In the next few months, thousands of hedge funds will go out of business. What the world will look like for the survivors.

The past several years, the most valued people in our society were those who could make money from money. They weren't cancer researchers or astrophysicists. They weren't even the really important people, like N.B.A. players or movie stars. They were hedge fund managers. Last year, five of them made well over $1 billion each.

They scored, in part, by charging enormously high fees to investors who felt lucky just to be in business with them. The air of mystery that surrounded hedge fund managers—aided by their unregulated status and in some cases their black-box investing techniques—seemed only to bring in more money.

So much for that. The hedge fund mystique died with the crash of 2008. Youthful traders and big shots from investment banks won’t soon be given billions to invest based on their résumés. Mystery and opacity will be a negative, not cause for reward. Regulators, one hopes, are unlikely to again ignore an industry that, under their noses, grabbed at its peak nearly $2 trillion to manage.

As many as half the funds that existed earlier this year, when the industry topped out at 10,000 funds in business, could fail or be wound up in a year’s time, industry watchers estimate. Assets under management at hedge funds are falling as investors rush to pull money out of good funds and bad. In September, investors took out an estimated $41 billion from the sector, the largest monthly outflow of money since experts began tracking numbers. October looked even worse.

Washington is gunning for the industry. In a now-infamous memo, disgraced Lehman Brothers C.E.O. Dick Fuld reported disapprovingly that Treasury Secretary Hank Paulson wanted to “kill the bad [funds] and regulate the rest.” Regulators may soon have the chance. In November, managers of the biggest hedge funds will be dragged before Congress and given a roasting that could make the treatment of Fuld look cool by comparison. What will emerge from the heat is a smaller, more focused hedge fund industry, regulated by the federal government, with pay that better reflects long-term performance.
Many of the industry's stars have been crushed. Tontine, a fund run by Jeff Gendell, one of the hot Greenwich, Connecticut, managers, was down 65 percent through September after a less than stellar 2007. Phil Falcone's Harbinger had more than $20 billion under management after its main funds were up 116 percent in 2007; it was up 40 percent in the first half of 2008, before that gain was almost entirely wiped out in the third quarter. Steve Mandel's legendary funds—among the so-called Tiger Cubs spun out of investor Julian Robertson's company—were off between 23 and 31 percent this year through September, and an investor in his funds says that through mid-October, each of the funds was down another eight percentage points or so. Two funds run by onetime hockey player Tim Barakett's Atticus were down 25 and 33 percent this year, and their assets under management fell by $5 billion, to $15 billion.

Many fund managers knew this day would come. They just thought it would happen to the other guy. Cliff Asness, a hedge fund manager and finance scholar, cautioned repeatedly in recent years about the faddishness of hedge funds. In 2004, he concluded, “The hedge fund structure does not create investing skill out of thin air…and the tools that hedge funds use (leverage, short-selling, and derivatives) certainly come with risk.”

At first, hedge funds were truly innovative. Eventually, though, so many new funds poured into the industry that they eroded the competitive advantage of the original investors. Hedge funds, it turns out, were not “hedged” in any meaningful sense of the word. Too few shorted enough stock or managed risk prudently. Recent months have made it clear that hedge funds as an industry were, as the wisecrack had it, a pay scheme masquerading as an asset class. Sure, many funds have their “high-water marks,” meaning they don’t receive their performance fees until they get back to the levels they had achieved at the peak. But many won’t bother staying in business.

Some managers may harbor secret hopes of reopening with new funds, à la the patron saint of undeserved second chances, John Meriwether, who blew up Long-Term Capital Management before blowing up again this year. But this time, the world won’t be fooled again. At least we hope.

To be clear: Though no group benefited more from the worldwide speculative bubble—not corporate chieftains, not homeowners, not individual investors—hedge funds didn’t cause the credit crisis. Some are doing well, even spectacularly. And many will survive. While hedge funds have been attacked for their risky behavior, in the end they weren’t the causes of systemic collapse. It was the “respectable” outfits—Bear Stearns, Lehman Brothers, A.I.G., Wachovia, Washington Mutual—that went down, bringing the world’s financial system with them. Hedge funds are now feeling the aftershocks.

Which is perhaps how it should be. The truth that’s now becoming clear is that hedge fund managers didn’t have some magical ability to spin wealth while the rest of us toiled at our day jobs. Instead, they made money because markets were predictable, stable, and for the most part, up. Hedge fund managers reached their apotheosis in recent years because of their dazzling performance after the Nasdaq crash. They seemed to have made good on their promise to make money in friendly markets and bad ones. But that was easy. Other than tech stocks and giant blue chips, nearly every possible asset class and sector had become cheap by 2000. Stock hedge funds shorted the obvious garbage and bought the cheap stuff, like real estate and industrials. Over the next several years, the investing world was placid. Prices didn’t gyrate. With interest rates low, it was logical to make more risky investments.

