"If you're so smart, why aren't you rich?" You don't say that to ex-professor Ed Thorp or his partner Jay Regan. Their hedge fund has made them plenty rich.

Beat the dealer

By William Baldwin

WHAT WOULD YOU DO if you were sitting on $350 million of short positions and the market were taking off? If you were Edward Thorp, short-seller, mathematician and amateur astronomer, you spent April in Australia watching Halley's Comet. Thorp can afford to relax. He has a black box that beats the market.

Princeton/Newport Partners, a private investment pool managed by Thorp, 53, in Newport Beach, Calif. and James Regan, 43, in Princeton, N.J., has $150 million in equity. To set $350 million in short positions on such a small equity base seems insane, if not illegal. But Thorp and Regan are doing fine. So far in fiscal 1986 (ending Oct. 31) Princeton/Newport is raking it in at an annual rate of 24%. And this is a low-risk investment. As one outside investor says, "I was using it as a T bill substitute."

Low risk? With all that selling of stocks that don't belong to them? Thorp and Regan, moreover, are heavy traders. At one point four years ago Princeton/Newport by itself accounted for 1% of the daily volume on the New York Stock Exchange.

Princeton/Newport is low risk because it is, in the truest sense, a hedge fund. The fund is so hedged that it's not really betting on stocks at all. It makes money on interest-rate spreads that are built into options, convertible bonds and the like. At bottom, Princeton/Newport is a bank. Says Regan, "We try to borrow money at the risk-free rate and lend money above the risk-free rate."

To understand why Princeton/Newport is a bank, not a mutual fund, is to see options, futures and convertible bonds in a way that retail investors rarely do. It is also to see why—for retail customers trading against pros like Thorp and Regan—options and such are a sucker's game.

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Ed Thorp and Jay Regan of Princeton/Newport Partners
"Taking candy from a baby."

Jay Regan, New York City stockbroker, met Ed Thorp, University of California-Irvine math professor, in 1969. Thorp, the son of a Los Angeles security guard, was the fellow who beat the dealers. He figured out how to win at blackjack by counting cards, until the casino operators started throwing out the card counters.

Thorp had pulled in about $100,000 from gambling profits and royalties on *Beat the Dealer*, the book he wrote about it. Now he was turning his attention to a larger crap game. Was it possible to do to Wall Street what he did to Las Vegas? Thorp was having some success playing with warrants, rights to purchase stock at a certain price. Warrant prices frequently got out of mathematical alignment with the underlying stock.

Regan at the time was bored peddling stocks on Wall Street, which he had been doing since graduation from Dartmouth in 1964. Thus was born Princeton/Newport, a small pool of Thorp's, Regan's and friends' money. In 16½ years it hasn't had a down quarter. Returns have averaged 21% annually after commissions, an extraordinary performance in a bumpy market that has averaged less than 11% annual gains over that period.

The black box, though, eats money, now $4.2 million a year. The box is the system for detecting which options, warrants, convertibles and futures are mispriced—which ones, that is, have the most lucrative interest spreads built in. It consists of 55 traders, mathematicians and other employees, two computers in California, and some leased phone lines that connect the computers to exchange floors and to traders' screens in New Jersey.

So net profits have averaged a mere 19%. Then Ed (who quit his teaching job in 1982) and Jay take off their standard hedge fund fee, a fifth of the net. That leaves a still generous 15% for the 70 or so limited partners, an assortment of rich people, pension trusts and foreign holding companies. It also leaves Jay and Ed very comfortable, Jay on his 225-acre horse farm in New Jersey, Ed in his 10-bathroom house on a Newport Beach hilltop. Their share of past profits seems to leave them owning at least a fifth of the $150 million pot, possibly a lot more.

What are they buying? These guys play their cards so close to the chest that they have to back off to read their own hand. But they'll tell you about what they were buying a decade ago: mortgage puts.

Regan heard on Wall Street about