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A Hedge Fund Falls Off the Face of the Earth

HELLO, this is Dan Marino," says a weary, raspy voice on an answering machine. Mr. Marino, the chief financial officer of the Bayou Group, a \$400 million hedge-fund and brokerage firm that is under investigation by state and federal authorities in Connecticut, sounds beleaguered. "Please leave me a message," he goes on. "I am receiving lots of phone calls. I am unable to pick up every call, so if you do call, leave a message and a number. I will get back to you."

Bayou investors are dying to know why their money has not been returned as the firm promised last month. But if they're hoping for a return call, they are out of luck. "Sorry," says a chipper female voice on the tape. "You cannot leave a message now. This mailbox is full."

Those few, unsettling words are just about all that investors in the four Bayou funds have to go on right now. Money that was supposed to be wired to their accounts in mid-August after the funds wound down has not appeared. The funds' principals, its accountants and its lawyer are not talking. The funds' offices in Stamford stand empty.

All that Bayou's investors can do is wait, fret and wonder what went wrong at the funds, run by Samuel Israel III, a folksy Wall Street veteran who seemed to turn in a steady, if unspectacular, performance.

"What panicked me, when I sat back and thought about it, was I know practically nothing about these people," said John C. Siegesmund III, an investor in Denver who had never put money in a hedge fund before he sank \$250,000 into Bayou in February 2003. "They had good returns, they seemed reputable, there's nothing sort of fly-by-night about them. But when the chips are down, you don't know what you're getting into."

The Federal Bureau of Investigation has joined Connecticut banking officials and federal prosecutors who are trying to plumb the Bayou mess. It is unclear what they will discover, but investors are hoping, of course, that their money will be found and returned.

Whether or not it is, the Bayou situation is a cautionary tale for investors rushing to participate in the hedge fund boom of recent years.

Calls to Mr. Israel and Mr. Marino, who is not the football player, were not returned. Neither were calls to Steven D. Oppenheim, the Bayou Funds' lawyer at Faust, Rabbach & Oppenheim, and its accounting firm, Richmond-Fairfield Associates of New York.

Investors who spoke about their involvement in the funds said they were surprised by recent events and that Bayou had none of the earmarks of a Ponzi scheme. For example, while Mr. Israel's returns were impressive - they almost always beat the returns in the broad stock market indexes by a few percentage points - they were not too good to be true. Last year, Bayou was up 12.8 percent, versus the 9 percent gain by its benchmark, the Standard & Poor's 500-stock average.

For the first six months of this year, Bayou documents show gains of 4.56 percent, versus a decline of 1.7 percent in the S. & P.

Bayou also allowed investors to leave the fund at any time - by contrast, many hedge funds have lockup arrangements that keep investors' money tied up. Bayou documents said that any investor looking to redeem his Bayou interest could receive it in 15 days.

Unlike most hedge funds, Bayou did not charge a management fee; its management simply took the standard incentive fee of 20 percent of profits. According to financial statements, that came to \$10.8 million in 2004. The funds paid almost \$8 million in commissions to the Bayou brokerage firm last year. At year-end, Bayou executives had \$18.6 million invested in the funds, the statements indicated.

Investors said they also liked the fact that Mr. Israel was in regular communication. Every week, he sent a detailed e-mail message with updated returns, noting what issues Bayou was long and short, its sector exposure and the average number of positions traded. The messages also included brief market commentaries from Mr. Israel.

Once a year, he would also conduct a conference call with investors, inviting their questions and discussing his views on the economy, world events and financial markets.

Bayou's investment strategy was also understandable: it was composed of stocks and exchange-traded funds. No murky derivatives, risky commodities or currencies. And the only leverage he used was garden variety: buying on margin.

Marketing materials for Bayou describe Mr. Israel, 47, as a "third-generation trader" who has been trading since 1978. His was a short-term strategy in which he would rarely keep positions for more than three days. He was satisfied eking out small gains rather than making big, directional bets on sectors or industry groups.

