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The Fall of China’s Hedge-Fund King

Xu Xiang was a legend in the country’s booming stock market — until the bubble he helped to create took him down with it.

By ALEX W. PALMER
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At 10:33 a.m. on Sunday, Nov. 1 of last year, the highway police in Ningbo, an industrial city on China’s eastern coast, posted a seemingly innocuous message to their official microblog. “Due to sudden traffic control,” the message read, “all the entrances and exits of the G15 Expressway at Hangzhou Bay Bridge have been closed.”

That weekend, Xu Xiang, one of the wealthiest men in China, had been visiting Ningbo, his hometown, to attend his grandmother’s 100th birthday party. As the founder of Zexi Investment, one of China’s most successful hedge funds, Xu had consistently produced returns that were truly unbelievable: His worst-performing fund had grown by nearly 800 percent in five years. He had also survived countless corruption investigations, market falls, purges and other scares. Yet even as his legend grew, Xu remained intensely secretive. He had amassed a fortune by trading on knowledge and information no one else had, rumors no one else knew — a strategy perfectly crafted for China, where information is tightly controlled and reluctantly released. (Almost every source I approached for this article would only speak to me anonymously, fearing government reprisal or harm to their business.) Even as Xu grew richer and more powerful, he kept nearly every detail about his personal life and his trading techniques jealously hidden.

That equilibrium seemed certain to crumble on June 12, when the Chinese stock market began a free-fall. In the span of three weeks, the market lost a third of its value. It continued to careen downward throughout the summer, with major declines on July 27 and Aug. 24. On the second of these, named Black Monday by The People’s Daily, the Shanghai composite index fell by 8.5 percent, its worst single-day tumble in eight years. In the span of two and a half months, $5 trillion was wiped out of the market. The ripples were felt around the globe. On Black Monday, the Dow Jones industrial average fell more than 1,000 points shortly after opening, and the FTSE 100 index in London lost $116 billion. Yet Xu (pronounced shu) somehow managed to survive this free-fall unscathed.

Despite his wealth, the party in Ningbo had been a low-key affair. Xu's family shared his taste for anonymity. His wife preferred the subway to her chauffeured car, and his grandmother still lived in the same middle-class neighborhood where Xu grew up. But the festivities were interrupted a little before 10:30 that Sunday, when Xu received a message bearing a warning: The authorities were coming for him.

Xu left the party immediately and sped north on the G15 Expressway toward Shanghai. As he drove, he passed neighborhoods of squat gray apartment buildings with smog-stained walls, unkempt courtyards and barred windows. He crossed the Fenghua River, which bisects Ningbo, and curved along Hangzhou Bay, racing toward the bridge. But he didn't know about the police blockade. When he reached the bridge, the authorities ushered him from his car and shuttled him to the side of the expressway to an office of the highway patrol.

For all the secrecy and intrigue that had long surrounded Xu, the moment of his downfall was strikingly prosaic. That evening, a photo of him appeared on the Internet. Dressed in a white Armani coat, gray button-down shirt and rimless glasses, he is clean-shaven, with pudgy cheeks and a receding mop of unruly black hair. Someone out of frame is carefully pulling back the sleeve on Xu's coat, revealing the clasp of a handcuff around his wrist. Xu stares directly into the camera, seemingly unmoved or uncomprehending. If he is surprised or distraught, his face betrays no hint of it. It is the only known photograph of the man who, until that morning, had been the king of China's stock market.

The story of Xu Xiang starts with the beginning of the Chinese market itself. Xu, who grew up in a quiet, lower-class neighborhood of hardscrabble shops and public housing projects in Ningbo, was a freshman in high school when China opened its first stock exchange in nearby Shanghai in 1990. Market fever spread quickly through Ningbo, which had a long history as a commercial hub and a proud business culture. Stocks were a natural fit, and a few trading outposts opened.

Xu began trading while still in high school. He was entirely self-taught: His parents, a retired factory worker and a homemaker, knew nothing about investing. "I studied the stock market by reading books and attending lectures and by studying foreign investment techniques," Xu later told Caixin, a Chinese news organization, in one of the few interviews he has given. After graduating from high school, he skipped China's infamous college entrance exam and borrowed 30,000 renminbi (roughly $5,000) from his parents to trade full time. He would later say that he had actually been born in 1993 — the year he first started trading stocks.

