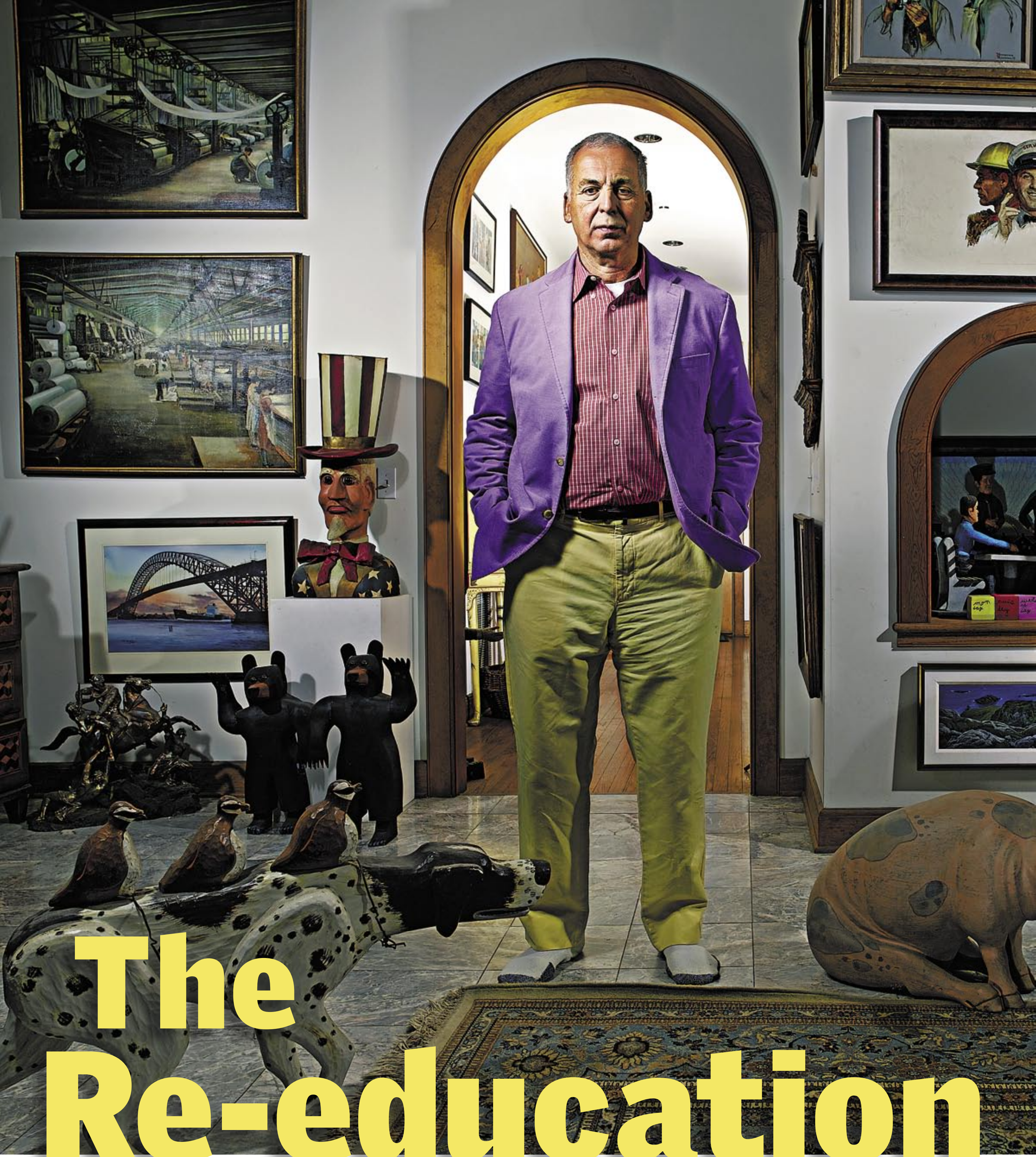


The Re-education of Victor

PHOTOGRAPHS BY BRAD TRENT

Niederhoffer in his Connecticut mansion

A hedge fund star of the 1980s and '90s, Victor Niederhoffer lost his firm and fortune almost overnight. This is the story of his long journey back.

By Deepak Gopinath

One evening in April, Victor Niederhoffer went to a party at the St. Regis Hotel in New York.

Niederhoffer, 62, used to be one of the most-prominent hedge fund managers in the U.S. He made a fortune during the 1980s and '90s, trading out of his New York office and chalet-style mansion in Weston, Connecticut. Then Niederhoffer lost it all—his $130 million fund and most of his own savings—when his bets on the markets went wrong.

