HOURLY RATES

A Modest Essay about Extraordinary Paychecks

40 YEARS
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Acknowledgments
This report was written by Bartlett Naylor.

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Every fourteen minutes in 2009, hedge fund manager David Tepper made President Obama's annual salary. With 2010 compensation figures forthcoming as companies prepare for annual meetings let's reflect for a moment on the results from 2009 with which they will be compared. And a preview of those 2010 figures: John Paulson will exceed Tepper. In fact, all the numbers for 2010 will pale next to what's already known about Paulson's compensation.

U.S. vs. the World

Begin at the bottom and work up. The World Bank documents that people in the Congo earned the least in the world, about $340 a year, or 17 cents an hour. (Assume an eight hour working day, and 2000 hours per year.)[1] Minimum wage in the United States was $7.25. Some states establish a higher threshold, with the highest in the state of Washington at $8.67. Income per capita in the U.S. in 2009 was $46,436.[2] This works out to $23 an hour. To sum, the average American made 135 times as much as the poorest compensated people in the world in 2009.

This essay is about numbers, namely millions, billions and trillions. Such large numbers are difficult to fathom. Some help: We know how long a second lasts. One Mississippi. A million seconds is about 12 days. Almost two weeks. A billion seconds is 30 years. We hope to live about three billion seconds. A trillion seconds is about 30,000 years. Humans did not know how to farm 30,000 years ago.

Top Earners

Now consider the compensation leaders. Again, begin at the bottom. Many consider government work a labor of conscience as opposed to an effort to maximize remuneration. Ignoring the fact that the best paid American government workers are actually the coaches of certain state universities (Alabama football coach Nick Saban made $5.9 million[3]), the U.S. president earned $400,000 in 2009, or $200 an hour. That was his first year on the job, where he navigated a major stimulus package through Congress, passed health insurance reform, commanded a military of 1.4 million active service members in two wars. He was busy. ("It's hard work," former President George Bush affirmed.) [4]The best paid head of

[1] http://data.worldbank.org/indicator/NY.GDP.MKTP.CD
[2] http://bber.unm.edu/econ/us-pci.htm
[3] http://www.huffingtonpost.com/2010/12/09/the-highest-paid-college-football-coaches_n_794387.html#s202436&title=Nick_Saban_University
[4] http://www.youtube.com/watch?v=ReoKQlOF4XY

state, however, was Lee Hsien Loong, prime minister of Singapore at $2,836,000, or $1,418 an hour. [5]

