MARKETS

Fund Boss Made $7 Billion in the Panic

By GREGORY ZUCKERMAN

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(See Correction & Amplification below.)

In this comeback year for investors, David Tepper may have scored one of the biggest paydays of all.

Mr. Tepper's hedge-fund firm has racked up about $7 billion of profit so far this year—with Mr. Tepper on track to earn more than $2.5 billion for himself, according to people familiar with the matter. That is among the largest one-year takes in recent years.

Behind the wins: a bet worth billions of dollars that America would avoid a repeat of the Great Depression.

Through February and March, Mr. Tepper scooped up beaten-down bank shares as many investors were running for the exits. Day after day, Mr. Tepper bought Bank of America Corp. shares, then trading below $3, and Citigroup Inc. preferred shares, when that stock was under $1. One of his investors insisted more carnage loomed. Friends who shared his bullish beliefs were wary of aping his moves amid speculation that the government was about to nationalize the big banks.

"I felt like I was alone," Mr. Tepper recalls. On some days, he says, "no one was even bidding."

The bets paid off. A resurgent market has helped Mr. Tepper's firm, Appaloosa Management, gain about 120% after the firm's fees, through early December. Thanks to those gains, Mr. Tepper, who specializes in the stocks and bonds of troubled companies, manages about $12 billion, a sum that makes Appaloosa one of the largest hedge funds in the world.

Mr. Tepper, whose office overlooks the parking lot of a Hilton hotel in Short Hills, N.J., across from an upscale mall, now is taking aim at a new target. He's purchased
about $2 billion of beaten-down commercial mortgage-backed securities. Among his purchases are bonds backed by chunks of the debt of Peter Cooper Village & Stuyvesant Town and 666 Fifth Ave. in New York, two high-profile real-estate deals that have fallen in value over the past two years.

Some experts predict more bad news for commercial real estate—and say that if Mr. Tepper’s move doesn’t pan out, it could jeopardize a chunk of his recent gains. Mr. Tepper says he remains optimistic.

Hedge funds, once darlings of well-heeled investors, suffered dearly in 2008, dropping 19%. Nearly 1,500 funds, or 16% of the total, shuttered last year. This year, hedge funds are clawing back, with gains of 19% through November, on pace for their best annual gains in a decade, according to Hedge Fund Research Inc.

A handful of funds—including Everest Capital’s emerging-market funds and the stock-focused Glenview Capital—have racked up fat gains this year. In sheer dollars, though, none appear to have come close to matching Appaloosa’s winnings.

Mr. Tepper grew up in a middle-class neighborhood in Pittsburgh, the son of an accountant who worked seven days a week and once won a $715,000 lottery payout. In the late 1980s, he helped run junk-bond trading at Goldman Sachs. Mr. Tepper wears jeans and sneakers to work, and can be self-deprecating, playing down his successes. He claims to have popularized on Wall Street the phrase "it is what it is" to explain the need to adjust a portfolio if facts on the ground shift.

After he was repeatedly passed over for a partnership, Mr. Tepper left Goldman to start Appaloosa in 1993. By 2008, he had a track record of annual gains averaging about 30% and a net worth estimated at about $2 billion.

Mr. Tepper lives in a two-story home in New Jersey he bought in 1990 for $1.2 million. He recently purchased an ownership stake in the Pittsburgh Steelers football team, and flies to every home game. In 2004 he gave $55 million to Carnegie Mellon University’s business school, his alma mater, which renamed itself the Tepper School of Business.

The husky, bespectacled trader laughs easily, but employees say he can quickly turn on them when he's angry. Mr. Tepper keeps a brass replica of a pair of testicles in a prominent spot on his desk, a present from former employees. He rubs the gift for luck during the trading day to get a laugh out of colleagues.

His biggest scores over the years have come from buying large chunks of out-of-favor investments. When Asian markets crumbled in 1997, Mr. Tepper added Korean stocks to a portfolio laden with Russian debt. The moves led to hundreds of millions of dollars in profits when markets rebounded two years later. He scored big on junk bonds in 2003, and his 2007 wager on steel, coal and other resource
companies paid off in 2008 when commodity prices soared.

But because he sometimes places more than half of his portfolio in a single trade idea, Mr. Tepper also is prone to brutal, abrupt losses.

That approach cost him more than $1 billion last year. In January 2008, Societe General SA trader Jerome Kerviel was revealed to have lost €5 billion ($7.2 billion), one of the world's largest trading losses. Mr. Tepper sold large chunks of his holdings, fearing a market tumble. Prices held up, though, hurting Appaloosa. In the spring of last year, he turned bullish on large-company stocks and did some buying, but suffered as markets declined.

Mr. Tepper made a big wager on Delphi in 2006. But in April of last year he and a group of investors withdrew from a deal to inject as much as $2.6 billion in the bankrupt auto-parts supplier, sparking a nasty legal battle that was resolved this summer. Appaloosa lost almost $200 million on its investment in Delphi.

Mr. Tepper's largest fund dropped 25% for 2008, worse than the industry's 19% average decline.

"Investing with David is like flying, with hours of boredom followed by bouts of sheer terror," says Alan Shealy, a client of more than 18 years. "He's the quintessential opportunist, investing in any asset class, but you have to have a cast-iron stomach."