At the time, millions of Chinese were opening stock accounts with an enthusiasm that proved long-lasting and transformative. Between Shanghai and a second exchange in Shenzhen, the market grew from a capitalization of $61 billion in 1993 to $10 trillion by the summer of 2015. Unlike in the United States, where institutional investors dominate the market, China's 200 million mom-and-pop investors make roughly 85 percent of all trades. According to a survey by the State Street Center for Applied Research, 81 percent of these trade at least once a month. But less-experienced individual investors are easily swayed by rumors and operate with a poor understanding of market fundamentals, making them easy prey for more systematic and sophisticated traders. "All these small individual investors are called 'chives' in the market," says Hong Yan, a finance professor at the Shanghai Advanced Institute of Finance. "They get cut over and over again, but they come back every time, like little weeds."

In his early days, Xu worked from the Galaxy Securities trading hall on South Liberation Road in Ningbo. Stock prices were written in chalk on blackboards, and arbitrary rule changes affecting stock issuance and corporate disclosure constantly jostled an already unpredictable market. In 1992, the Shanghai index grew by 167 percent — then tumbled roughly 75 percent between April 1993 and July 1994. The fact that China Galaxy Securities was a state-owned enterprise offered little protection; as Xu cut his teeth, the traders around him won and lost fortunes almost overnight.

On an overcast Monday morning last December, I visited Galaxy. The building itself had hardly changed from the days when Xu first set foot inside. Located beside a pharmacy that glowed with blue lights, the eight-story structure seemed on the verge of physical collapse. A wide concrete staircase, littered with cigarette butts and sunflower seeds, led up to the main trading hall on the second floor, which, by 9 a.m., was packed with haggard-looking investors. Directly opposite the trading board, hung above a small statue of a golden bull, was a red banner urging traders to "stay away from illegal securities activities."

The heady tumult of those early days in China's stock market shaped what would become Xu's signature style: Buy quickly, sell quickly and always go big. It was the familiar ethos of day trading, but taken to the extreme within a Wild West market in which information was scarce, unreliable or nonexistent. Xu won renown so quickly that by 1995, at 19, he was rumored to be the subject of a heated dispute between two powerful Shanghai gangsters. Having seen the lucrative potential of the market, and the exceptional returns of the young trader, both men wanted Xu as their own personal investor. Several sources told me that the dispute was eventually settled by a leader from one of China's infamous triad gangs — and that, improbably, the episode later became the inspiration for a series of Hong Kong gangland movies about stock-market geniuses.

As Xu's fame grew, so did his network. By the late 1990s, he became the unofficial captain of a group popularly known as the Ningbo Death Squad. The squad made its reputation by manipulating cheap, relatively unknown stocks, which in the Chinese market are not allowed to rise or fall more than 10 percent in a single trading day. To game the system, the squad devised a strategy: Out of nowhere, it would place a gigantic order for a chosen stock. Other traders, seeing the sudden upward movement in price, would flood in, pushing the stock toward its daily 10-percent limit. Once the stock hit the limit on the first day, the momentum became self-perpetuating. Eager traders rushed to buy the stock as soon as the market opened the next day, propelling it toward the 10-percent limit once again. The movement generated its own publicity and easy profits. After a few days, the squad would sell out, and the stock would tumble back to a lower price as other traders followed. In the American context, this tactic was reminiscent of present-day schemes in "penny stocks," but with much higher stakes, and playing out in a regulatory environment that mirrored the early days of the United States market. One Chinese day trader I talked to spoke in reverent tones about the turn-of-the-century American stock picker Jesse Livermore, who made and lost several multimillion-dollar fortunes before killing himself in 1940 at 63.

As the squad gained notoriety, other traders began to monitor the buy orders coming from the Galaxy trading hall — any stock they picked was guaranteed to attract attention, and a corresponding surge in buy orders. Profit was almost unavoidable.

Despite Xu's preference for anonymity — he eschewed flashy purchases while other squad members parked new sports cars conspicuously in front of the trading hall — the group took on a mythical status. There was a series of books by two self-proclaimed "Ningbo masters," as well as traveling seminars that promised to teach legions of novice investors the moneymaking secrets of the Ningbo Death Squad. Copycat death squads popped up in other Chinese cities.

The attention was not all positive. After a 2003 article in The China Securities Journal raised questions, the China Securities Regulatory Commission, the country's chief market watchdog, assigned a special czar to investigate the trading practices at Galaxy Securities and five other Ningbo trading halls. In the process, the czar called in a number of big-name local traders for an "informal discussion session." The squad disappeared from the market, only to return a week later when the czar released a public statement saying he had found no evidence of wrongdoing. Whatever the traders' methods, they were pulling in millions, and Ningbo — and the greater Chinese economy — was thriving.

