

## How to Make \$600 Million? Get \$1.3 Billion

*A Hedge Fund, Bailey Coates, Sees Its Assets Shaved in Half;  
Feeling the Downside of Leverage* WSJ, 5/23/05

LONDON -- In early 2003, Jonathan Bailey and Stephen Coates, two analysts at hedge fund Perry Capital LLP's United Kingdom office, struck out on their own to form Bailey Coates Asset Management LLP. Though they hadn't directly managed Perry's successful European fund themselves, the two attracted about \$1.3 billion in less than two years for their new venture.

Those assets in just the past few weeks have halved, to about \$635 million, according to people familiar with the firm. What happened, so fast? As the firm's fund, Bailey Coates Cromwell Fund LP, posted losses amounting to more than 20% so far this year, investors pulled their money. This, in turn, triggered a massive, forced sell-down of the fund's portfolio over eight weeks because Bailey Coates had used borrowed funds to invest and had to pay that money back.

There could be more selling by investors, but Bailey Coates has sufficient cash to return money to investors if required, according to people familiar with its operations. Major Wall Street investment houses are continuing to do business with the firm, these people added.

"We intend to continue operating as a business, which means keeping the fund going," the firm said in a statement.

The turn at Bailey Coates underscores that when a hedge fund runs into trouble, the use of borrowed money, or leverage, can magnify the problems. Mutual funds, by contrast, generally don't borrow funds to invest so they rarely experience such forced selling or such a speedy investor run on their assets.

"Leverage is a double-edged sword," said Narayan Naik, director of the Center for Hedge Fund Research at London Business School. "When things go right, it scales up the returns. But when things go wrong, it speeds up the downfall."

Bailey Coates's experience also helps explain why the current performance problems dogging hedge funds -- lightly regulated investment pools -- have stoked concerns about potentially broader market problems. The chief worry: a large group of hedge funds using similar strategies get caught wrong-footed at the same time, leading to rapid unwinding of their portfolios.

Unlike many hedge funds, Bailey Coates didn't dabble in complex derivatives or fixed-income products. Instead it sought out investments where it believed markets had mispriced shares, and made bets that they would rise or fall in value. Launched July 1, 2003, the firm generated an annualized return of 20% in its first six months while assets grew to about \$600 million. In 2004, when the firm posted a return of about 5%, assets more than doubled to \$1.3 billion.

Early this year, the firm ran into trouble as a number of investments in the U.S. turned sour. Losses on some of these positions ranged from 15% to 35%, according to a person familiar with the matter. At the time, the firm's portfolio was leveraged at a ratio of about 2.5 times its capital, this person said, meaning it had total investments of more than \$3 billion. Recent bets against some European stocks also didn't work.

When its investments began to go bad earlier this year, Bailey Coates got margin calls that forced it to sell stocks, often at a loss, to pay back the borrowed funds. That, in turn, unnerved investors, who began asking for their money back. Such vicious cycles are hard for hedge funds to break. "The more redemption notices you receive, the more you have to sell in a falling market and that drives prices down further, and you get a downward spiral," Mr. Naik said.

The firm made what now turns out to have been a tactical mistake. In a March newsletter to investors, the firm detailed problems with its U.S. investments and said it planned to pull back its horns and close its office in the U.S. That telegraphed its intentions to other investors, allowing them to take advantage of any selloff by Bailey Coates of its larger positions.

Bailey Coates could have decided to hold on in the face of losses, which could have proved an even riskier move and could have led to an outright blow-up at the firm. Instead, it sold about \$2.5 billion in securities between mid-March and mid-May to bring its portfolio to an unleveraged position and to raise enough cash to meet investor redemptions, according to people familiar with the fund. The fund has about 20% of its \$635 million in assets in cash to provide a cushion for redemptions, if needed, a person familiar with the fund said.

Among U.S. stocks that took hits: Gateway Inc., one of Bailey Coates's largest holdings. At the end of 2004, Bailey Coates owned about 4.4% of the computer-hardware company's stock, according to filings with the Securities and Exchange Commission. At the time, Gateway, Irvine, Calif., traded at about \$6 a share, valuing Bailey Coates's stake at about \$98.7 million. By the end of March, Gateway's share price had fallen about 33%. During that time, Bailey Coates halved its holding, but still owned about \$33 million of the stock, SEC filings show. By mid-May, Gateway's stock had fallen to about \$3 a share.

Bailey Coates also had big positions in LaBranche & Co., a financial-holding company that is one of the floor-trading firms known as specialists at the New York Stock Exchange, and Neenah Paper Inc., a Georgia-based paper and pulp producer, according to SEC filings. Both stocks started 2005 off well, but sank from the start of March. From then to the beginning of May, LaBranche's stock fell 35% while Neenah's fell 16%.

Even Bailey Coates's investments in some big names didn't work: Morgan Stanley, News Corp. and Cablevision Systems Corp.'s all tanked for various reasons. When unwinding its portfolio, Bailey Coates sold off most, if not all, its U.S. holdings, according to people familiar with the firm.

