Ken Griffin's $15 billion firm was flirting with disaster this fall. In a rare interview, he explains how it survived.

ON THE MORNING of Friday, Oct. 24, James Forese, Citigroup's head of capital markets, picked up the phone and called Kenneth C. Griffin, the founder and chief executive officer of Citadel Investment Group, a Chicago-based hedge fund that manages $15 billion and has 1,300 employees worldwide. For Forese, it wasn't an easy call to make, but he felt compelled to do it. People were gossiping all over Wall Street, on CNBC, and on blogs that Citadel was toast. Word had it that the firm's two hedge funds were down as much as 40%. Talk of the firm's liquidation was rampant. Then there was the most damaging rumor of all: Griffin had been holding "secret meetings" with the Federal Reserve, looking for a bailout.

According to the scuttlebutt, Citadel was shaping up to be the next tragedy of the credit crisis--soon to be tagged and bagged alongside Bear Stearns, Fannie Mae, Freddie Mac, and AIG. The firm's vital signs were in fact weak: Credit default swaps (essentially insurance) on Citadel's bonds were trading at distressed levels, priced higher than the ones on Lehman Brothers during the Friday before the investment bank declared bankruptcy.

As one of Citadel's trading partners, Forese knew the truth: Citadel's liquidity position was fine, though its flagship funds were down about 35%. So Forese told Griffin to do something that went against every clandestine bone in the hedge fund manager's body: take his case public. "Ken, you guys are getting killed in the rumor mill," Forese said. "Most of these things are just blatantly false. If you get out there and say you're fine, it will mean a lot to the market right now." Griffin, 40, took the advice to heart and staged a conference call in which he addressed the firm's cash position and performance. Within days, the rumors ceased and the firm stabilized--albeit with assets down about 25% from where they had been at the end of 2007.

"I have never seen a market as full of panic as I have seen in the past two months," Griffin told Fortune in a rare interview on Nov. 14 at New York's Four Seasons Hotel. The experience of being inside the panic changed Griffin and changed his firm. Once thought of as humorless and stiff, he now comes across as more personable and even makes the occasional quip. He no longer speaks about how Citadel will become the Goldman Sachs of the 21st century.

While it may be hard to relate to a guy who buys an $80 million Jasper Johns painting (as Griffin did two years ago), the story of how Citadel clawed its way back from the abyss is a cautionary tale for any investor who would try his hand at making money in volatile markets. The firm's
horrific downturn provides a lesson about the way raw human emotions like panic can trump even the smartest mathematical models. More important, the tactics the hedge fund used to survive--preventing its investors from withdrawing en masse and opening up its books--may become trends for hedge funds in the future. He summed up this life lesson when he testified before the House Committee on Oversight and Reform in November: "Our financial markets work best when they are competitive, fair, and transparent."

Griffin, a math whiz who traded stocks from his dorm room when he was at Harvard, had until very recently succeeded in insulating his firm from risk. Since starting his hedge fund in 1990, Griffin had become a multibillionaire. He had grown Citadel beyond a hedge fund into a diversified financial company with lucrative, fee-based businesses. These include trading and back-office services as well as a trading platform that handles more than 30% of U.S. equity options trades and more than 8% of Nasdaq and New York Stock Exchange stock trades.

The firm seemed so solid that two years ago it effortlessly sold roughly $500 million of bonds in its first offering and was considering going public. Indeed, Citadel has been one of the most successful and consistent hedge funds over the years. The firm prided itself on using state-of-the-art technology to turn investing into a science. Between 1998 and 2007 it notched returns of 20% a year, more than three times that of the Standard & Poor's 500-stock index. Citadel's best year ever was 2007, because its flagship fund, Kensington, rose 30%.

Part of the explanation for these healthy returns was Griffin's talent for steering clear of investing fads. He also stepped in to profit from the wreckage when hot money chased the mania of the moment. Citadel pounced on Amaranth Advisors, the $9.5 billion hedge fund that cratered over bad natural gas trades (see "The Man Who Lost $6 Billion" on fortune.com). Citadel bought Amaranth's positions and eventually turned a sizable profit on them. It also swooped in and bought credit portfolios of Sowood Capital Management in mid-2007 when that $3 billion hedge fund took a 50% nosedive and imploded.

After watching Long-Term Capital flame out in 1998, Griffin specifically designed Citadel to be prepared for almost any market calamity. "We had planned for a repeat of the crash of '87. We had planned for a repeat of '98," says Griffin. He claims, for example, that Citadel would have made it through a 1987-style crash losing just a few percentage points, or "in pretty good shape." But, he is quick to add, "the idea that the largest banks in the world would simultaneously fail, need government support, government guarantees, and/or government intervention to survive was not in my range of realistic scenarios."