By 2005, Xu had outgrown his hometown. He needed to be closer to power and money on a scale that Ningbo couldn't provide. With his usual perfect timing, he moved to Shanghai with hundreds of millions of renminbi just as the country's hedge-fund industry was taking off. The industry existed in some form as early as the 1990s, but in those days the amounts traded were small — China's economy was still developing — and there was no local expertise or legal framework. What funds did exist operated in the shadows, absent any type of government regulation. "Who could run hedge funds?" a former Chinese regulatory official says. "At that time, it was an open question."

It was only in 2005 that a revision to China's Securities Law helped pave the way for hedge funds. Those funds that decided to operate openly within the new framework became known as "sunshine funds," to distinguish them from funds who kept their participants hidden. As this was happening, a new class of wealthy Chinese, enriched by the country's rapid economic boom, suddenly found themselves with billions of renminbi to invest. "It was just the perfect storm," says Zhang Howhow, the director of strategy at KPMG in Hong Kong. "People were starting to study the regulations more closely, more seriously, to find a relatively legal way to approach this as a business. The market was going up, and you have a group of high-net-worth individuals." This was Xu's chance "to build a proper hedge fund in China — the biggest, the most successful."

On Dec. 7, 2009, Xu founded Zexi Investments with 30 million renminbi — a little under $4.5 million — in capital. The name was a homage to the two men Xu admired most: "Ze" for Mao Zedong, the founder of the People's Republic of China, and "xi" for Emperor Kangxi, the longest-ruling emperor in Chinese history. In March 2010, Xu opened Zexi's first fund with one billion renminbi. It was technically a sunshine fund, but because it had fewer than 200 investors, he wasn't required to divulge the names of his clients.

As a boss, Xu was obsessive and untiring. Friends say he had no hobbies or interests outside the stock market. He arrived at Zexi's sleek Shanghai office each morning at 8:45, and often stayed until 2 a.m. From his seat at the back of the firm's trading floor, he personally directed Zexi's investments, even as the firm's assets approached 30 billion renminbi. He remained intensely secretive. The firm's researchers did not know if he had heeded their stock recommendations until they saw their performance assessments at the end of each year. "Xu Xiang is always trading," a longtime friend said. "If he's not trading, he's thinking about trading."

In meetings, Xu was glued to two smartphones, one displaying market prices and the other pinging with news about economic developments. He preferred to let others speak, and when he did interject, his answers were brief and dismissive. One Western fund manager said he seemed as if he was "bored of answering questions and would rather get back to trading." He dressed informally, sometimes in tracksuits.

As he had in Ningbo, Xu regularly poured billions into big, risky bets that always seemed impeccably timed. He focused on buying stocks that were either small and relatively unknown or sinking toward bottom-dollar price, then pulled out as soon as he made a profit. The strategy was partly a reaction to the peculiarities of the Chinese market. Practices common among United States hedge funds, like short-selling stocks to protect against downturns in the market (in other words, hedging), are restricted in China, where regulators treat them with suspicion. Instead, fund managers rely almost exclusively on buying and selling stocks at just the right time.

The results Xu achieved were unbelievable — perhaps literally. Between March 2010 and October 2015, Zexi's Fund No. 1 produced a return of more than 3,270 percent, even while the Shanghai Stock Exchange index grew by only 11.6 percent. Other Zexi funds grew at similarly startling rates. By 2015, Xu controlled at least 28 billion renminbi, the most of any Chinese hedge-fund manager. An adoring public, aspiring to his rags-to-riches tale, called him "China's Carl Icahn," "Xu the Legend" and "Hedge Fund Brother No. 1."

Throughout his career, Xu's wild success provided fodder for rumors and speculation: about his access to insider information, his uncanny timing and the possible government connections of his wealthy (and entirely anonymous) clients. The most persistent rumor held that Xu was investing on behalf of wealthy and corrupt Shanghai-based "princelings," the second-generation descendants of prominent Communist Party officials. These princelings, the rumors went, fed Xu inside information and protected him from prosecution; in exchange, he managed their wealth in private funds that were tailored to their needs and hid both the amount invested and the identity of the investor. These rumors had the virtue of being both entirely plausible and entirely unverifiable.