Mr. Tepper entered 2009 cautiously, with more than 30% of his firm's assets in cash, or more than $2 billion. He itched to do some buying. Mr. Tepper explains his investment philosophy with a line from Allan Meltzer, a professor at his alma mater: "Trees grow." In other words, growth is the natural state of economies, so optimism usually is rewarded.

On Feb. 10 of this year, Mr. Tepper read that the Treasury Department was introducing the so-called Financial Stability Plan. It included a commitment by the government to inject capital into banks by buying their preferred stock, or shares that carry less chance of reward but also less risk than common stock.

At the time, investors worried that the government ultimately would have to nationalize big banks. U.S. officials said they had no intention of such a move, which could wipe out common shareholders, but investors were dubious.

The news from the Treasury Department struck Mr. Tepper as proof that the government would stand behind the banks. He directed his traders to begin buying bank stock and debt.

Few investors were feeling as optimistic. The Dow Jones Industrial Average fell more than 382 points on the day Treasury Secretary Timothy Geithner introduced the plan, nearly 5%. Bank shares continued to tumble in the days that followed. Bank of America shares fell as low as $2.53 on Feb. 20. By March 5, Citigroup traded as low as 97 cents.

"This is ridiculous, it's nuts, nuts, nuts!" Mr. Tepper recalls saying to Michael Lukacs, one of his partners,
on the firm's small trading floor. "Why would the government break its word? They're not going to let these banks go under, people aren't being logical!"

Mr. Tepper huddled with Mr. Lukacs and Jim Bolin, another top Appaloosa executive. Mr. Tepper insisted that stimulus spending and low interest rates would boost the economy. He said he estimated there was only a 20% chance that the U.S. would nationalize banks such as Citigroup.

Mr. Bolin, who people at the firm say tends to be more conservative than Mr. Tepper, was bullish about banks, but still thought it safer to stick to bank debt than to riskier shares. Mr. Tepper says he listened to the arguments, but said it was time to place a big bet.

Over several weeks, Mr. Tepper's team bought a variety of bank investments, including debt, preferred shares and common shares. Just months earlier, the government had injected billions of dollars to keep companies such as American International Group Inc. going, much as they were now doing with the banks. But that didn't prevent shares of those companies from tumbling.

At one point in March, the firm was down about 10% for the year, or about $600 million. Mr. Tepper got on the phone to make more trades, something he often left to subordinates. This time, he wanted to talk directly to Wall Street brokers to test how bad things really were.

The answer: really bad. Mr. Tepper says he was told that he was the only big investor doing much buying.

"Clients were nervous that the game had changed and capitalism wouldn't be the same. There was real fear," recalls Timothy Ghriskey, chief investment officer at Solaris Asset Management, a $2 billion investment firm, who says he only bought a small amount of bank shares during this period.

One day in late winter, Mr. Tepper heard from a skeptical client of his own, Mr. Shealy.

"This thing is far from over," Mr. Shealy recalls saying, referring to the bank problems. Still, Mr. Shealy, who runs an investment firm in Boise, Idaho, stuck with Mr. Tepper. "I figured the positions were fairly liquid, so if he was wrong, he would get out."

Mr. Tepper hadn't paid his investors' nerves much heed since 2000. That year, he bet that the tech-heavy Nasdaq index would fall. But so many investors complained that Mr. Tepper was straying from his roots in debt investing that he canceled his bets. When the Nasdaq collapsed months later, Mr. Tepper fumed.

By late March of 2009, Citigroup shares had tripled, and Mr. Tepper's other holdings, including junk bonds, were rising. He and his team bought more, spending more than $1 billion, when various banks conducted share sales. Mr. Tepper says his average cost for shares of Citigroup was 79 cents; for Bank of America it was $3.72.

At one point in the summer, Mr. Tepper had recorded about $1 billion of profits in shares of just Citigroup and Bank of America, and his overall gains soared past $4.5 billion, or 70%, since January.
After Mr. Bolin, the Appaloosa executive, urged caution, Mr. Tepper did some selling to lock in gains. But the firm remains a big holder of both Bank of America and Citigroup shares, which now trade at $15.03 and $3.40, respectively.

Mr. Tepper remains upbeat. He says he expects interest rates to stay low, and argues that stocks and bonds are reasonably priced.

This belief is driving another risky bet. At the end of each quarter this year, Mr. Tepper noticed that investors were dumping holdings of troubled bonds backed by commercial properties. He had never dabbled in these investments, but he and his 10-person team did some research and judged them attractive, with some seemingly safe debt trading at yields above 15%.

Mr. Tepper slowly spent more than $1 billion to gain ownership of between 10% and 20% of highly rated slices of commercial mortgage-backed securities, or CMBS. He focused on debt backed by loans of properties including Stuyvesant Town and 666 Fifth Ave. in New York.

His bet: If the economy improves, he'll earn hefty interest payments on the bonds. But if the properties can't make their payments, Mr. Tepper believes he owns so much of the debt that he'll have a big say in how the properties get restructured. That means he could ultimately end up ahead.

He's taking a big risk, some analysts warn. The value of commercial real estate continues to fall. Owners of debt classes don't always have much power to influence a commercial real-estate restructuring. And because the debt of these big properties was carved into many pieces, and many investors are involved, any battle for control will be complicated.

Mr. Tepper says the worrywarts have it wrong: "If you think the economy will be fine, as we do, then we're going to do very well."

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Correction & Amplification

David Tepper has purchased bonds backed partly by debt of 666 Fifth Ave. in New York. A previous version of this story described the property as 666 West 57th Street in New York.