Maybe if he had paid more attention to English literature back in Cambridge, Griffin would have remembered Hamlet's admonition to his risk manager: "There are more things in heaven and earth, Horatio, than are dreamt of in your philosophy."

UNTIL LABOR DAY, Griffin thought he had pulled off one of the most difficult feats in investing: calling the bottom of the market. On trading desks, this strategy is also known as "catching a falling knife." Not long after Bear Stearns collapsed in March, Griffin and his traders swooped in and bought truckloads of what they considered undervalued investments, mostly in the financial sector. They were hoping to catch a falling knife. They ended up catching the blade, not the handle.

Citadel's positions in financial companies seemed fine until mid-September. Up until then, Griffin would occasionally come into the office a little late, maybe even at 10 A.M., so that he could play with his 1-year-old in the morning. This new, semi-chilled-out Ken was a huge departure from the pre-fatherhood version, for whom the day rarely started no later than 7 A.M. Sure, his two main funds, Kensington and Wellington, were experiencing general market losses, but they were still doing better than their benchmarks. In fact, the downdraft didn't start until Monday, Sept. 15, when Lehman Brothers filed for bankruptcy. Griffin's response was to get on the phone with Fed board members.

"We were very focused on the collateral damage from Lehman to the overall system. What I was worried about was the money market funds breaking the buck," he says. The Fed board members assured Griffin that the markets would remain orderly as Lehman unwound its positions. But he says in retrospect that he experienced a false sense of security. He describes the feeling on that particular Monday as akin to watching a giant wave go underneath a boat you're sailing on, and nothing happens. As devastating as Lehman's failure was, it appeared to Griffin at the time to be a manageable event.

The big problems at Citadel didn't start until at least a week later. That's when Griffin realized that the wave was "an undersea earthquake," he says. "In the case of Lehman, it wasn't a few hours later but a few days later when the wave hit the shore. But it wasn't a little wave anymore. It was a giant tsunami." The tsunami that threatened to capsize Citadel was the massive global credit freeze. Like other hedge funds, the firm
found it nearly impossible to borrow money to finance its positions—particularly in convertible-bond arbitrage—a market Citadel had stormed into during the summer when convertible-bond prices were dirt cheap.

Convertible-bond arbitrage is a strategy in which investors generally buy the convertible bonds of a company while simultaneously shorting the company's common stock. It's essentially a bet that the bond will perform better than the stock. An added headache for Citadel created by Lehman's throwing in the keys was that as Lehman's positions were sold into the market, the selloff brought down prices on all stripes of securities. It didn't matter whether Citadel was long equities or short equities; the assets the firm had to fund with banks suddenly were repriced to the point where Citadel struggled to fund them. This was a shock wave that Citadel never anticipated. In other words, as many of Citadel's positions sank, the banks called, needing more collateral to back up the beaten-down assets.

Citadel's convertible-bond holdings—which accounted for around a quarter of the hedge fund's total losses—were hit hard when traders all over the world were forced to sell bonds to raise cash. It was even difficult to unwind positions. "Anything credit-related like convertible bonds was tainted," said Tom Sowanick, chief investment officer at Clearbrook Financial in Princeton, N.J., which manages $22 billion. The widespread selling also mangled Citadel's high-yield and investment-grade bonds and leveraged-buyout loans. All of these holdings were hedged with credit default swaps, which are supposed to protect buyers in the event of a default. But the gap between credit default swaps and the prices of the bonds they insured widened as lenders stopped doling out money, and it became clear that more companies would default. The result was a topsy-turvy situation in which the credit default swaps were becoming pricier than the bonds they were supposed to protect.

The panic that swept through the capital markets after Lehman declared bankruptcy was one form of human frailty that Citadel's sophisticated mathematical models could never have anticipated. The second and perhaps more devastating one occurred on Wednesday, Sept. 17, when news broke that the Securities and Exchange Commission was considering a temporary ban on short-selling 900 stocks—799 of them financial stocks.

The proposed ban was good news for the banks and brokers. It meant that Morgan Stanley, Citigroup, and others didn't need to worry that hedge funds could drive them to the brink. Yet the news was horrifying for hedge funds like Citadel. Scores of Citadel's positions—particularly in convertible arbitrage, which requires shorting—would simply blow up if the ban went into effect.

According to sources, Griffin phoned Christopher Cox, the SEC's chairman. Griffin pleaded with Cox, telling him the ban could mean certain death to many hedge funds—including Citadel. Cox, according to these sources, was unmoved and merely responded with the party line about how the country was going through a national financial crisis and the SEC needed to do what it had to. There was nothing Griffin could do or say to sway him, and on Friday, Sept. 19, the ban was made official. (The SEC declined to comment for this story.)