In an elegant waterfront coffee house in Ningbo, I met a young stock trader who speculated about the web of political connections that had enriched and ultimately doomed Xu. "Xu was pushed onto the stage," the trader told me, as fashionable young women toting Gucci bags and wearing Cartier watches strode past us. "There are a lot of red capitalists in Shanghai, the children of leaders and important officials. They put a lot of money into his private fund to use as their personal bank account."

By the young trader's telling, Xu's entire operation was a cover for this simple scheme. "Xu had seven products," the trader told me. "The most successful are for the red capitalists. The others are rat funds" — dummy products used to drive up stock prices and enrich Xu's clients.

Nearly every one of the experts I spoke with repeated some version of the same rumor: that Xu was less a financial genius than a puppet of even larger powers. Most often, this explanation was deployed in response to a question that had been troubling observers of the Chinese financial world for months: Why hadn't Xu stopped earlier? Rumors of his illegal methods were an open secret, and he had already built the most successful hedge fund in China, reaping billions of dollars in personal wealth in the process. Why keep going and risk a reckoning?

"That goes to the investor conspiracy," a former hedge fund researcher told me. "The people who give money to him to manage would not like to see the fund wound down." Whether Xu had begun as a willing partner or was coerced from the start was just further speculation. "When you have someone very politically powerful and well connected coming to you who wants you to manage money for him or her," the researcher said, "then it's sort of difficult to say no, right?"

If Xu was indeed tied to figures in the country's opaque political elite, his carefully protected anonymity was all the more crucial. In a nation where political and economic control are inseparable, and where the flashiest are often the first to fall, remaining unknown can serve as a survival technique. Even the true value of his assets remains a mystery. In 2015, the Hurun Rich List ranked Xu as the 188th-richest person in China, with a value of $2.2 billion. But that figure does not necessarily include all of Xu's earnings from privately managed funds, the money he controlled through family members or assets stashed outside Zexi. Xu's true wealth was unknown and unknowable.

As Zexi grew and thrived, the fund began to operate through murkier market channels. Buying and selling shares was no longer adequate to keep the empire growing apace. Xu needed a new business model.

In late 2010, he began operating through a network of shell companies and affiliated investment funds with near-identical names, purchasing ownership stakes in companies. He took on the role of the activist investor, padding corporate boards with his associates, who would then implement investor-friendly policies — particularly dividend payouts.

Between 2010 and 2014, Zexi invested in 45 companies that issued dividends — more companies than the average Chinese hedge fund had invested in altogether during that period. "That strategy was quite unique," the China-based Western fund manager told me. "Maybe in part because there are only a few managers who can pull that off." But Xu had the leverage and the connections. A company's performance or fundamentals did not seem to concern him; if he could find a few winning stocks, he could use his tactics to ride them to huge profits. Zexi would use dividend payouts to purchase additional shares in the company, which it could then sell when prices rose, netting millions more in profits.

To execute this scheme, Xu relied on a network of trusted proxies. Two of the most important were his parents. As executives at Zexi and controlling shareholders at several related companies, Xu's mother and father helped direct billions in investment in their son's name. They also ran many of the companies that made up Xu's secret empire. Through a Zexi-affiliated fund, Xu's father owned a large share of Ningbo Zhongbai, a department store company based in Xu's hometown. Other corporations, like an unprofitable apparel chain called Shanghai Metersbonwe Fashion & Accessories, were run by friends and allies.

The stock rout last summer coincided with the apex of both Xu's success and his notoriety. The government's response to the crisis was swift and heavy-handed. Large shareholders were prohibited from selling listed stocks; I.P.O.s were halted, and state-run institutions were ordered to maintain their positions or to buy shares. The government also mobilized a "national team" of brokers and investors, backed by up to three trillion renminbi in state capital, to purchase shares and raise prices.

But while the rest of the market was collapsing, Xu continued to thrive. From the beginning of 2015, one of Zexi's funds grew by 357 percent, ranking first among 1,649 funds in China. Another grew by 187 percent. All five publicly listed funds had growth of at least 20 percent during three weeks of the crash in mid-June.

Xu benefited from seemingly miraculous luck and timing, according to The South China Morning Post. At least three of the stocks that Zexi held most heavily were purchased en masse by the "national team." More remarkable still, all the funds run by Xu seemed to exit the stock market at just the right moment, when it briefly rebounded during the late summer before plummeting again. By the end of the summer, the annual return on his funds was more than 200 percent.