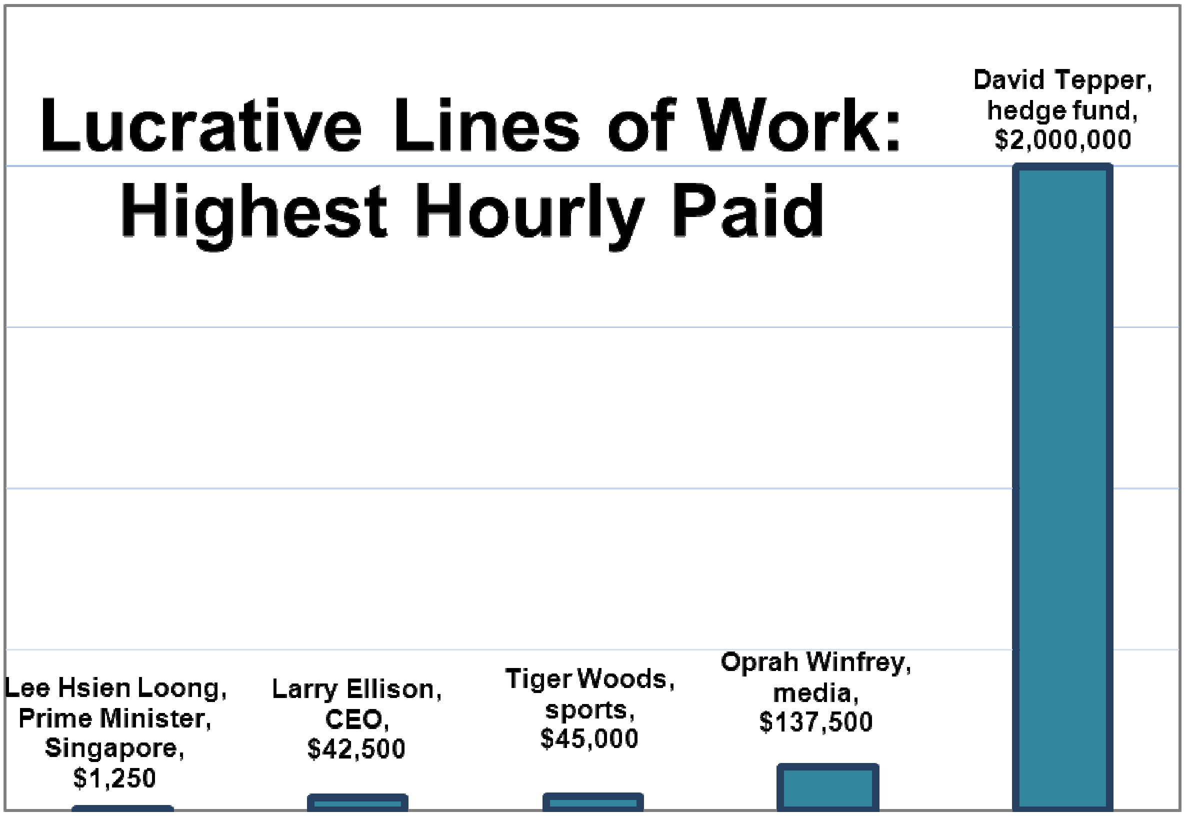
Leading entertainers certainly earned more in 2009 than leaders of the free world. Forbes declared Johnny Depp the best paid actor at $75 million. That would translate to $37,500 an hour. For a regular year-long 40-hour work week.[6] Forbes figured Oprah Winfrey also retained her hold on best paid entertainment figure at $225 million, or $112,500 every hour. Golfer Tiger Woods came in to the final clubhouse at $90 million for 2009, according to Sports Illustrated.[7] This includes endorsements. That would be $45,000 an hour.

Sports figures' pay has long drawn questions. When Nolan Ryan became the first baseball player to earn more than $1 million in a year, at least some working people found themselves personally insulted. How could a person playing a game be paid so much? One fan challenged Babe Ruth to defend his $80,000 paycheck in 1930 ($1.05 million in current dollar terms) arguing this exceeded President Hoover's $75,000. "I had a better year than he did," the sultan of swat explained.

No matter how well compensated our Hollywood and sports stars are, the real money comes from the business of money. The AFL-CIO's PayWatch noted that recently major bankers, apparently embarrassed by their dependence on record taxpayer subsidies, have tightened their belts. Thomas Montag, president of global banking at Bank of America, received only $29 million, or $14,500 an hour.[8] But the hedge funds have no such restraint. The magazine Institutional Investor declared David Tepper the best paid hedge fund manager in 2009 at $4 billion.[9] To put this in perspective, that is $2 million an hour. That is one million dollars every half hour. A Pittsburgh native, he donated $55 million to Carnegie Mellon University, which gratefully changed the name of a graduate program to the David Tepper School of Business.[10] That was half a week's paycheck.

The world economy struggled in 2009. Experts calculate that 2010 was better. Compensation presumably grew richer for those at the top. Will someone top $3 million an hour? We'll have to wait until the numbers are released, generally in May.

[5] http://www.democraticunderground.com/discuss/duboard.php?az=view_all&address=132x8314324
[6] http://www.forbes.com/lists/2010/53/celeb-100-10_Johnny-Depp_PCS9.html
[7] http://sportsillustrated.cnn.com/more/specials/fortunate50/
[8] http://www.aflcio.org/corporatewatch/paywatch/
[9] http://www.institutionalinvestor.com/alternatives/Articles/2781314/David-Tepper-Gets-Off-To-A-Good-Start.html
[10] http://www.cmu.edu/cmnews/extra/040319_dtepper.html



The Long and the Short of the Hedge Fund

What distinguishes a hedge fund from say, a traditional mutual fund such as Fidelity or Vanguard, is that managers may sell short and use substantial leverage. Selling short provides a means of profiting when a security falls in value. The short seller "borrows" a security, then sells it at the market price, then purchases the security and returns it to the lender. If the short seller borrows shares and sells them when they are worth $100 a share, then repurchases later at $70 a share, she gains $30 a share. Traditional mutual funds, by contrast, only buys "long," meaning that they take a position in a company such as Microsoft, and profits when the shares rise in value.