Niederhoffer's life collapsed beneath him. He closed his firm. He mortgaged his house and sold his cherished collection of antique silver. Among those treasures was a 5-foot (1.5-meter) horn of plenty that had once belonged to King Charles XV of Sweden. Niederhoffer says he became so depressed that his family feared he might kill himself.

As he walked beneath the gilt chandeliers of the St. Regis that April night, sporting a lavender blazer, Niederhoffer was back on top. He was being honored at a fete for some of the country's top money managers. Since 2002, Niederhoffer has parlayed $2 million into a new, $346 million hedge fund, Matador Fund Ltd. Last year, he posted a 56 percent return, for an average annual return of 41 percent. "I appreciate the difficulty and the courage it took to give me an award, since I once went under," Niederhoffer told the crowd of 300 money managers.

It's been a long journey back for Niederhoffer, a Wall Street iconoclast who celebrated his early achievements in a memoir titled *The Education*

Niederhoffer

of a Speculator (John Wiley & Sons, 1996). The book traced his personal odyssey from Brighton Beach in the New York borough of Brooklyn—“the underdog capital of the world,” he called it—to the pinnacles of finance. Niederhoffer wrote of his prowess on the squash court, his unflinching concentration, his high-stakes trades. He told of his games of chess and tennis with billionaire financier George Soros, for whom he’d once managed about $100 million.

No sooner had the book been published than Niederhoffer’s unhedged trades in U.S. stock options and Thai equities blew up. Niederhoffer was wiped out, as a chain reaction of devaluations in Asia rocked world markets. The fiasco foreshadowed the spectacular collapse of Long-Term Capital Management LP, John Meriwether’s hedge fund firm in nearby Greenwich, Connecticut, which lost more than $4 billion in 1998 after Russia defaulted on debt.

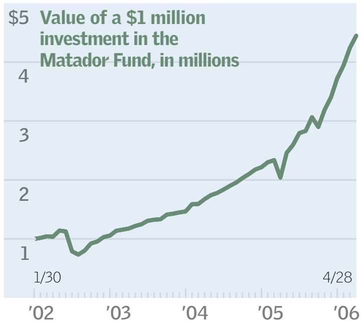
Niederhoffer has recovered from his ’97 blowup. ‘In America, people get a second chance,’ he says.

Niederhoffer became a Wall Street pariah, the butt of black humor and gossip. Brokers refused his business, he says. When he walked into the Four Seasons restaurant in Manhattan, the whispers would start. He says co-owner Alex von Bidder told him the restaurant’s patrons got a thrill from seeing the mighty humbled. “You know how people like to talk,” he says von Bidder told him. “‘There’s Niederhoffer. He just went under. Went in over his head. Got too big for his britches.’” Von Bidder picked up his tab.

Niederhoffer’s 1997 debacle still resonates on Wall Street. When his old broker, Refco Inc., collapsed in scandal last October, word spread that New York–based Refco might have hidden losses that it had incurred on Niederhoffer’s trades. The talk irked Niederhoffer and prompted him to deny what he calls unsubstantiated rumors. He says he had nothing to do with Refco’s unraveling.

Minting money

An investment in Niederhoffer’s fund quadrupled in four years.



Source: Bloomberg

Niederhoffer says he’s emerged from the ashes a changed man. His failure has taught him humility, he says. A Harvard College graduate with a Ph.D. in finance from the University of Chicago and, colleagues say, a preternatural tolerance for risk, Niederhoffer says he no longer believes he can master all markets. He refuses to chase profit in faraway places such as Thailand, where he once lost $50 million. Instead, he focuses almost exclusively on the $130 billion–a-day market in futures and options on the Standard & Poor’s 500 Index. “I try not to reach for the stars,” Niederhoffer says.

Niederhoffer hasn’t lost his appetite for risk, however. As he was during the 1990s, Niederhoffer is a bull. In the argot of Wall Street, he’s long-biased. He tries to make money from short-term movements in the S&P 500. To do that, he buys and sells various futures and options contracts on the index as many as two dozen times a day. He typically holds each position for one to five days. To stoke returns, he employs a tool common to hedge funds, one that accelerated his undoing nine years ago: leverage. Niederhoffer buys on margin, or with borrowed money. The value of the positions he holds far outstrips the amount of money he actually has. Because Niederhoffer is a bull, he’s vulnerable to market declines and has lost as much as 30 percent in a month.

