Scaling the Heights
The Top 75 Hedge Funds

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IT'S EASY TO IMAGINE JAMES DEAN BEHIND THE STEERING wheel of a hedge fund.

Amid the recent extreme volatility we've seen two relatively young Bear Stearns funds crash, setting off a conflagration that eventually consumed the entire firm. Funds from Carlyle Capital, Peloton and Sailfish have disappeared. So far this year, John Meriwether's leveraged bond fund, which he started after his previous effort, Long-Term Capital Management, collapsed spectacularly in 1998, has suffered substantial losses. Meanwhile, the former chief executive and star trader of Amaranth Advisors, which closed after losing $6 billion in 2006, are both out trying to raise money for new funds.

Michael Sugrue

Jim Cunningham (left), John Burbank and Walther Lovato of top-performing Passport Capital made a small fortune in commodities and energy last year.

So why do investors keep giving them the keys? Because they believe the very best hedge-fund managers can provide market-beating performance over time without fiery wrecks and that they provide an important alternative to traditional market returns. It's hard to dispute their popularity: At year end, Lipper recorded about 9,500 funds handling roughly $1.79 trillion in assets.

Barron's ranking of the top 75 hedge funds suggests that some funds can deliver on these promises without accidents. Nine of them have gained more than 40% a year over the past three years, net of fees.

"Hedge funds are a story that still sells," says Ferenc Sanderson, senior hedge-fund analyst with Lipper. "Even though performance was disappointing last year, hedge funds on a risk-return basis generally outperformed the equity benchmarks," he notes.

Indeed, the average fund returned 10.2% versus 5.5% for the Standard & Poor's 500 and 7% for the Lehman U.S. Aggregate Index.

This list is our attempt to highlight funds that have posted strong returns not just for one year, but over a three-year span. We eliminate funds that invest in a single sector, country or region because we want to focus on savvy investors rather than those who happen to be operating in an attractive marketplace. And we set a minimum fund size of $300 million to assure the group offers stability. We worked with two hedge-fund database companies, BarclayHedge (www.barclayhedge.com) and CASAM CISDM to sort through literally thousands of firms. A free-lance journalist who specializes in markets, Eric Uhlfelder, then confirmed the figures and supplemented the information with additional reporting.

Michael Crouser

Harbinger's Philip Falcone: Shorted financials and bought metals.

Playing the short side of the subprime mess was definitely a winning strategy for funds like **Passport II Global**, **Balestra Capital Partners**, **Harbinger Capital Partners Flagship** and **Whitebox Hedged High Yield** (profiles of their strategies begin below). Other winning strategies were related either to commodities or emerging-markets (like that of **Everest Capital Emerging Markets**, also below) or shorts on specific stocks or markets.

It's still a slick course these funds are racing on. January, for instance, was a disastrous month for many funds, coming on top of last summer's abrupt decline. Even some of our winners, like Kinetics Partners and Dynamic Power Hedge, saw 14%-plus losses in the first month of 2008. Already in the fourth quarter of 2007 the flow of money into hedge funds had dropped to $13 billion from $39 billion in the third. Many funds are imposing restrictions on investor withdrawals, but that may not be enough to stem an outflow this year.

The general deleveraging of the credit markets means fewer mergers and acquisitions for arbitragers to play and much tighter terms for bank loans, which are the lifeblood of many funds. Strategies that use a lot of leverage to generate low-risk profits will now be tough to pull off.

Chris Casaburi

James Melcher of Balestra: Doesn't believe financial crisis is over.

That's why big institutional investors like major pensions keep homing in on new ways to get good performance while spreading their risk. The $52 billion Ontario Municipal Employees Retirement System, for instance, is in the process of shifting its annual asset allocation mix from 90% financial instruments and 8% alternative assets in the early 1990s to a roughly 50-50 mix by 2010.

OMERS is even going a step further, buying hard assets on its own. "There's just too much volatility in the public markets to provide the match that OMERS needs to fund its long-term liabilities," says Michael Nobrega, president. He acknowledges that no capital pool can escape the volatility of public markets. "Even if we don't have asset-backed commercial paper, we wind up getting caught in the down-draft," he notes. "Financial assets give the illusion of liquidity. Down-drafts affect everyone who can't get out at their price. We find that a lot of pension funds are coming in our direction of an asset mix strategy that shifts toward the acquisition of hard assets and away from financial assets," Nobrega says. Either way, however, investment performance remains at the heart of the issue.

Table: Hedge Funds

John Burbank
Passport II-Global

Burbank is a big-game hunter. "We care about things that can double over the course of two years," explains the 44-year old founder of San Francisco's Passport Capital and manager of its flagship, the $860 million Passport II-Global fund, our No. 1 performer.

Burbank's quest takes him to places that many of his peers overlook or shun. "In every decade, there is an asset class or category in which people have underinvested," he says. "What we make a lot of money in is what other people haven't seen coming, where there is real change under way."