What Bayou does best, a recent investor note said, "is hit singles on a regular basis." Perhaps most appealing, Bayou's funds had lower minimum investments - \$250,000 - than are typical at other hedge funds.

As is true of most hedge funds, Bayou hired outside marketers to bring investors into the fold. According to one investor, its assets under management really ballooned in 2003 and 2004, rising to more than \$400 million from \$100 million.

Problems started emerging, investors said, in late 2004, when Mr. Israel wrote a letter trying to quell rumors about his funds that he said were circulating around Wall Street. "This is not the sort of letter I am used to writing and hope never to have to again," he wrote.

In the letter, Mr. Israel described a lawsuit that had been filed by Paul T. Westervelt Jr., a trader he had hired in 2002 and fired a bit more than a year later. Mr. Israel said Mr. Westervelt failed to follow the firm's trading discipline and methods, investing "based on Wall Street information which my investors know I do not believe in."

In disclosing details about the lawsuit to his investors, Mr. Israel said, he hoped to put the matter to rest. One investor, who was granted anonymity because he hopes to keep his involvement in Bayou a private matter, said he was impressed with the forthright nature of the letter.

AFTER Mr. Westervelt was fired, he sued Mr. Israel. Included in his suit were allegations of activities he said he had seen at Bayou that may have violated securities regulations. The case was moved from federal court to arbitration. Lawyers on both sides did not return phone calls seeking comment.

The Bayou investor who declined to be identified, a certified public accountant with a background in forensic accounting, said he had conducted extensive due diligence on the fund in 2002, before he invested in it. He called Bayou's lawyer, its accounting firm, as well as Wall Street veterans he knew, to check out Mr. Israel. Everything came up clean. He invested about \$725,000 in 2003. As of June 30, his account was worth almost \$1 million. He has not received any of his investment back.

Mr. Siegesmund said that he began to become nervous last spring, when he talked with a hedge fund marketer who told him that his firm was telling its clients to exit Bayou Funds. "He said: 'There's not enough transparency there. They use their own brokerage, and we can't figure out how they do their internal accounting,'" the investor recalled.

A short time later, Mr. Siegesmund said, a Bayou marketing executive told him that he was leaving the firm for other opportunities. Mr. Siegesmund said these events did not exactly worry him, but he did begin to wonder.

Interestingly, Mr. Israel seemed to start turning down new investors earlier this year. "I talked to a money guy," said the investor who declined to be identified, "and he said, strangely enough, that he had people with another \$30 to \$50 million to invest in March, but Sam said he didn't think he could handle it."

In mid-June, the weekly updates from Mr. Israel stopped. Mysteriously, the funds' returns stopped changing week to week. Investors started to ask questions.

In July, investors received a letter from Mr. Israel advising them that he was going to close the funds and return their money after an audit was completed. He said that personal problems were preventing him from running the funds effectively.

The investors said they were told that they would receive their money on Aug. 15. They are still waiting. As they do, no one from Bayou is talking. The only people the investors can reach are federal and state authorities who are investigating.

The investor who declined to be identified said that, in hindsight, he should have recognized one red flag in the fact that Bayou had two accounting firms - one to oversee the brokerage unit's books and another to vet the hedge funds' financials.

"We've seen fraud in stocks, bonds and commodities," said Ross B. Intelisano, a lawyer at Rich & Intelisano in New York who represents many Bayou investors. Referring to the hedge fund industry, he said: "What we're now seeing is an increase in what could be called hedge fund fraud. It just shows that even sophisticated investors who do their due diligence can be defrauded."

The investor who declined to be identified said that he was surprised to reach Mr. Israel on his cellphone last Tuesday. He said he told Mr. Israel that his e-mail messages were not being answered and asked why his money was not being returned.

"I said, 'We're in the dark, Sam,'" the investor recalled. "He said, 'I really can't say much right now; we're having a meeting with our attorney.' I said, 'You have a duty to your investors, and I want to continue our conversation.' He hung up on me."