Hedge funds also use leverage, or loans, to amplify their results. If a hedge fund has borrowed $9 from an investment bank for every $1 received from investors, a gain of 10 percent on the $10, or $1, means a $100 percent gain for investors. But only those with iron stomachs should apply: a 10 percent market loss means a 100% wipeout for investors. In September 1998, shortly before its collapse, Long-Term Capital Management held $125 billion of assets on a base of $4 billion of investors' money, a leverage of over 30 times. [11]

[11] http://www.moneyweek.com/news-and-charts/economics/did-we-learn-nothing-from-the-collapse-of-ltcm

Calling these "hedge" funds makes for something of a misnomer and stems from historical origins. In 1949, a sociologist named Alfred Jones developed a portfolio strategy that involved both purchasing assets long as well as selling short as a means of reducing, or hedging, against risk.[12] The name stuck though the strategies have become more complex.

High compensation for hedge fund managers derives from management fees averaging 2 percent of assets under management, and a share in profits between 20 and 50 percent. Some call this "2 and 20." That means a fund with $1 billion under management must pay its managers $10 million. If the fund leverages with another $2 billion in loans, then rises in value by 20 percent, or $600 million, a fund manager might receive $310 million for his troubles.

In the financial sector where compensation is already key, hedge funds are built on compensation. The New York Times explained: "'Hedge funds are an innovation of compensation,' said one fund-of-funds executive. 'It's a compensation system, not an asset class.' The comment is meant to be positive: in hedge funds, compensation is aligned with absolute performance. In the mutual fund industry, by contrast, compensation is usually tied to performance against a benchmark, like a Standard & Poor's index, or assets under management."[13]

The mutual fund industry has featured luminaries such as Peter Lynch of Fidelity, and John Bogle, founder of Vanguard. In their respective books, they extoll the virtue of kicking the tires on companies to decide where best to invest. Another of America's most admired investors remains Warren Buffett, who gleans investment ideas through detailed attention to a company's financial results, an understanding of management competence, and other fundamental elements.

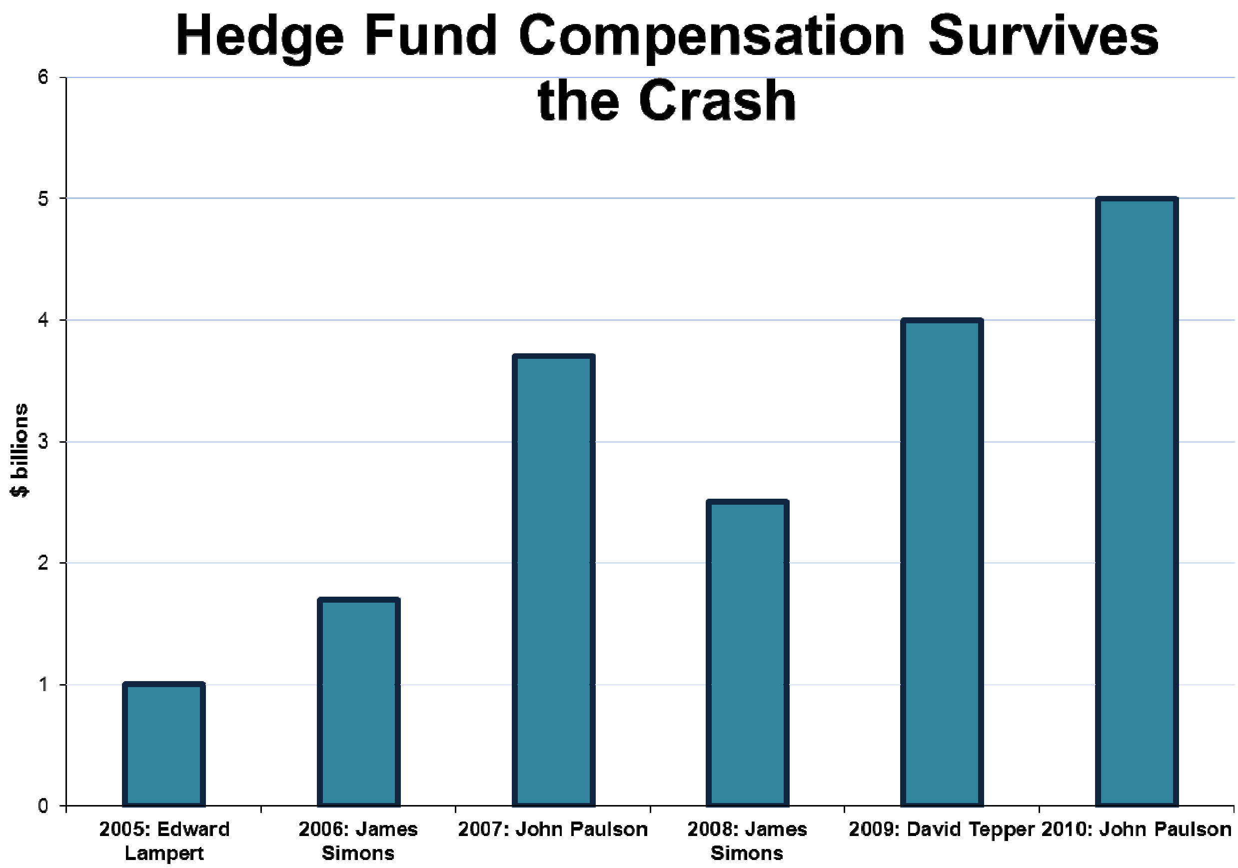
Hedge fund managers live in a world of complex mathematical algorithms and exotic derivatives. The math behind high finance requires advanced degrees (or uncommon native talent.) Many--presumably all--are extraordinarily intelligent.