Citadel was now hemorrhaging money. Over the weekend and throughout the following week, Griffin talked with his portfolio managers and told them to dump the dogs and keep the racehorses, meaning preserve the positions that they believed had long-term upside as they engaged in a selloff. By the end of September, Citadel's funds were down 20%. In early October, Griffin sent a letter to investors stating that September had been the "single worst month, by far, in the firm's history. Our performance reflected extraordinary market conditions that I did not fully anticipate, combined with regulatory changes driven more by populism than policy."

ASIDE FROM FALLING PREY to panic and the "populism" of Christopher Cox, Citadel would also get a lesson in the importance of another emotion—namely confidence. Hedge funds and banks need to have confidence in each other for markets to operate efficiently. By the time Griffin turned 40 on Oct. 15, that trust in Citadel's viability was starting to fray.

Credit default swaps on Citadel's debt and its leverage ratio became the next problems for the firm. They were now being quoted at distressed levels, meaning confidence in the firm's ability to back its bonds was at an all-time low. (Citadel has roughly $300 million in bonds outstanding after buying back about $200 million worth, and the bonds are rarely traded. Still, in mid-October, Standard & Poor's downgraded Citadel's bonds from stable to negative. On Nov. 18, S&P downgraded Citadel's bonds again, citing the firm's market losses.)

During October, Citadel also had to crush a rumor that appeared on a blog about its leverage hitting a ratio as high as 13 to one. According to the firm, the ratio was actually four to one (that means for every $1 of assets under management, Citadel had borrowed another $4). Nevertheless, by that time smart fund managers had already drastically reduced leverage to almost zilch. The reason? They didn't want to fall...
prey to margin calls, forcing them to dump stock to repay the loans. Citadel was getting some margin calls from lenders. But according to Gerald Beeson, Citadel's CFO and COO, the firm was able to pay the banks, which included Goldman Sachs, Merrill Lynch, and Deutsche Bank, with proceeds from its trading platforms and cash reserves.

"We became a story. That's not a good place for a financial institution to be. People may become incentivized to feed the rumors and take the other side of your positions, and some may try to push your portfolio against you," says Griffin, who believes there were traders trying to take his firm down. His persona as a Chicago-based maverick who had little time for the Wall Street Boys Club did not help matters.

"Ken has created a number of enemies on Wall Street," says a rival hedge fund manager.

Griffin set out to be generally independent of Wall Street. His business model was to create a diversified financial firm that did not rely on investment or commercial banks for trading or capital, which left Citadel with few friends in a world that requires fraternization through trading with one another, sharing information, dealmaking, and fee splitting. "That very notion has pissed off a lot of people along the way," says the manager. (Recently, for example, Jamie Dimon, J.P. Morgan's CEO, temporarily refused to trade with Citadel after Griffin poached several top bankers.)

Regardless of its source, the gossip reached a tipping point during the week of Oct. 20, when the potentially lethal Fed bailout rumor surfaced. There were also reports that the Fed had been questioning Citadel's trading partners, asking them how much exposure they had to the firm. Griffin acknowledges that the Fed did indeed question Citadel's trading partners, but he is quick to point out that the Fed was questioning all counterparties that traded with large hedge funds, not just his firm's, and that it was standard practice. But it was the Fed bailout rumor coupled with Forese's phone call that coaxed Griffin into the spotlight.

Despite some disagreement among Citadel's top management about conducting an emergency conference call, Griffin took Forese's advice, and his firm announced around 12:30 P.M. that very day, Oct. 24, that it would be staging a call primarily for its bondholders, but that the call would also be open to others. Ironically, there was a major technical glitch for the firm, which prides itself on its technological prowess: The call was scheduled for 3:30 P.M., but because more than 1,000 people tried to pile on--investors, Wall Street, the press--Citadel's lines couldn't handle the traffic, causing a 25-minute delay. Those who got on the call were forced to listen to what one participant describes as "annoying techno music" during the wait.

Forese had told Griffin that there were two things he needed to convey on the call: "First, just get the facts out about your solid liquidity position. Second, you need to stem rumors about your survival."

The actual call was short--just 12 minutes. Griffin and Gerald Beeson assured the public it wasn't going under, telling them it had 30% of its investment capital in cash and an $8 billion credit line it could tap, among other things. Says Beeson: "That next Monday when we came in, things were noticeably quieter. The conference call did stop the [press calls] and allow us to get back to work."

