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A Pullout by Pensions Hammers a Hedge Fund

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In May, executives of FrontPoint Partners LLC were trying to stop the flood of money that was leaving the firm because of an insider-trading scandal when the telephone rang with more bad news.

Jim Elkins, an official at Michigan's state pension fund, told FrontPoint it had decided to yank its remaining $375 million investment in the Greenwich, Conn., firm's flagship hedge fund. That was close to one-fourth of all the money left in the shriveled fund.

Mr. Elkins says that FrontPoint executives didn't try to change his mind. "They knew we had to make a decision," he says.

Three years ago, FrontPoint was one of the world's most prominent hedge-fund operations, managing $10 billion in assets in more than a dozen funds including the main one, according to fund documents. Now it is down to about $1.5 billion. Most of what was left in the fund abandoned by Michigan was being returned to clients last week. FrontPoint already has closed that investment fund and nine smaller ones.

"The firm is moving forward," said a spokesman for FrontPoint, which has noted to investors that it hasn't been accused of wrongdoing.

The firm's rise and decline, extreme even for the boom-and-bust standards of many hedge-fund firms, shows just how sensitive pension funds can be to any allegations of insider trading.

FrontPoint, which started in 2000, had about $7.5 billion in assets under management when U.S. officials disclosed in November that they had arrested a French doctor, charging him with giving a FrontPoint employee who helped run a health-care fund confidential information about a disappointing drug trial. The government said those tips alerted the manager to sell millions of dollars of shares in a biotechnology company.

Prosecutors and regulators didn't name FrontPoint in civil and criminal complaints, but the firm put the manager, Joseph F. "Chip" Skowron III, on leave. Mr. Skowron is discussing a potential plea agreement with the government, according to court filings. A lawyer for Mr. Skowron declined to comment.

Even though FrontPoint and its executives weren't charged with wrongdoing, the insider-trading allegations were followed by an exodus that ultimately overwhelmed the firm's efforts to persuade clients to stay put.

Many pension funds are trying to bolster their returns to overcome funding shortfalls and disappointing performance from stocks and bonds. At the same time, pension funds are supposed to avoid excessive risk-taking and sudden, steep losses. For some investors, FrontPoint's troubles set off alarms.

"One person's alleged actions can have a real impact on people's lives,'' says Jon Braeutigam, chief investment officer for the Michigan Department of Treasury, which oversees $52 billion in pension funds. "You're talking about retirees.''

The South Carolina pension system pulled out about $475 million from FrontPoint funds near the end of last year, partly because state officials worried that the insider-trading allegations might cause too many clients to panic. The system worried that a rapid withdrawal of funds could lead FrontPoint to suspend withdrawals.

"It is not a message that someone likes to hear, but they understood our position and they respected that position," said Hershel Harper Jr., deputy chief investment officer of the South Carolina Retirement System Investment Commission.

FrontPoint was swept up in the troubles in early November as the U.S. government was cracking down on insider-trading involving "expert network" firms, which charge fees to connect industry and company experts with traders looking for information.

By late November, FrontPoint told investors it had redemption requests for as much as 40%, or $3 billion, of its assets under management at year-end.

For about the next four months, FrontPoint executives told employees and clients they were optimistic that several big investors would stay put—and might even give the firm more money to invest. FrontPoint officials were especially optimistic about Michigan's pension system, people familiar with the discussions recall.

Michigan officials were in frequent contact with FrontPoint executives, talking by phone and meeting in person in Connecticut and Michigan. In April, FrontPoint agreed to pay $33 million to regulators for alleged losses that it avoided by selling shares in the biotech company.

Other investment clients had less patience than Michigan.

"As assets under management dropped, the situation became almost a death spiral," Mr. Braeutigam said, adding that Michigan made money on its investments with FrontPoint.

Michigan pulled out $100 million in the first quarter. In phone calls on May 10, Messrs. Braeutigam and Elkins told FrontPoint's co-chief executive, Daniel Waters, that Michigan was withdrawing the remaining $375 million it had invested in FrontPoint’s biggest fund.

Mr. Waters thanked them for Michigan's support over the years, including during drawn-out negotiations to take back control of FrontPoint from Morgan Stanley during the past two years. The New York securities firm had bought FrontPoint in 2006 as part of a push into the hedge-fund business.

After reviewing the math, Mr. Waters and co-CEO Mike Kelly decided that FrontPoint's flagship fund, which would shrink to $1 billion in assets once all its redemption requests were met, probably would be too small to support multiple offices and most of the underlying investment strategies.

In a May 20 letter, FrontPoint executives told clients they would return most of their money by the end of June—and the rest by the end of the year. "They made the right business decisions," said Jim Hacking, head of Arizona's Public Safety Personnel Retirement System. "Their multi-strategy funds were simply not sustainable."

In early June, prominent FrontPoint hedge-fund manager Steve Eisman, best known for bets he made against mortgages during the financial crisis, said he would leave the firm.

FrontPoint's remaining assets include a fund with about $1 billion to make loans directly to smaller companies. Investors have committed to staying put for several years, and Michigan has committed $200 million to the lending fund. FrontPoint executives, meanwhile, have discussed plans to expand again, according to people familiar with the situation.