In 1990, hedge funds managed less than $40 billion. By 2010, that figure topped $1 trillion. In fact, the largest 225 funds held an estimated $1.1 trillion under management.[14] The 25 largest funds in 2010 managed more than $500 billion, led by JP Morgan Chase, with $53 billion; Bridgewater Associates at $43 billion; Paulson & Co. with $32 billion; Brevan Howard with $27 billion; and Soros Fund Management at $27 billion.[15] This figure still trailed far behind the traditional mutual fund industry, which counted more than $11 trillion under management in 2010.[16] But while few have complained that mutual fund managers suffered low pay, the smart managers gravitated to hedge funds, where compensation grew from exorbitant to unfathomable.

[12] http://www.investopedia.com/articles/mutualfund/05/HedgeFundHist.asp
[13] http://www.turtletrader.com/hedge-march.pdf
[14] http://www.absolutereturn-alpha.com/
[15] http://www.businessinsider.com/the-biggest-hedge-funds-in-the-world-2010-3
[16] http://www.icifactbook.org/fb_sec2.html

For example, in 2003, David Tepper received an estimated $510 million, eclipsed only by George Soros, who made $750 million that year, according to Institutional Investor magazine.[17]

Hedge fund manager compensation was good before the crash began. It was really good during the crash. James Simons of Renaissance Capital studied mathematics at MIT, then received a Ph.D. in the subject at University of California at Berkeley. He remained in academic cloisters advancing such complex fields as string theory. He began financial work in 1978. He led the list of best paid hedge fund managers in 2006 and 2008 with more than $1 billion in annual compensation. [18]



[17] http://www.tradingblox.com/forum/viewtopic.php?t=465&start=60
[18] http://www2.ed.gov/about/bdscomm/list/mathpanel/bios/simons.html

Top Earning Fund Managers in 2009

1.David Tepper, Appaloosa Management
Est. 2009 personal earnings: $4 billion

2. George Soros, Soros Fund Management
Est. 2009 personal earnings: $3.3 billion

3. James Simons, Renaissance Technologies
Est. 2009 personal earnings: $2.5 billion

4: John Paulson, Paulson & Company
Est. 2009 personal earnings: $2.3 billion

5: Steve Cohen, SAC Capital Advisors
Est. 2009 personal earnings: $1.4 billion

6. (tie): Carl Icahn, Icahn Capital
Est. 2009 personal earnings: $1.3 billion

6. (tie): Edward Lampert, ESL Investments
Est. 2009 personal earnings: $1.3 billion

8. (tie): Kenneth Griffin, Citadel Investment Group
Est. 2009 personal earnings: $900 million

8. (tie): John Arnold, Centaurus Advisors
Est. 2009 personal earnings: $900 million

10. Philip Falcone, Harbinger Capital Partners
Est. 2009 personal earnings: $825 million

Compiled by The Big Picture
at http://www.ritholtz.com/blog/2010/04/top-10-hedge-fund-managers-2009-salary/