It turns out that Burbank -- an English major who headed off to teach in China, pondered film school, ran a painting company and worked for beverage outfit Odwalla before finally entering finance at the age of 30 -- is good at identifying those inflection points. Launching Passport as the dot-com bubble was bursting back in the summer of 2000, "I saw emerging markets go down massively, and stuff that didn't make much sense go up massively, both unexpectedly," he says. "Markets weren't terribly efficient around big changes; I could profit from that."

Profit, indeed. Burbank's clients reaped a 219.44% return in 2007, bringing their annualized three-year gain to a hefty 65.50%. It's also worked out nicely for Burbank: His firm, launched with $800,000 in capital from friends, had $3.7 billion in assets at year end.

While India has been a popular target of hedge-fund and mutual-fund managers in the past few years, Burbank began investing there in 2002. "There was very little correlation between what was happening in India and the United States," he recalls. He was also early to see the credit bubble and turned bearish on U.S. markets in 2004, ultimately betting against subprime lenders. "We started owning credit-default swaps on subprime mortgage pools in 2005 -- and earned 30 to 40 times our money," he explains.


Joe Treleven

Andrew Redleaf's Whitebox offers contrast to mysterious black boxes.

Commodities have been another source of profit. Two key colleagues -- Jim Cunningham, who advises him on mining and metals businesses and oversees a Passport fund dedicated to that sector, and veteran energy investor Walther Lovato -- established the fund's hefty positions in everything from gold stocks to direct investments in iron-ore and coking-coal projects in sub-Saharan Africa. Burbank's interest in energy has evolved beyond fossil fuels: Passport is now investing in companies that use technology to develop alternative sources of energy.

Not enthusiastic about U.S. markets, Burbank & Co. is eyeing the Middle East, particularly Dubai. "There are great financial-services companies and a few commodity companies there that are really appealing," he says. "This is shaping up to be yet another one of those big market moves that the rest of the world didn't see coming."

-- Suzanne McGee

James Melcher

Balestra Capital Partners

Melcher doesn't think the bailout of Bear Stearns signaled the end of the credit-market crisis. His skepticism is understandable in light of his recent experience.

Melcher's $450 million hedge fund posted an amazing 199.14% return last year (lifting it to a 48.59% annualized gain over three years), mostly by putting money behind its conviction that there was a credit bubble in the U.S. financial system.

The 68-year-old Wall Street veteran bought credit- default insurance on investment-grade mortgage-backed securities as well as on the debt of companies like Countrywide Financial (ticker: CFC), MBIA (MBI), Ambac (ABK) and Bear Stearns (BSC) -- all of which eventually got into trouble. Two years ago, Balestra went so far as to get itself an International Swap & Derivatives Association license, which allowed it to buy and sell derivatives and swaps that weren't available to the general public. Balestra was able to liquidate the mortgage-backed insurance at a huge gain in last summer's initial crisis, and more recently made a similar killing on the insurance for the firms' debt.

It also bought a long-term put on Bear Stearns common shares at a strike price of $60 when the stock was still trading at about $100; months later, it sold with the shares at $3.50. He was short the ABX Index, which tracks mortgage-backed performance. That, too, was an extremely profitable trade.

Balestra is known for bold stands: It went to cash anticipating many of the problems that eventually occurred in Russia in 1998 and again in 1999 when tech stocks looked grossly inflated. Melcher remains a bear because he thinks more bad news will come out, possibly in the credit-default swap marketplace, owing to the confusing array of huge cross-pledges big institutions have made

"I fear it's going to get worse before it gets better," says the manager.

-- J.W.

Philip Falcone

Harbinger Capital Partners Flagship

This fund got off to a strong start buying distressed securities in the bear markets of late 2001 and 2002. But the respectable mid-teens returns from those investments didn't anticipate last year's bonanza: The $14.1 billion New York-based fund rose 116.10% as it exploited the subprime crisis, among other opportunities.

The former high-yield trader at Gleacher & Co. and Barclays Capital built a short position in mortgages via credit-default swaps in 2006. By 2007, Falcone was also betting against commercial and investment banks like Bear Stearns, mortgage specialists and monoline insurers. These plays helped the big fund achieve a 43.90% annualized return over the last three years.

Although he's kept about a third of his subprime exposure through credit-default swaps, Falcone unwound the rest early this year, reallocating his winnings into stocks, distressed debt and cash. He's retaining the balance, along with his short position in financial stocks, because he thinks market enthusiasm triggered by aggressive Fed action is overdone.

Subprime wasn't the No. 8 finisher's only smart recent move. The fund still would have been up by more than 30% in good part because of its 20% stake in Australian iron-ore producer **Fortescue Metals Group** (FMG.Australia). In 2004, Fortescue was short of capital. Convinced its management was sound, Falcone started buying the ordinaries at US $2. He liked iron-ore because it's less volatile and speculative than gold, copper or oil. Demand for the metal appears to be well ahead of supply.

Today, Fortescue's shares are trading at a split-adjusted price of around $60.

Falcone has two other stocks he likes based on favorable supply-demand trends. He owns more than 20% of independent power producer Calpine (CPN) and has a stake in a wireless company, OTC-traded SkyTerra Communications (SKYT).