Sol Waksman, founder of Barclay Group Ltd., a Fairfield, Iowa–based firm that tracks hedge fund performance, says he lost some of his own money—he won’t say how much—when Niederhoffer went under in 1997. He says he doesn’t have the stomach to invest with him again. “I never thought in my wildest dreams that it would go to zero,” Waksman says of his investment. “I wasn’t fully aware of the risks he was taking.”

Even before disaster struck, Soros had warned that Niederhoffer was vulnerable to big moves in the markets. “There was a flaw in his approach,” Soros, 75, wrote in *Soros on Soros* (John Wiley & Sons, 1995). “It is valid only in a trendless market.” Soros, who stopped using Niederhoffer to manage money in 1995, declined to be interviewed for this story.

Niederhoffer says he does take risks. That’s the only way to reap market-beating returns, he says. “Not an hour goes by here that we don’t have direct action taken to prevent ourselves from being overwhelmed by tidal movement,” he says.

On a sunny, late-January afternoon, Niederhoffer and his nine researchers/traders are at work in the second-floor trading rooms of his 20,000-square-foot (1,858-square-meter) Connecticut mansion. The estate sprawls over 13 acres (5.26 hectares) in bucolic Weston. A narrow drive stretches past a dozen wooden bulls and bears. One of the bears is 12 feet tall. To the right is a racquetball court that Niederhoffer, a five-time U.S. squash champion, uses to work on his tennis strokes.

Niederhoffer is about 6-foot-2 and has close-cropped gray hair. He favors blazers and trousers in pastel hues of pink, blue, orange and yellow. He never wears shoes indoors.

A collector of 19th- and 20th-century American folk art, Niederhoffer has filled his home with 2,500 paintings, sculptures and carvings. Among them are pictures he has commissioned of people and places that have shaped his life: his father, Artie Niederhoffer, a policeman who worked in Brooklyn's Coney Island; a trading floor; and Brighton Beach in the 1950s. One room contains nothing but glass shelves holding seashells. (Niederhoffer says he's fascinated by evolution.) Another is filled with antique toys.

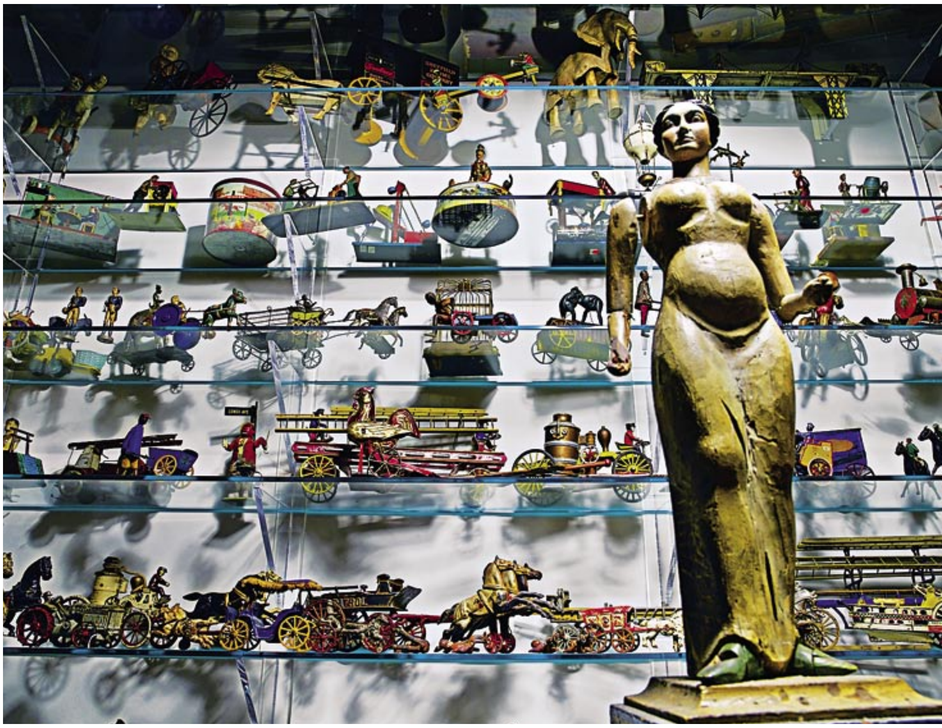
Niederhoffer has stocked his library with more than 15,000 books. He owns a first edition of *The Wealth of Nations* by Adam Smith and a sketch of the light bulb by Thomas Edison. One of Niederhoffer's icons is Francis Galton, a Victorian polymath who pioneered statistical correlation and regression (and, among other things, invented fingerprint identification). Niederhoffer named the eldest of his six daughters Galt, and a portrait of Galton hangs in the library. Another hero is Ayn Rand, author of *The Fountainhead* and *Atlas Shrugged* and a champion of free markets. His library holds some of her letters. Niederhoffer named his third daughter Rand.