But the king of compensation must be John Paulson: Born in Queens, N.Y., he graduated first in his class from New York University, then earned an MBA from Harvard. After various financial positions, including one at Bear Stearns, he founded what became Paulson & Co. in 1994 with $2 million, managed by himself and two partners. Paulson epitomizes the ability of hedge funds to profit from woe. In 2007, Paulson bet correctly that many of the securities underpinning the housing market would collapse. Attracting some controversy, he sought to protect these bets by lobbying against efforts to limit foreclosures and rework mortgage loans.[19]

[19] http://www.bloomberg.com/apps/news?pid=newsarchive&sid=abjCQZNiUxjY

Paulson also figured in a controversial deal with Goldman Sachs. The SEC civil fraud complaint alleged that Goldman allowed Paulson & Co. to help select securities in a package of debt instruments. Goldman didn't tell its investors that Paulson was shorting the CDO, or betting its value would fall. When the CDOs value plunged within months of its issuance, "Paulson walked off with $1 billion" according to one account of the SEC fraud suit.[20] [21]Paulson released a statement that it was "not the subject of this complaint, made no misrepresentations and [was not] the subject of any charges."[22]

John Paulson reportedly earned $3.7 billion in 2007, $2 billion in 2008, and $2.3 billion in 2009. [23] [24] [25]In 2010, he exceeded David Tepper's 2009 earnings of $4 billion by securing an estimated $5 billion in fees and profit share from his firm.[26] That's $2.5 million each hour. Or $42,000 a minute. Or $700 a second. That's twice the per capita income in the Congo.

Pay Olympics

Hedge funds are part of the financial sector, which should be merely a handmaiden to what Dr. Robert Johnson of the Institute for New Economic Thinking (funded by Soros) calls the real economy. One might reckon, then, that the real compensation money might come from this real economy. Survey the world, examining the five largest economies as measure by GDP, and surely there will be some one better compensated than a person who profited on the insight that a housing bubble would burst.

In an international contest of paychecks, a "pay Olympics," the best compensation might come from the largest economies, as measured by GDP.

Begin with the U.S., an economy measuring $14.6 trillion in GDP, Tepper topped the list in 2009 and Paulson in 2010. Among non-financial executives, Gregory Maffei, head of Liberty Media group, won honors as the best CEO in the United States. The AFL-CIO PayWatch study calculated his pay at $87.4 million.[27]

In the world's second largest economy, namely the People's Republic of China, with $5.7 trillion in GDP, The China Daily reports that the best paid executive may have been Leung Ka Kui, deputy general manager of Ping An Insurance Co. Leung earned 28.59 million yuan in pre-tax salary in 2009, surpassing Frank Newman, chairman of Shenzhen Development Bank, 2008's highest paid, with 15.98 million yuan in annual compensation.[28] Newman

[20] http://money.cnn.com/2010/04/16/news/companies/sec.goldman.fortune/index.htm?hpt=T1
[21] http://www.institutionalinvestor.com/article.aspx?articleID=2467281
[22] http://www.sec.gov/litigation/complaints/2010/comp-pr2010-59.pdf
[23] http://www.nytimes.com/2008/04/16/business/16wall.html?_r=1
[24] http://www.nytimes.com/2008/04/16/business/16wall.html?_r=1
[25] http://www.nytimes.com/slideshow/2010/04/01/business/20100401hedgePics_4.html
[26] http://online.wsj.com/article/SB10001424052748704268104576108390332589096.html
[27] http://www.aflcio.org/corporatewatch/paywatch/
[28] http://www.chinadaily.com.cn/business/2010-05/17/content_9856358.htm

ranked second with 17.41 million yuan this year. In U.S. dollars, the pay of Leung Ka Kui translates to $4.2 million.

In Japan, with an economy measuring $5.3 trillion in GDP, the culture does not cotton to high American CEO pay. In fact, the highest paid head of a Japanese company last year was an American, namely Howard Stringer, who received $4.5 million on top of stock options.[29]

In Germany, with a $3.3 trillion GDP, the CEO of Deutsche Bank AG Josef Ackermann led the list of all managers with an annual income of nearly 9.6 million euros ($13.2 million) in salary and bonuses. Among nonfinancial firms, Siemens boss Peter Löscher and the head of RWE, Jürgen Grossmann, both took home incomes of more than $10 million in 2009, closely followed by Volkswagen chief executive Martin Winterkorn, who pocketed $9 million euros. [30]

In the UK, with a GDP of $2.2 trillion, Bart Becht of household products manufacturer Reckitt Benckiser received 93 million pounds, or $148 million, eclipsing the best paid American executive.[31]

Despite this valiant effort from a plucky Englishman, managing the world's great corporations simply doesn't hold a candle to pecuniary rewards of those hedge fund managers.