That led to a worldwide bubble. Too much money was chasing the same things. Some people warned of impending pain, like money manager Jeremy Grantham or New York University economist Nouriel Roubini, but they were dismissed as one-note permabears. Former Federal Reserve Chairman Paul Volcker, nobody’s idea of a panicker, sounded the alarm about the fragility of the financial system in a 2005 speech that was widely circulated on Wall Street. And it was just as widely ignored.
Then came the misbegotten ban on short-selling implemented by the Securities and Exchange Commission in the wake of the failures of Bear Stearns and Lehman Brothers. Hedge funds couldn’t unwind bets they had already made. The measure of how damaging that move was is that investors now talk about “political risk” when assessing the United States. Previously, that phrase was reserved for investments in a capricious state like Russia.

Other problems were self-inflicted. Hedge funds have been like lemmings over the past several years. They ran the same strategies. Often, they crowded into the same stocks. In October, Volkswagen soared mysteriously to briefly become the largest company in the world by market cap amid the global economic chaos. The reason? Hedge funds had bought Porsche and sold short Volkswagen, of which Porsche owned a piece. Once the market began to crash, they all rushed to reverse the same trade.

In their heyday, fund managers would go to “ideas dinners” at the best restaurants in New York and London and persuade one another to make the same investments. Those excluded from the dinners would peer at the S.E.C. filings of the smarter among them and copy their trades, eliminating the advantages the more intelligent investors had in the first place.

The deeper problem among the long-short equity investors—those using the most popular hedge fund business model—has been Warren Buffett idolization. These investors didn’t worry about having to get out of an investment, because they were buy-and-hold guys, like Buffett. They didn’t worry about overconcentration because Buffett had famously said, “Wide diversification is only required when investors do not understand what they are doing.” Hedge fund managers took it to heart.

Harbinger’s Falcone is fast becoming the poster child for this approach. He had a spectacular 2007. And then in the first half of 2008, again, he was continuing to blow away the indexes.

There’s an old joke on Wall Street in which an investor calls his broker every day to tell him to buy. After a couple of weeks of this, the stock is up. The investor calls the broker and tells him to sell. The broker says, “Okay. To whom?”

The joke was on Falcone. Take the case of a tiny biopharmaceutical company called Medivation. Falcone’s funds filed a notice that they had become a holder of more than 10 percent of the company in December 2007. After that, Falcone was an insider, required to file with the S.E.C. within two days each time he bought and sold the company’s stock. Everyone in the market could see every move he made in it, which meant he lost whatever competitive advantage he had.

Then there is the age-old problem of leverage. Equity hedge funds began using more and more leverage in the past decade. The rule in the U.S. on stock investing is that you cannot borrow more than half your position. But many long-short hedge funds had much more leverage than that, in part by running some of their money through affiliates in London, where regulation is weaker. Some equity funds would go to five or even six times.

The Fed has the responsibility of interpreting margin rules, and in theory, the S.E.C. enforces them. In reality, the rules have been interpreted to the point of meaninglessness. When he was Fed chairman, Alan Greenspan explained the central bank’s view, testifying in November 1995 that the Federal Reserve Board “continues to believe that self-regulatory organizations should be given greater responsibility for margin requirements.” In 1996, the Fed came out with an updated rule that allowed for American broker-dealers to “arrange” credit for their clients in other countries, if they couldn’t give it themselves. The result was that investors could shop around for jurisdictions that allowed as much leverage as they wanted. “That’s when our
world changed from asking ourselves, ‘How levered can we be?’ to ‘How levered do we want to be?’” says one hedge fund veteran. Today, nobody knows precisely how much leverage is out there in the financial markets because no one attempts to keep track.

Investment banks’ prime brokerages would offer their clients “enhanced leverage,” according to hedge fund insiders, through their London affiliates, neutering the rules to the point of uselessness. When Lehman went down, everyone paid the price. Dozens of managers found that their money wasn’t held in separate, accessible accounts. Today, they are standing in line with everyone else, somewhere on the long list of Lehman creditors.

Smart investors will always be with us. They will continue to invest both long and (assuming that it remains legal) short. They will call themselves hedge funds unless they get smart and rebrand.

But the hedge fund business itself will not look anything like it did during its heyday. Washington clearly intends to declaw the industry. That will probably mean, among other things, that hedge funds (and private equity firms) will finally lose the argument about taxation. No longer will their income be taxed as capital gains but as regular income. The additional tax dodge of keeping money offshore to defer taxes for years should, and probably will, be closed.

After having looked obviously unsustainable for years, the egregious hedge fund fees will come down. The model of charging a 2 percent management fee while the fund manager takes a fifth (and sometimes more) of the profit is finally under sustained attack. Not long ago, the trend was for hedge funds to become bigger. They morphed into traditional money managers and began to manage tens of billions of dollars. Most hedge fund watchers think the biggest fund managers will only get bigger. But that’s hard to see. Endowments and pension funds are going to be chastened. The remaining hedge fund investors will demand focus from their managers. Small will become beautiful again. The survivors will be nimble and run less money. The esoteric strategies based on levering up small arbitrage opportunities will become less popular if regulators do their job and crack down on excessive borrowing.

Perhaps ironically, many hedge fund managers are anticipating great times—if they survive. “This will be the best moneymaking environment of my career,” the hedge fund veteran tells me. “Tons of competition are out, and even the capital that will survive is underlevered. And we are starting with disparities and opportunities you’ve never seen.”

For the survivors, it’s going to be a wonderful time. But there won’t be many of them.