Up on the second floor, Niederhoffer and his team sit at wooden desks in two rooms connected by a door and an open window. Niederhoffer, whom his colleagues call "The Chair," sits in one room. A few feet away is Steve "Mr. Wiz" Wisdom, 44, Niederhoffer's right-hand man. Only Niederhoffer and Wisdom trade with investors' money. The rest of the team tests ideas by trading with the $50 million house account, part of Niederhoffer's personal fortune, which he has replenished through profitable investments.

It's an eclectic crew. House trader Ari "Ace" Siegel, 36, put himself through the Yale School of Management by playing poker on the Internet. Now he trades futures on the euro, bonds, oil and U.S. and German stocks for Niederhoffer. Alex "Doc" Castaldo, a graduate of the Massachusetts Institute of Technology with a Ph.D. in finance from the City University of New York, stays on top of academic research and European markets. Charles "The Professor" Pennington, a former physics professor at Ohio State University, specializes in futures and individual stocks. Duncan "The Director" Coker, a former real estate developer and an early Matador investor, researches futures. California native Michael "Dude" Pomada trades stocks.

No one wears shoes. No one speaks. Though they sit just desks away from each other, everyone communicates via e-mail. A stereo softly plays songs from *Show Boat* and other Broadway musicals. Once in a while, someone pads to the kitchen to grab a snack or make tea for Niederhoffer. Occasionally, two men disappear for a game in the indoor squash court, just beyond the library. Above Niederhoffer's desk hang two paintings by New York illustrator Tom Lovell. One depicts a 19th-century daredevil who's tightrope walking across Niagara Falls while carrying a man on his back. The other shows escape artist Harry Houdini, his hands bound, about to jump off a bridge.

Now in his seventh decade, Niederhoffer says he's determined to show the world he isn't a failure. He says his crash cost him more than money; it cost him his reputation. It

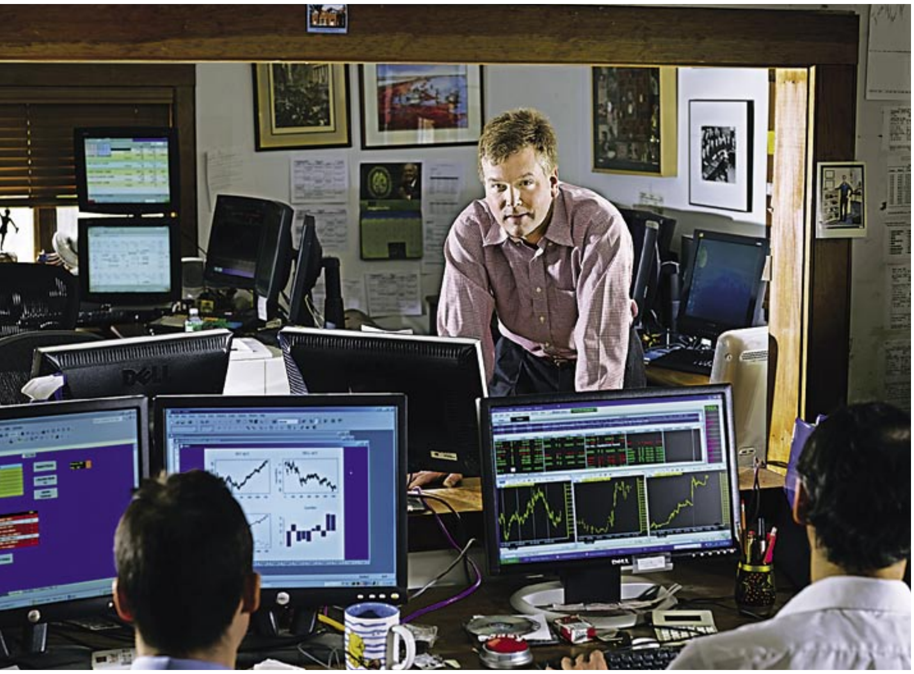


Niederhoffer collects antique toys and seashells. His library holds 15,000 books.

hurts to be branded as a loser, he says. "The ridiculous thing, in all candor, is that I think I've had the greatest run of success in the history of speculation," Niederhoffer says.