SITTING IN THE BAR of the Four Seasons Hotel in New York with Griffin on a Friday afternoon--a day after watching him on C-SPAN, justifying his existence to Congress--is an odd experience. The past two months have felt like an entire year to him. True to his nature, he maintains a Zen-like calm, his cool blue eyes rarely blink, and he sips a glass of water as he talks about the lessons of the crisis.

If anyone could use three fingers of Wild Turkey, it's Griffin. Just the day before, on Thursday, Nov. 13, he was scrutinized by the nation as he and hedge fund compadres such as George Soros and James Simons were grilled on Capitol Hill by a congressional panel on issues such as why hedge fund managers make gobs and gobs of money; whether hedge funds are toxic to the market; and why they are so darn secretive.

During the panel, Congressman Edolphus Towns said, "All of you have successfully navigated the recent problems in the economy, which appear to have blind-sided the people on Wall Street and, of course, the people here in Washington. I don't think we can pass up this opportunity to explore what it is that you knew that allowed you to get so far ahead of everyone else when it came to predicting what would happen in the markets."
Unlike John Paulsen, seated to Griffin's left, who had profited hugely from shorting subprime and was able to explain his strategy, Griffin had to tell Congress, America, the world, that his firm had screwed up. He said, "Sir, the last eight weeks have been a challenging eight weeks for Citadel."

Back at the bar, Griffin seems somewhat humbled. Citadel's survival isn't a 100% done deal. According to investors, the flagship fund was down 47% year-to-date as of Dec. 4. But odds are that Citadel isn't going away, for several reasons. First, its cash position continues to be strong. Second, investor redemptions are not a huge concern right now. After Long-Term Capital cratered in 1998, Griffin astutely put in two-year lockups. For investors who pull money out early—and they are allowed to take out only a portion—there are steep fees, as high as 16%. Citadel expects year-end redemptions to be around 10%—comparatively low for the industry.

Also, Griffin is already taking action to streamline his business. Citadel let 20 people go in their trading division recently, and people close to the firm say more cuts are in the offing. He is shuttering a $1 billion fund-of-funds business. The firm is getting out of reinsurance, which hasn't been lucrative. Citadel is also creating new low-price funds that will pursue specific trading strategies, unlike his flagship funds, which are multistrategy. It's possible some of these smaller funds will be long only, eschewing hedging. And Griffin is expanding his capital-markets division, which consists of market-making, trading platforms, and back-office services—all fee-driven businesses.

In case you're wondering, Griffin's personal holdings aren't suffering. He's worth an estimated $3 billion, of which a large portion is tied up in Citadel, and he will remain a major benefactor on the Chicago art scene. Last year he and his wife pledged $19 million to the Art Institute of Chicago to build the Kenneth C. and Anne Griffin Court, set to open in about a year.

But what will Citadel look like at that time? It will be a leaner shop, possibly with fewer assets under management. It will obviously hold on to cash cows such as its options and stock-trading platforms. Griffin says the firm will engage in far fewer complex trading strategies—that long-short equities will be its core: "I think we're looking at a period of time going forward where the market will value simplicity." As he said on the conference call heard round the world, "We need to face the fact that we need to evolve. We will embrace the changes that are part of that evolution, and we will prosper in the new era of finance."

Right now, there are plenty of opportunities Citadel would love to pounce on: loads of cheap stocks, undervalued deals—the kind of things Griffin obsessively seeks out. He says, in fact, he plans to start a convertible-arbitrage fund again as soon as he can. When asked if he would have done anything differently in the past months, he responds not much, other than perhaps reducing some of the firm's more complex investments. Then, after thinking a moment, Griffin says with a sly smile: "With hindsight, of course, I would have been all in cash!" And thus he demonstrates another skill that he mastered during the credit crisis—gallows humor.

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[Reference]
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[Illustration]
[BRENDAN SMIALOWSKI--BLOOMBERG]; "WHEN GENIUS ALMOST FAILED GRIFFIN TESTIFIES BEFORE CONGRESS ON NOV. 13, A MONTH AFTER HIS FIRM WAS RUMORED TO BE SEEKING A BAILOUT.; PHOTO

[BILL HOGAN--CHICAGO TRIBUNE]; TOP OF THE MARKET (FROM LEFT) THOMAS MIGLIS, GERALD BEESON, GRIFFIN, AND MICHAEL PYLES POSING AT CITADEL’S CHICAGO HEADQUARTERS IN 2005; PHOTO

[RETURN ENGAGEMENT FORTUNE DUBBED CITADEL "AN EXQUISITE TRADING MACHINE" IN AN UNAUTHORIZED LOOK AT THE FIRM BACK IN APRIL '07.]; PHOTO

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