Abstract (summary)

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Full Text

In an exclusive journey through the labyrinthine empire of the master speculator, Stephanie Cooke and Charles Raw find gains are 'reallocated' to a charmed circle of associates

"I STILL consider myself selfish and greedy," says George Soros. "I am not putting myself forward as any kind of saint. I have very healthy appetites and I put myself first."

Mr Soros is the man who made $1bn when Britain left the European exchange rate mechanism in September 1992, earning him the status of a legendary investor. But that status was tarnished last month, when he lost a similar sum on the yen.

Nevertheless, he has set the tone for a new generation of large-scale professional investors who run so-called hedge funds on behalf of wealthy private clients. Markets regularly hang on his predictions for the course of gold, currencies and shares.

The size of these hedge funds means they are regularly singled out as the cause of seismic shifts in financial
markets. That is putting Mr Soros into sharper focus, simply because he is the leader of the pack. If he should falter, the knock-on effect could be widespread.

That is why central banks have started to ask questions about unregulated offshore operations such as his.

Ever the master of public relations, Mr Soros welcomed the central banks' probe. "I feel there is an innate instability in unregulated markets," he told the Reuters news agency.

Until now, however, remarkably little has been known about how the Soros financial empire is organised.

The first detailed analysis of the funds' published documents reveals that he has created a complex and bizarre financial creature in which the interests of Mr Soros, his family, close friends and key executives in the business are incestuously intertwined with those of his public investors.

Some of those investors may not have noticed that in the past few years Mr Soros has altered the structure of the organisation so as to reallocate some of the profits in favour of his private circle.

Mr Soros started his offshore fund operation with $4m in 1969, at the age of 39, after learning the arbitrage and investment business in London and New York.

He appears from the start to have aimed at wealthy individuals and professional European investors. He told prospective clients that the purpose of his key Quantum fund was "to enable sophisticated investors to participate in an internationally diversified investment portfolio". The Quantum fund is active in currency, commodity and interest-rate markets as well as equities and fixed-interest securities.

Later, in the early 1980s, Soros honed to perfection the technique of charging buyers a premium based on the supply and demand of fund shares.

Normally an open-ended investment fund is sold or redeemed at net asset value, with a sales charge added or an administrative charge deducted. But the Quantum fund can issue shares at a premium to its net asset value. The premium, however, is not based on an open market value.

Instead it is set by the fund's managing director, Citco (Curacao Investment Trust Co) in Curacao in the Netherlands Antilles. This is declared to be "by or at the direction of the fund's board of supervisory directors", which is chaired by Alberto Foglia of the Banca del Ceresio in Lugano, Switzerland. Its seven other members are mainly European bankers and brokers, including in London the renowned fund manager Nils Taube of Lord Rothschild's St James's Place Capital.

In the late 1980s the Quantum fund's documents stated that the premium would not rise above 25 per cent. As the premium for buying the fund was as low as 1 per cent during that period, it was not an unduly onerous restriction. But in the past few years, as the fund's fortunes have risen, the restriction has been quietly dropped and the premium soared at one point to nearly 40 per cent. After the Japanese loss last month, it dropped four points to 35 per cent, but is now back to 36 per cent.

Possibly to avoid problems with the US authorities, Soros states that his funds are barred to Americans - whether in the US or abroad. At least one exception to this is Soros himself, who became a US citizen in 1961.

By 1972 the fund was worth $20m. For reasons not made clear in recent documents, the operation was relaunched under the Quantum name in 1973. The fund was registered in the Netherlands Antilles, but Soros ran it from New York through Soros Fund Management. No information is given about this firm's precise corporate status, other than that it has always been wholly owned by him personally.

Although Soros now leaves the running of SFM to his executives, the documents state that in his "personal capacity, he manages a securities trading partnership formed for the benefit of members of the Soros family and several
other family accounts”.