Niederhoffer's story begins in Brooklyn, in an era when people drank egg creams on the Coney Island boardwalk and cheered "Da Bums"—the Dodgers baseball team. It was there that Victor Niederhoffer was born in 1943. His father, Arthur, graduated from Brooklyn Law School in 1939, and he became a policeman because the job offered better pay and more security than working as a lawyer. Victor's mother, Elaine, taught school. Young Victor grew up in a small, art deco apartment a block from the beach, the elevated train and Public School 225.

Brooklyn was then a town of working-class stiffs, rebels and losers, according to Niederhoffer. "The mere mention of the name is traditionally good for a raised eyebrow, a snicker or a joke," he wrote. By his own account, Brighton Beach taught him much of what he needed to become a successful trader. "The games, bargains, music, sex and fauna taught me to appreciate the earthy and the nitty-gritty," he wrote. "That's the proper foundation for buying low and selling high, the trade of a speculator."



Steve 'Mr. Wiz' Wisdom helps Niederhoffer trade and manage risk.

The streets of Brighton Beach, teeming with gamblers and dandies, were the Harvard of his boyhood. Victor spent his Sundays there watching handball players with nicknames such as "Bitter Irving," "Bookie," "The Animal" and "The Milkman" play while "Louie the Lion" held a $50 stake under his hat. "Kids aspired to emulate the champions, and Vic was exposed to that," his uncle, Howard Eisenberg, says. "It became very important to win and compete."

Artie soon introduced his son to tennis, and young Victor went on to become the junior champion of New York City five years in a row and win a scholarship to Harvard. There he took up squash and vowed to become a champion. He practiced one shot every day for a month, over and over and over, until he mastered it, and then he moved on to another shot, Eisenberg says. Niederhoffer often wore mismatched sneakers on the court, a habit that earned him a reputation as an oddball. By the time he graduated in 1964 with a degree in economics, he'd become the U.S. intercollegiate squash champ. He went on to win the U.S. national championship five times.

Niederhoffer was never a graceful athlete, says Vic Elmaleh, his doubles partner at the 1968 nationals. He won because he was consistent, Elmaleh, 87, says. "He was also one of the most-confident people I had ever known," he says.

Niederhoffer was an iconoclast off the court, too. His senior thesis, "Non-Randomness in Stock Prices: A New Model of Price Movements," challenged the so-called random walk theory, which holds that market prices follow a haphazard path. Niederhoffer argued that stocks followed patterns. For example, he found that when stocks fell on a Friday, they usually declined the following Monday, too. "At that time, it was considered academic heresy," says Ronald Volpe, 63, a professor of finance at Youngstown State University in Ohio.

From Harvard, Niederhoffer headed west, first to the University of Chicago, where he collected his doctorate in 1969, and then on to the University of California, Berkeley, where he became an assistant professor of finance. He didn't stay in academia for long. While teaching at Berkeley, he co-founded a boutique investment bank with Frank Cross, a former Merrill Lynch & Co. executive, and Richard Zeckhauser, a friend from his Harvard days who had a Ph.D. in economics. The firm, Niederhoffer, Cross & Zeckhauser, which started out with $400 of capital, pioneered mail-order mergers, soliciting small, private companies with advertisements or letters and then lining up buyers for them.

"Victor took a business that was very hush-hush—investment bankers meeting CEOs in a private club—and changed it into a mass-marketing business," says Daniel Grossman, 64, a former lawyer at NCZ and now an entrepreneur.

Niederhoffer bought several companies himself. One sold snails whose shells had been decorated with rhinestones. "It was a fantastical, whimsical idea that was, in retrospect, foolhardy," Niederhoffer says.

As he had on the squash court, Niederhoffer projected a quirky image to impress clients and unnerve competitors, says Henry Juszkiewicz, who worked at NCZ in the early 1980s and is now chief executive officer of Nashville, Tennessee–based Gibson Guitar Corp. "He acted kind of weird and brilliant during client meetings," Juszkiewicz says. "He'd just have to throw out a few looks and the deal was signed."

Niederhoffer broke into commodities trading in 1979, starting in gold and silver and eventually moving into fixed income and foreign exchange. He hired college kids to input historical market prices into 12 Radio Shack TRS-80 computers that he'd wired together. Niederhoffer, an empiricist like Galton, wanted to base his trades on hard data, not just hunches. He used his jury-rigged mainframe to find predictive relationships between markets.

Niederhoffer hasn't lost his appetite for risk. A bull, he's vulnerable to market declines.

Zeckhauser, now a professor at Harvard's John F. Kennedy School of Government, says he became uneasy with Niederhoffer's risk taking. He quit the firm in 1983 to pursue a full-time academic career. Cross died in the '80s. "Victor's failing was that he got overenthusiastic about things," Zeckhauser says. "No matter what your edge, you can lose everything. You hope and believe he will learn his lesson."