Total Wealth

As hedge funds count as relative newcomers in the financial world, the billion dollar paychecks for fund managers date to the last decade. As a consequence, the billions have not yet piled up to rank any of these managers at the very crest of the richest people on the planet.

There's the bromide that one can't get rich working—one must own property. Bill Gates, though no sloth, readily acknowledges that his wealth derives from the amazing products devised by his wizards at Microsoft. His wealth stems from his significant ownership of that Seattle software firm.

Indeed, the world's richest people land on this list of the world's wealthiest individuals through ownership. Carlos Slim added some $20 billion in 2010 to bring his total fortune to $74 billion, according to the New York Times. Slim's Grupo Carso derives the lion's share of its net worth from a telecommunications business operating in Latin America.
He owns stakes in other firms, including the New York Times. [32]

[29] http://articles.nydailynews.com/2010-06-19/news/27067631_1_vaio-pcs-bravia-tvs-playstation
[30] http://www3.wsws.org/articles/2010/mar2010/ceo1-m17.shtml
[31] http://www.telegraph.co.uk/finance/7996294/Executive-Pay-Report-top-20-earners-in-the-FTSE-100.html
[32] http://dealbook.nytimes.com/2011/03/09/carlos-slim-widens-lead-as-worlds-richest-man-2/

Bridge partners Bill Gates and Warren Buffett, of Microsoft and Berkshire Hathaway respectively, hold the number 2 and 3 spots.

French luxury goods owner Bernard Arnault also increased his wealth by $13.5 billion to a total of $41 billion, making him Europe's richest man, and fourth richest in the world. [33]

At No 5, Oracle CEO Larry Ellison, whose net worth also surged by more than $10 billion to $40 billion. [34]

But the hedge fund managers know about ownership as well. In fact, the technical truth about Paulson's fine year in 2010 is that he invested in his own fund. His $5 billion stems from about $1 billion in actual compensation, and $4 billion from being one of his own largest investors.[35]

Those at the crest have learned that money makes money, and the hedge fund titans may well reach this summit.

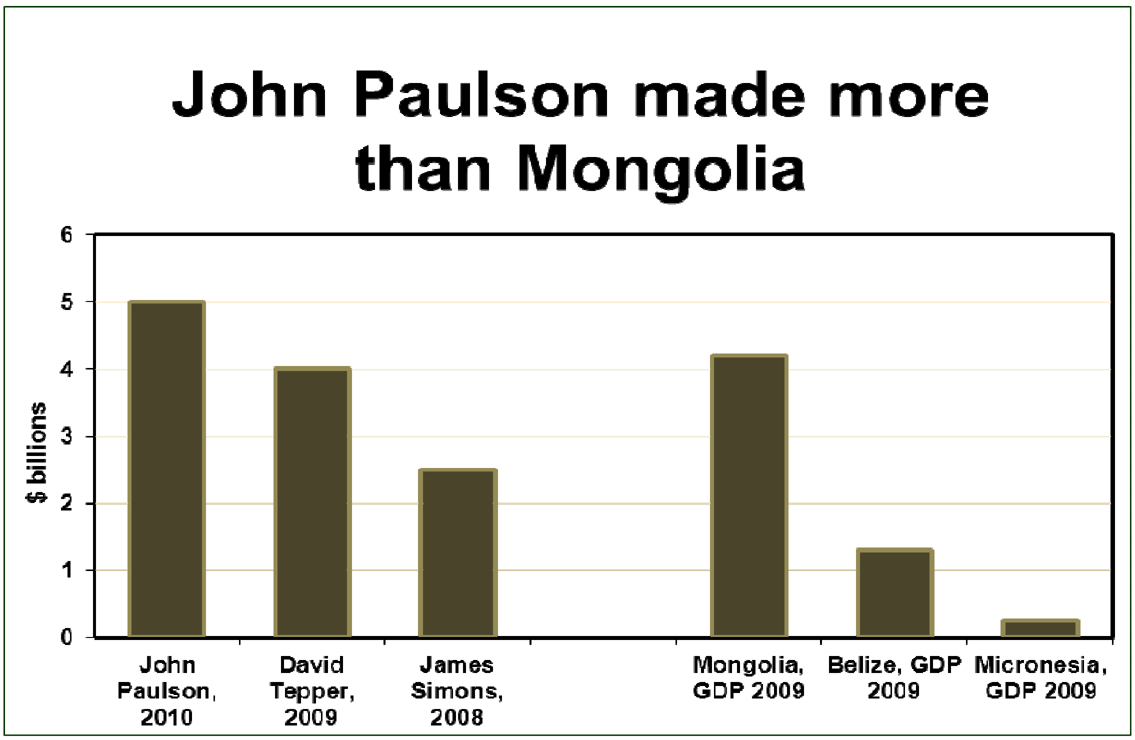
[33] http://dealbook.nytimes.com/2011/03/09/carlos-slim-widens-lead-as-worlds-richest-man-2/
[34] http://www.aflcio.org/corporatewatch/paywatch/
[35] http://www.vancouversun.com/business/your-money/truth+about+John+Paulson+billion+year/4185028/story.html