By the end of 1980 the fund was worth more than $380m and the net asset value of each share had risen by almost 4,400 per cent. In 1981 Quantum shares fell by 23 per cent, their first drop in value, and the fund nearly halved to $193m. The following year a new category of share was created - the B share - in which Soros placed money invested by himself and his trusts and charities. His own main investment in the fund is now via these shares. It is through them that he apparently exercises control over the fund, although the voting rights of these shares are not explained in more recent documents. He can and does convert B into A shares from time to time, but these are primarily held by outsiders. No single external investor is allowed to exercise more than 4.9 per cent of the votes.

Although the fund recovered and grew once more, it hit another rocky patch in the late 1980s when more investors were selling Quantum shares than were buying. Around this time Soros made serious efforts to expand his operation.

In 1989, in spite of the fact that very few investors came into the fund, the net asset value of Quantum increased by 31.6 per cent.

Mr Soros had demonstrated the magical effect of simple mathematics, something not immediately apparent to laymen. Because of the high number of redemptions during 1989, the benefits were divided among fewer shares, so the net asset value still rose.

By then the operation was working as follows. Under an agreement approved by shareholders in 1988, Soros Fund Management is paid a basic investment advisory fee of 1 per cent a year, payable monthly. But the real cash cow is the annual performance fee. The fee is mainly composed of a sum equal to 15 per cent of any increase in net assets resulting from the fund's operation - before the deduction of the performance fee itself, of course.

There is another element in the fee - 15 per cent "in net assets resulting from premiums realised on fund share subscriptions and premiums or discounts realised on fund share redemptions".

Although the fund can issue shares at a premium direct to investors and - as is normal with open-ended funds - redeem them, in practice Quantum acts differently.

It has a subsidiary called Quasco which sells Quantum shares at a premium and buys them back either at a smaller premium or, should the situation arise, a discount of up to 1 per cent. Quasco makes a profit from the margin between the premiums charged to buyers and the price offered to sellers. In recent years the margin has been around 4-5 per cent.

Quasco’s accounts are not available, but it is clear it makes a substantial amount of money through these dealings. This money has historically been reinvested in the fund and SFM has taken its 15 per cent cut.

Indeed, the very fact that the money was ploughed back has been used as a strong promotional point by brokers selling the funds.

But in 1991 things started to change. In a significant restructuring of the operation that included the launch of new funds, Mr Soros began the "reallocation" of some of the gain for "selected persons associated with SFM".

By then Mr Soros had apparently finally decided that Quantum’s growth had to be curtailed. In February of that year he announced the biggest distribution so far: $4,000 per share, a total of $611m. To satisfy investors who did not want cash, he offered shares in a new fund, Quasar International.

Quasar was a different animal to Quantum. Instead of investing directly in securities, it would invest only in one entity - Quasar International Partners. That in turn would carry out investment activities under advice from SFM. But Quasar, like Quantum, had a dealing subsidiary, Quinter.
The fund was not the only investor in the partnership, however. Mr Soros, "certain members of his family and other selected persons associated with the partnership's management" also joined the club.

The Quasar fund has had a very successful run. In only its second year of operation it showed an increase in net asset value per share of 56.2 per cent, following a 44.9 per cent rise the previous year.

The accounts for the year ending 31 January 1993 show that of the $18.2m netted on premiums, $5.6m was "reallocated to other partners". In the previous year they were allotted $2.55m in premiums. These reallocations were based on their share of the partnership, which had risen from 24.6 per cent at the outset to 29 per cent by the end of the second year, partly because of the reallocations.

Thus Mr Soros, his family and key members of his management team had effectively increased the membership dues for Quantum's sophisticated investors in the fund, and helped to dilute the fund's interest in the partnership.

In the explanatory memorandum about Quasar, Mr Soros explained that "the Fund’s net profit or loss from transactions in the Fund shares (whether realized directly or through Quinter) generally is accounted for as if earned by the Partnership, and thus is shared among the Fund and the other partners."

Close examination of the accounts also reveals that the "selected persons" appear to have benefited in another way from the establishment of the partnership.

In April 1991 Soros told Quantum shareholders that they had subscribed for a total of $541m in "Quasar", without specifying whether he meant the fund or the partnership.

In fact the accounts reveal that while $541m of Quantum's assets were indeed transferred to the Quasar partnership, the Quasar fund's initial net asset value was only $493m - a difference of $48m.