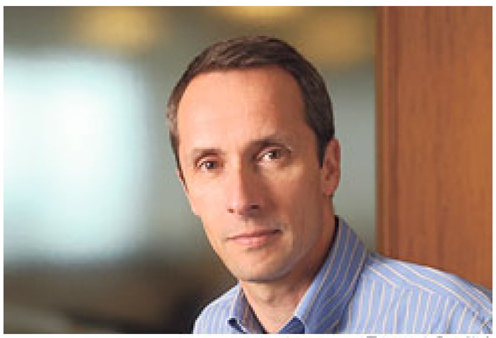
Harbinger's bet on SkyTerra is in the red, but the firm can certainly afford to be patient.

-- Eric Uhlfelder

Marko Dimitrijevic

Everest Capital Emerging Markets

Chief Investment Officer Dimitrijevic is a firm believer in the promise of emerging economies. Supported by a rising middle class, these areas are just beginning to come into their own: Their consumption already is affecting the supply and demand for everything from food to telecom services to banking, he says. And their needs are spurring huge gains in infrastructure spending, providing still more growth opportunities.



Everest Capital

Everest's Marko Dimitrijevic likes Middle East shares.

Swiss-born and of Yugoslavian descent, the 48-year-old Dimitrijevic skillfully played these themes last year, using shares, bonds, commodities and currencies on both the long and short sides to realize a 30.20% rise in Everest's $1.1 billion fund. Overall, the fund, No. 54 in *Barron's* ranking, posted a 23.10% annualized three-year return.

Dimitrijevic continues to benefit from his long soft-commodity exposure in soy, corn, rice, coffee and cotton. He's also in the stocks of local banks where these crops are grown, such as Brazil's **Unibanco** (UBB) and Indonesia's **Bank Rakyat** (BBRI.Indonesia), that profit from the increased business. Another favorite: **Arabtec Holding** (ARTC.Dubai), a UAE construction company that's a play on the Gulf region's massive investment in infrastructure. Dimitrijevic, who ran money for New York activist Nelson Peltz before setting up his Bermuda-based firm in 1990, is also long the Chinese yuan and the Kuwaiti dinar versus the dollar.

The manager's biggest emerging-markets concern at present is inflation. Real rates are negative in economies like Argentina, Singapore and Taiwan, and rising prices will likely force central banks to tighten lending. That, in turn, could reduce some of the consumption that Dimitrijevic has played so effectively.

Should shareholders worry about the first-quarter sell off of emerging-market shares? The veteran global investor believes it's a correction set off by nervous investors rather than any reflection of systemic problems in these economies.

-- E.U.

Andrew Redleaf

Whitebox Hedged High Yield

"Especially now, credit is much more interesting than equities," says Redleaf, founder and CEO of Minneapolis' Whitebox Advisors, whose $1.3 billion Hedged High Yield fund posted a 32.90% gain last year, raising its three-year annualized return to 20.82%, good for the 63rd spot on our list.

The Yale grad, who earned both his bachelor's and master's degrees in math over just three years and traded options in Gruntal's New York office for about 18 months afterward, chose the name Whitebox as a contrast to mysterious "black box" quantitative operations. "That term," he says, "either implies that the mathematics is too unearthly to be understood by mortals, or so elegant and original that it must be kept secret. Neither is true."

Although he won't discuss the specifics of his high-yield strategy, Redleaf, 50, is known as a creative thinker. For instance, rather than just buying commodities, he's bought entire grain elevators as an added play for some funds.

Whitebox did short the subprime mortgage market last year and also bet against mortgage-finance companies as well as the big global banks. The high-yield fund specializes in stress situations using all of a company's capital structure for arbitrage. Back in 2005, when General Motors (GM) was in big trouble, Whitebox bought the long-dated paper of its financing arm, GMAC, while shorting eight-year GM bonds and stock. It's also played airlines like Delta Air Lines (DAL), going long the bonds and short the stock.

Redleaf is glum about stocks' intermediate-term prospects: "The stock market is set for a long, grinding decline, which many investors will refuse to acknowledge until it is too late." The credit markets, in his view, will afford many more opportunities than equities.

-- J.W.

A Brutal Start to 2008

With the exception of short-equity strategies and some global macro investments, virtually no hedge-fund plan worked well in the first quarter.

Index	Q1 2008 Return*
Barclay Hedge Fund	−4.33%
Sub-Indexes	
Convertible Arbitrage	−3.92
Distressed Securities	−4.72
Emerging Markets	−9.45
Equity Long Bias	−6.86
Equity Long/Short	−3.52
Equity Market Neutral	−0.66
Equity Short Bias	12.44
European Equities	−2.30
Event Driven	−3.75
Fixed Income Arbitrage	−2.18
Fund of Funds	−4.27
Global Macro	1.23
Healthcare & Biotechnology	−9.83
Merger Arbitrage	−0.37
Multi Strategy	−1.71
Pacific Rim Equities	−7.21
Technology	−5.39

* Performance does not include all constituent returns for March

Source: BarclayHedge.com