Through much of the 1980s, Niederhoffer went from success to success. Soros entrusted him with a separate account to manage in '81. Niederhoffer says he returned that money in '93 because he felt he'd temporarily lost his edge. "He made good money while the markets were sloshing around aimlessly," Soros wrote of the episode. "Then he started losing money, and he had the integrity to close out the account. We came out ahead."

By the mid-1990s, Niederhoffer's returns—which had averaged 35 percent annually for 15 years—ranked him among the country's top futures traders. In '94, *Business Week* magazine named him the best U.S. commodities fund manager.

Niederhoffer soon reached for more. Emerging markets were on fire. He began betting on stocks in Mexico and Turkey. He hired Steve "Bo" Keeley, a veterinarian-turned-hobo, to travel the world and provide a worm's-eye view of developing economies. Keeley went to Thailand and reported that the economy looked sound. His evidence? The management of Bangkok brothels had improved. "I'm a good point man, willing to go to the heights and depths to acquire accurate data," says Keeley, who now lives in a buried trailer in the Southern California desert.

Based in part on Keeley's reports, Niederhoffer made a trade that was to prove disastrous. In early 1997, he bet heavily on Thai stocks. By then, the tremors had already started in Thailand. Its economy, one of the fastest growing in the world, was becoming overbuilt, overheated and overleveraged. Thai banks had trouble collecting money on property loans, which caused investor confidence to wane and put pressure on the baht, which was pegged to the dollar. On July 2, the Bank of Thailand abandoned the peg. The currency plunged more than 19 percent against the dollar in a day. By August, Niederhoffer faced potential losses of $50 million.

"I was very successful for many years, and I figured I could apply my techniques that worked in the most-liquid markets to emerging markets," Niederhoffer says now. "I made a qualitative inductive leap rather than a quantitative empirical leap."

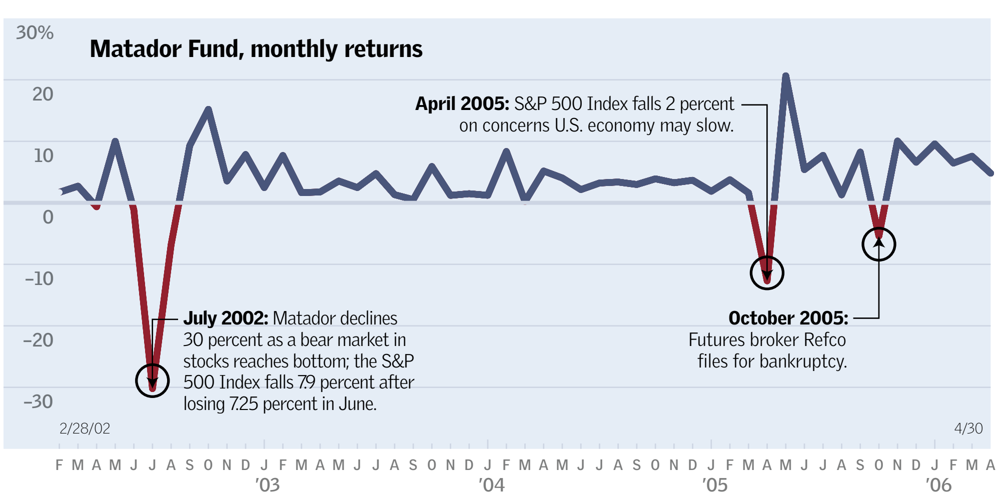
By October, the financial crisis had spread to Brazil and Russia and had begun to shake U.S. markets. Still bullish, Niederhoffer used options to bet that the S&P 500 would rally.

The end came on Oct. 27, 1997. That day, the Dow Jones Industrial Average plunged 554 points, prompting the New York Stock Exchange to halt trading at 3:30 p.m., 30 minutes early. When his broker, Refco, called in his margin loans, Niederhoffer didn't have the money.

Niederhoffer was left owing Refco $2 million. He mortgaged his house and called Sotheby's to sell his silver. His colleagues deserted him. Niederhoffer says he didn't know what to do. He was so used to having things done for him,

Hypersensitive

Niederhoffer's fund has suffered steep monthly declines.



Source: Manchester marketing materials

getting whatever he wanted whenever he wanted it, that he had trouble finding his own kitchen, he says. His sister, Diane, a psychiatrist, sent him a list of 10 symptoms of clinical depression. Niederhoffer says he had shown every one: weight loss, impotence, fatigue—on and on. He says his family put him on suicide watch and made sure someone checked on him whenever he was left alone.