Frontrunning the Mob

A penultimate thought about working people: Mongolia is a nation of nearly three million people whose forebearers included Genghis Khan. Today, this rich mining economy features the world's largest coke coal deposit, supplemented by vast agriculture and an emerging telecommunications sectors. The country recently completed a 600 mile north-south highway from Russia to China.

John Paulson made more in 2010 than Mongolia.

The value of all their industrial and service output figured less than what this man received. Mongolia placed 143rd largest economy in the world, with 43 countries trailing in gross domestic product in the world of 185 nations. In fact, if one totals the national economic output of the bottom 14 nations—including Samoa, East Timor, and Micronesia--one would still come a half billion dollars short of the $5 billion Paulson received in 2010. [36]



If Mongolia seems distant, consider Gannett. The company employs 32,500 workers. They produce 83 daily newspapers, including USAToday. They operates 23 television stations. Gannett's Des Moines Register won a 2010 Pulitzer. "Gannett informs, inspires and entertains millions of people at home, on the go and around the world," according to its website.

[36] https://www.cia.gov/library/publications/the-world-factbook/fields/2012.html

"Through our compelling products, we show people the world we live in today, sparking conversation and prompting change."[37] The company reported roughly the same revenue in 2010 as John Paulson's pay.[38]

Can John Paulson look at the entire population of three million Mongolians and claim that he is worth more than their entire economic input? More than the value of all the coal they mined? More than the grain they harvested? More than all the telecommunications equipment they produced? Combined? Or all of the 32,500 journalists and other workers at Gannett and tell them he's worth more?

Conclusion

The hedge fund managers largely profit in a zero sum game. They don't produce or provide services in the ordinary sense. They place bets against other gamblers, and for every dollar they win, someone else loses. Many of the securities in which they traffic are synthetic, meaning they are mere bets on the performance of other things such as real stocks, bonds, commodities or mortgage payments. If a bond fails, then the credit default insurance, or credit default swap, becomes valuable. A package of these swaps, or collateralized debt obligations, becomes very valuable. The successful hedge fund manager detects these trends ahead of the crowd, and benefits when the crowd finally learns the truth and reprices a security.

To whom is the hedge fund manager valuable? Certainly, the ones who generate profit and high compensation for themselves benefit their investment clients. Some might wish that the 20 to 40 percent of the profits the manager takes could be shared with the investors themselves. Does the manager serve a greater purpose? Short sellers can introduce integrity into markets. Investors benefit when short sellers identify the false claims of corporations touting their stock. A short-seller revealed the corruption of Enron. But it's debatable whether such a service should be compensated more than all of Mongolia, or the entire output of Gannett.

Economists assure us that the market will eventually correct such compensation anomalies. The higher math behind hedge fund strategies will eventually be understandable to a wider, more competitive labor marketplace. Meanwhile, some hedge fund manager is bound to make more than $3 million an hour.

[37] http://www.gannett.com/section/BRANDS&template=cover
[38] http://finance.yahoo.com/q/ks?s=GCI+Key+Statistics