The Quantum investors choosing to invest in Quasar were thus effectively paying a premium of about 9.5 per cent for their new shares.

Another discrepancy appeared in the calculation of the net asset value at the end of the second year. While the fund’s holding of the partnership at that time was 71 per cent, when it came to dividing up the net increase in the partnership's capital resulting from operations, the fund got only 67.1 per cent. This is possibly because the "selected persons" do not pay advisory fees.

The pattern for spinning off new funds had been set.

When Quantum's next distribution of $1.166m was made in February 1992, two further funds were launched: Quota and Quantum Emerging Growth.

Quota was different because it would be managed entirely by outside advisers (but, of course, under SFM's overall direction).

Quantum Emerging Growth remained inside the SFM stable - but its performance fee was set at 20 per cent and also spawned a partnership arrangement similar to the Quasar operation. In effect, therefore, it too raised the stakes for the growing ranks of investors in what was by this stage fast becoming the Soros phenomenon.

This time, though, there was no discrepancy between the assets of Quantum transferred to the partnership and the new fund's equity stake, according to the accounts issued for the first 15 months to 31 March 1993.

During that period the "selected persons" put some $100m into the partnership. Their share rose from less than 5 per cent at the outset to 15 per cent at the end of the period. Their allocation of the $40m in profits, generated by the premiums from dealings in the fund’s shares, was $4.7m.
As the fund's fortunes rocketed, self-restraint among its management seemed to wane. The 25 per cent restriction on the premium had long since disappeared.

Then it spawned two property funds, each with a high-profile partner.

One, Quantum Realty Trust, was with Paul Reichmann, whose Olympia & York operation had collapsed as a result of the financial drain of the Canary Wharf development in London's Docklands.

The other, Quantum UK Realty Fund, was with John Ritblat of British Land. Again, capital was provided partly out of distributions from Quantum and Quasar as well as by Mr Soros and his family, but also this time by other participants.

Although the structure of these new funds is highly complex, they are essentially closed-end operations. What may not have been noticed was that in June 1993 the directors of the open-ended flagship - the Quantum fund - removed an important investment restriction: a prohibition on direct investment in property.

Until the audited accounts for 1993 are available (they are expected to be out in May or June), investors will not know whether advantage has been taken of this change, or what effect it may have had on the liquidity of the fund.

Last year, Quantum quietly transformed itself. On 1 August "substantially all" of Quantum's assets and liabilities were transferred to a new Curacao partnership, Quantum Partners.

As with Quasar and Quantum Emerging Growth, the Quantum fund is not the only partner. "Selected persons associated with SFM" - including SFM's managing directors - subscribed for 1.3 per cent of the new partnership's net equity.

In effect they were getting a share in Quantum without having to pay a premium. Already by the end of September their share of the net equity had risen to 1.9 per cent - $78m - and, as with Quasar and Quantum Emerging, they would get a share of the net premiums made from dealings in the flagship fund.

Again, just how much this will be will not be known until the 1993 accounts are available. But in 1992 such dealings contributed $68m towards the rise in the fund's net asset value.

Additionally, SFM's managing directors and "trusts and charitable foundations created by them" have taken an insurance policy on the future of the fund. This comes in the form of $220m of convertible debentures that pay 6 per cent a year and are convertible in 2003 into partnership shares at 120 per cent of their net asset value on the issue date. They may be worth considerably more than that by then.

In the great tidal wave of money into the Soros empire, which at the end of 1993 stood at $4.9bn for Quantum alone and more than $10bn for the whole group, there is another sum that may one day cause repercussions of its own: the size of the performance fee that SFM leaves in the fund. At the end of 1992, the latest reckoning available, that totalled nearly $550m.

These deferred fees are so structured that they share in the appreciation of the fund, but investors are given no clear picture of when SFM can or will withdraw them.

It is curious that Mr Soros has not yet taken this money out, since it would be one way of reducing the size of the funds. But to take it out quickly now might suggest he was losing confidence in his own creation.

(Photograph omitted)

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