Galt Niederhoffer, right, next to her daughter; her sisters, from left, **Kira, Katie, Artie** and **Rand**

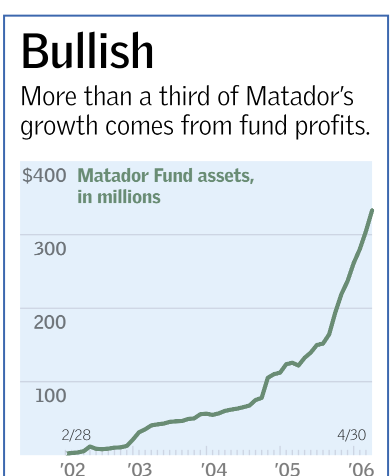
JOE FORNABAIO/THE NEW YORK TIMES

Niederhoffer says he escaped into novels. He read *Gone With the Wind, Les Miserables* and *Master and Commander.* He tinkered with electronics and invented a device that raised and lowered his toilet seat. "It would have saved a lot of marriages," he jokes.

To help him get back on his feet, Al Hallac, a friend who runs Weston Capital Management LLC in nearby Westport, set up a small hedge fund, Wimbledon Fund Ltd., for Niederhoffer to manage. Niederhoffer says brokers were reluctant to handle his trades. Some, worried that they'd be on the hook for his losses if he crashed again, forced him to put up double or triple the usual margin, he says. "Brokerage houses were loath to open an account with me, not only because of their own fear of being involved in a debacle but also reputation risk," Niederhoffer says.

In 2000, Niederhoffer and Laurel Kenner, a former editor at Bloomberg News, began writing columns together for Web sites such as thestreet.com. Later, they began posting musings on the markets on their own site, dailyspeculations.com.

And so it went until July 2001, when one of Niederhoffer's old investors, Mustafa Zaidi, called with the offer Niederhoffer had been waiting for. Zaidi, 39, asked Niederhoffer to become the trading adviser for Matador, an offshore fund Zaidi had set up for institutional investors in Europe and South Africa. Niederhoffer jumped at the chance. When Matador began trading, in February 2002, it had a mere $2 million in assets.



Source: Manchester marketing materials

Zaidi, a money manager who had met Niederhoffer in 1994 at Junto, a monthly salon that Niederhoffer hosts for investors, thinkers and executives in New York, says his one worry was that Niederhoffer might once again stray into unfamiliar markets. He says he gave him specific instructions: Matador would invest only in S&P 500 futures and options. "There was hubris involved in 1997," Zaidi says of Niederhoffer. "He's definitely learned his lesson."

Since then, Matador's assets have ballooned. The fund charges an annual management fee equal to 2.5 percent of its assets and takes a 22 percent cut of any profit. In February, Niederhoffer and Zaidi began marketing the fund to other investors. Niederhoffer has also started a second hedge fund, Manchester Partners LLC, which, unlike Matador, is open to U.S. investors. Niederhoffer named the fund after the one silver trophy he'd managed to keep: the Manchester Cup, given to the winner of the Steeple Chase in Manchester, England, in 1904.

Wisdom, who has known Niederhoffer since 1983, defends his boss's investment strategy. "You need to take risks if you are going to have consistent returns of 25 percent or more," Wisdom says. All the same, Wisdom calls Niederhoffer a changed man. "He realized he was fallible," he says. "He wants to leave a legacy."

It's Wisdom's job to ensure that Niederhoffer doesn't get carried away again. Matador has a history of volatile returns. The fund plunged 30 percent in July 2002 as U.S. equities sank. Matador lost 12.7 percent in April 2005, and it was down 5.42 percent in October 2005. "I am the fail-safe," Wisdom says. "I've gotten good at keeping us one step ahead of the bill collector." Wisdom says he's willing to take losses of 15–20 percent a month.

Niederhoffer and Wisdom use Niederhoffer's database, now run from servers in Weston and nearby Norwalk, to spot potential trades. Niederhoffer says he's added new options pricing programs to his predictive database. Unlike derivatives traders who use theoretical models, Niederhoffer says he has created empirical models of where derivatives should be priced based on historical data of market movements.

"The reason for his success as an athlete was his obsessive and focused mind," says his daughter Galt, 30, an award-winning film producer whose novel *A Taxonomy of Barnacles* (St. Martin's Press, 2005) tells the stories of six sisters—Bell, Bridget, Beth, Belinda, Beryl and Benita Barnacle—and their eccentric father, Barry, a New York pantyhose tycoon, who longs for a male heir. "The same with his trading," she says.

