have survived have branched out into new investment areas," says Smith, chief investment director of multi-manager funds at GAM, a unit of UBS AG that farms out \$17.5bn to hedge funds.

"To adapt to the new world order, you need new skills." Tudor, for example, was one of the first macro managers to develop an expertise in trading stocks, Smith says.

He adds that hedge fund managers sometimes get too greedy and lose discipline and creativity, which is one reason that GAM generally doesn't stay with a fund manager. "Managers often become distracted by the financial reward and they lose their ambition," he says. Tudor has been a GAM manager since 1994. "They've never relaxed," Smith says, "they've had a great strength in Europe and now they have to push into Asia."

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Tudor opened its first European office, in London, in 1992 and it now has two offices in the London area with about 80 employees. They include a seven-person stock investment team, a leveraged buyout group and traders who specialise in macro trading, bets on emerging markets and trades in debt of troubled companies.

Jones says he didn't always expect to be a trader. After he graduated from high school in Memphis in 1972, he went to the University of Virginia where his father had earned a law degree. He says he considered being a journalist. His father ran a financial and legal trade newspaper and Paul used to write articles under the byline Eagle Jones. He says he was drawn to managing hedge funds because he has always loved games and odds. Back in college, he says, he routinely played poker.

When he read an article during college about Richard Dennis – who started with \$400 and became a millionaire by making bets at CBOT on moves of commodities like soya beans, corn and sugar – he says his future was fixed. "That's my dream job," Jones says he thought at the time. "He was standing in an arena physically and mentally competing with hundreds of other bright and talented people in an ultimate test of wits."

After graduating with a bachelor's degree in economics in 1976, Jones asked his uncle, a cotton merchandiser, to help him get a job as a trader. He says his uncle sent him to Eli Tullis, a cotton trader in New Orleans, who gave Jones a job on the floor of the New York Cotton Exchange. From there, Jones became a commodities broker at EF Hutton & Co, trading futures on the cotton exchange for clients.

In 1984, he decided it was time to start his own company. "I wanted the camaraderie of working with folks and my appetite was such, wherever there was opportunity I was going to go," he says.

Jones says his biggest battle in his current

trading life is against being too conservative. "You get so you really want to avoid drawdowns because they are so painful," he says. While some fund managers aren't easily thrown off a position once they take it – even if it's losing money – Jones, who says he spends about 90% of his time trading – sees no point in suffering if a bet moves against him. "All day long, I try to find a happy place," he says.

About half of Jones's trading depends on technical analysis using historical price charts to predict market moves, he says. Jones's toughest time in recent years was in 1999 when he had trouble trading both stock indices and currencies. "Personally, I contributed squat. I was completely, totally wrong – and early – that the Nasdaq would break." Even though Jones barely made any money for Tudor BVI that year, other traders did. In Boston, Pallotta's portion of the fund returned 98%.

"We have 45 portfolio managers and at any one time, a handful will have markets that present good opportunities, while other portfolio managers are inactive or playing good defence," says COO MacFarlane, who joined Tudor in 1998. The approach lets Tudor traders practise patience, Jones says. "If you don't see anything, you don't trade. You take risk only when you see an opportunity."

Managers are given plenty of leeway. The nine-person management committee meets each quarter to discuss which assets of the \$3.8bn Tudor BVI Fund each manager will trade.

Over the past few years, about 60% of assets have gone to Jones and other macro traders. An additional 30% is dedicated to global equities and the balance to other strategies.

The trader then is left alone. Each manager has a maximum loss level. The risk management department monitors positions to ensure traders stay within limits. If losses exceed the limits, the top executives will meet the trader to discuss what action should be taken, Jones says.

MacFarlane, who is responsible for risk management, says he recalls only three times in five years when traders exceeded their limits, causing management to tell them to sell their positions.

Tudor pays well, basing compensation on revenue they generate and expenses they incur, says Dalton. Initially traders get around 15% of their profits, generous compared to other hedge funds. "That's designed to grow over time until it's competitive to having one's own firm," Dalton says.

Jones's decision to give other traders the opportunity to manage their own funds came as assets grew to about \$775m in 1991, almost triple what they were three years earlier.

"You learn early in life that half of everything you do is wrong," Jones says. "It's great to have other people's opinions for you to rely on."

This feature is an edited version of an article that first appeared in Bloomberg Markets magazine in June.

KEY POINTS

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Company founder Paul Tudor Jones sees China as the next place to look for profits.

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