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# Sowood's Short, Hot Summer

**How Founder of Hedge Fund, a Star at  
Harvard's Endowment, Fell From Stratosphere**

By GREGORY ZUCKERMAN and CRAIG KARMIN

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In early July, hedge fund Sowood Capital Management LP had been grinding out steady, if unspectacular, gains. Its 49-year-old manager, Jeffrey Larson, once a star at Harvard University's endowment, had girded the fund for turbulent markets.

He didn't seem particularly worried, according to investors who spoke with him at the time.

By the end of July, Sowood was out of business. Its investors lost more than half their money, and its founder was humbled by a market storm that continues to reshape the financial landscape.

Sowood's collapse was among the most dramatic moments in a summer when market forces that the models and strategies predicted could never happen erupted with regularity. Now, analysts and academics are trying to understand how it happened, to avoid similar blowups.



Stephen Gilpin

Mr. Larson was confident about his strategy, and eager to borrow large sums of money to make it pay off. But independent hedge funds -- even those started by cautious, well-respected investors -- are vulnerable to unpredictable moves in financial markets. Once again, hedge-fund stars are suddenly feeling the heat.

"There's very little wiggle room if you don't have the financial resources behind you," said Michael Napoli, who runs Absolute Return Group, a Los Angeles hedge-fund advisory firm. "That's one of the lessons that some hedge-fund managers like Mr. Larson learned this summer."

Mr. Larson declined repeated requests for comment.

After an early trading career at the agricultural commodity giant Cargill, Mr. Larson joined Harvard's endowment, where he earned a reputation as a savvy investor during 12 years there. He focused on foreign stocks and was responsible for \$3 billion of the endowment's \$20 billion in assets by the end of his tenure, taking home as much as \$17 million a year in compensation.

Mr. Larson launched Sowood in 2004, luring a dozen members of Harvard's investment team. He led a group of four partners, including Stuart Porter, who ran commodity investing, and Rick Dowd, a friend of Mr. Larson's who became Sowood's chief financial officer and ran its operations.

The firm, which grew to about 70 members, gained around 10% annually during its first three years, often through savvy bets on debt investments.

Mr. Larson focused on Sowood's portfolio. But he also became heavily involved in other areas, such as the fund's operations, or "back office," sometimes clashing with Mr. Dowd, according to people close to the matter. By last year, Mr. Larson stripped Mr. Dowd of his partnership and brought in another executive to run operations. Mr. Porter and Mr. Dowd left Sowood in December of last year to start

a private-equity firm.

Mr. Dowd declined to comment.

Mr. Larson immersed himself in details large and small at the firm. When colleagues left a mess in the office kitchen or bathroom, Mr. Larson fired off memos to his employees, asking that they do a better job cleaning up.

By the beginning of this year, Mr. Larson was worried about many kinds of riskier debt investments, according to people familiar with the situation. To protect himself and take advantage of those risks, he bought senior debt securities and sold short, or bet against, a range of investments generally viewed as more risky, such as junior debt securities and various stocks.

Mr. Larson's strategy depended heavily on using borrowed money, or leverage. Because he was betting on small movements -- such as whether a company's senior debt would go up more than its junior debt went down -- he borrowed as much as six times the firm's capital to generate respectable returns when his bets were right..

But Mr. Larson's tactics started to backfire in June, when Sowood's investments lost 5%. Despite that, Sowood was up 5% during the first six months of the year, the fund managed more than \$3 billion, and Mr. Larson stuck with his strategy.

In early July, Mr. Larson put \$5.7 million of his own money into the fund. And he directed his traders to borrow even more money to expand the investments, according to people familiar with the situation.

Within weeks, Sowood's positions amounted to as much as 12 times its investment capital, well above most rivals, according to investors in the fund. Sowood relied on a group of banks to lend money for its trades, using certain Sowood investments as collateral.

### **Selling Safety**

As debt markets got nervous, Sowood's portfolio suffered in unexpected ways. Some large banks and investors, dealing with their own losses, sold investments that Sowood owned that were safer, and thus easier to trade, such as certain loans and credit-default swaps on leading companies. The riskier debt investments Sowood hoped would drop didn't move much.

The \$35 billion Harvard endowment would have been able to absorb Mr. Larson's losses. But like many traders who have recently left large organizations to start their own funds, Mr. Larson found he didn't have any leeway in times of crisis.

And as the value of Sowood's investments tumbled, the lenders began marking down the value of the collateral they held, asking that the hedge fund come up with

more collateral to back the borrowing.

Mr. Larson began selling, starting with healthy positions that he could sell easily, such as shares of companies involved in mergers. When that wasn't enough he dumped easily traded bonds, keeping his lenders at bay.

Sowood's investors were not able to withdraw money until the end of 2008, according to terms of their investments. If he could get through this rough period, the firm could regain its footing, he figured, according to an investor who spoke with him.

But by the week of July 23, losses were topping 10% and pressure from lenders was building.

### **Turned Down by Harvard**

Realizing he needed help, Mr. Larson approached executives of Harvard's endowment asking for an additional investment. They turned him down. He then asked for a line of credit but this, too, was rejected. Harvard's executives determined that extending any more money to Sowood was too risky, according to people familiar with the matter.

Talking to a friend that week, Mr. Larson said he was "embarrassed" about his firm's troubles, according to the friend.

By early Friday, July 27, Sowood was down more than 10%; Mr. Larson worked through the weekend, grabbing a few hours of sleep at the nearby Jurys hotel. By Sunday, Sowood was down more than 40%.

At least one investor urged Mr. Larson to go on, but he was ready for desperate measures. Mr. Larson called Ken Griffin, the head of Chicago hedge fund Citadel Investments, asking if he would be interested in buying Sowood's entire portfolio.

On Monday, July 30, Sowood revealed to its investors that its two funds lost as much as 55%. Harvard, the biggest investor, lost about \$350 million. Mr. Larson apologized, telling investors that he had salvaged just \$1.4 billion.

The fund returned to investors \$90 million of fees collected before the problems hit. But they're waiting for more. In recent weeks, Mr. Larson has told investors he'd like to resume his trading career. He said he wasn't reckless, and that his investments eventually would have led to profits. On this point, few would dispute: Citadel has made big gains on the investments, according to people familiar with the situation.

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