Niederhoffer has high hopes for Manchester, which charges a 1 percent management fee and takes a 20 percent cut of profits. Jamie Fee, who markets Manchester, says Niederhoffer might be able to manage as much as $400 million in the fund. "We need investors who are prepared for volatility," Fee, 51, says. As of May 1, Manchester had $28 million in assets.

Niederhoffer is already eyeing markets beyond S&P 500 futures and options. Unlike Matador, Manchester isn't limited to trading stock index futures and options. When Wisdom starts to answer a question about areas Manchester might explore, Niederhoffer cuts him off. "We are going to have to improve our abilities to trade fixed-income markets," Niederhoffer says. "We hope to be able to compete in foreign exchange in the future." For now, both funds make the same investments.

As Niederhoffer builds his funds, his personal life is taking a new turn, too. His seventh child—at long last, a son—was born on April 3. Niederhoffer named the child Aubrey, after the sea captain hero of Patrick O'Brian's novel *Master and Commander*. On April 5, Niederhoffer took 2-day-old Aubrey to dinner at the Four Seasons. Niederhoffer and Kenner, 52, plan to raise the child together. Niederhoffer and his second wife, Susan, are in the midst of a divorce.

In the music room of Niederhoffer's mansion, above the grand piano, hangs another painting. This one is of the *Essex,* a 19th-century whaler. There's a story behind it, one Niederhoffer tells again and again. The tale is a reminder of what Niederhoffer has at stake as he tries to make the most of his second chance.

In August 1819, the *Essex* set sail from Nantucket, bound for the whaling grounds of the South Pacific. There, in a stroke of bad luck, the ship was rammed by a sperm whale. At sea in three whaleboats, Captain George Pollard and his crew of 19 struggled eastward toward the coast of Peru. The food ran out; the men began to die. Several crew members were eaten by their shipmates. After three months adrift, eight survivors were rescued. The story inspired Herman Melville to write *Moby-Dick*.

Pollard sailed only once more from Nantucket, as captain of the whaler *Two Brothers*. In February 1823, that ship, too, went down, wrecked on a coral reef. Pollard returned to Nantucket a pariah. He had failed not once, but twice. He ended his days as the town night watchman.

"In America, people get a second chance," Niederhoffer says. "They don't get a third."

DEEPAK GOPINATH is a senior writer at Bloomberg News in New York.
dgopinath@bloomberg.net

BLOOMBERG TOOLS

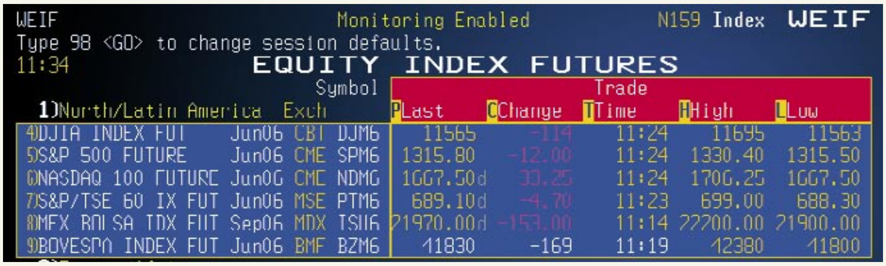
Monitoring Derivatives on the S&P 500

Type SPX <Index> OMON <Go> to use the Option Monitor function to track the prices of put and call options on the Standard & Poor's 500 Index, which are the main instruments used by Victor Niederhoffer's Matador Fund. Put options give the holder the right to sell the underlying index at a specific strike price; call options give the holder the right to buy the underlying index. Call options on the S&P 500 appear on the left side of the screen, and put options are displayed on the right side. OMON tracks the bid, ask and most-recent-trade prices for each strike price on the screen.

To add data items to OMON, click on the Edit button and select Columns. To add implied volatility data, for example, click on the plus sign next to Risk Information. Scroll down and click on Trd Matched Imp Vol to move it to the list of data items selected on the right side of the screen. Click on the Save/Return button to display OMON with the new information.

Type WEIF <Go> to monitor the price of the near-month S&P 500 futures contract traded on the Chicago Mercantile Exchange along with the prices of futures on other benchmark equity indexes, as shown below. To see the prices of S&P 500 futures for different months, type 5 <Go> from the Equity Index Futures screen and then type CT <Go>.

JOHN DIXON



For the Option Custom Monitor function, type OCM <Go>.