But as the market dried up, Xu became a target. In September, a social-media post implicating Zexi in corruption and insider trading went viral on the Chinese Internet. The post, written anonymously, claimed that Zexi had conspired with Citic Securities, a powerful state-owned investment house, to direct buyers toward Shanghai Metersbonwe Fashion & Accessories, which saw its share prices surge during the worst of the market rout. Zexi denied that Xu had worked with Citic to manipulate the price of Metersbonwe, but the arrest of several Citic executives that fall only fueled more speculation.

The same post provided a possible motive for the swindle. It began when a Shanghai princeling who held shares of Metersbonwe complained to Xu about the stock's low price during the summer rout. Xu called in a favor at Citic Securities, and in a matter of weeks the "national team" purchased 15 percent of the company's total shares in circulation, sending prices soaring. The C.S.R.C. noticed the incident and began investigating. Almost immediately, the government placed restrictions on Xu's ability to travel outside the country.

Nine days later, Xu was fleeing his grandmother's birthday party, trying to reach Shanghai. The timing was not coincidental. A special group organized by the Central Commission for Discipline Inspection was about to begin a top-to-bottom review of the activities and leadership of the C.S.R.C. Taking down Xu — especially in public, and with photographic evidence — was a display of force and competence from a government battered by a summer of bad economic news. "In China," one fund manager told me, "the compromising and bargaining is in the execution of the law, not the formulation. The government is using this case to show that from now on, they will enforce the law."

Xu himself seemed to sense the end coming. A year before his arrest, in November 2014, he moved to Beijing and opened an office less than half a mile from the headquarters of the C.S.R.C. According to colleagues, the move was the start of a yearlong effort by Xu to use his connections and money to avoid a reckoning. But despite his billions, Xu was an ordinary man from a poor family. By itself, Xu's market malfeasance might have been enough to spell his downfall; that he was said to be protected by some of the same corrupt officials targeted by the anticorruption push meant there was no escape.

Xu Xiang remains in detention in an undisclosed facility somewhere in Beijing. Months after his capture, the only detail confirmed by the Chinese government is that he has been detained for insider trading and stock manipulation. There has been no word of a trial, no taped confession, no formal charges or publicly disclosed evidence of wrongdoing. In his absence, Zexi has crumbled. Xu was Zexi; without him, the magic is gone.

In the months since the crash, the Chinese government has instituted a sweeping crackdown on illegal practices in the financial markets. "There are many, many, many, many, many other managers in the market who could be apprehended for the same reasons," the Western fund manager told me. Xu proved an irresistible target not because of his own malfeasance, but because he offered a path to an even larger target — perhaps the clique of Shanghai princelings. "If you're going to knock somebody down, first you take out the whole row of people around them, the people who support them," the fund manager said. "You tighten the noose around them."

From the beginning of 2015 through September of that year, 34 companies listed on the Chinese stock market reported officials as either missing or under investigation by the authorities, according to Bloomberg News. As of late November, Xinhua, the official Chinese news agency, had identified at least 16 major finance industry figures tied directly to the stock-market cleanup who were either arrested, under investigation or assisting the authorities. In early January, the chairman of Metersbonwe joined the list, disappearing without explanation for more than a week.

"The level of corruption is beyond your imagination," a prominent Beijing-based hedge-fund manager told me over coffee several weeks after Xu's arrest. Like all my sources, this fund manager was extremely nervous about being interviewed. The irony of the crackdown was clear: Though a lack of transparency had clearly shattered the market, the Chinese government was responding with a crushing clampdown on information. The fund manager insisted that I could not use his name, for fear of being blacklisted or arrested. The ubiquity of wrongdoing, he said, did not make anyone safe. "No one knows who will be next. If they want to catch you, they will catch you."

The term used to describe what happened to these executives — *shilian,* "lost contact" — has become a coy euphemism for the Communist Party's holding individuals indefinitely for questioning or arrest. The campaign was partly a reaction to widespread anger within China: The people, the party and the government all wanted someone to blame for the loss of face — and money. Xu became the emblem of ubiquitous financial corruption. "There will be new tricks," the former regulatory official says. "But none will be as outrageous as his."

For China's would-be tycoons, the stakes of the crackdown go far beyond the market. During my conversation with the Beijing-based fund manager, which took place in a cafe on a university campus, a young man wandered toward us, admiring a pair of paintings on a nearby wall. The manager went quiet, and shifted uncomfortably, watching the potential eavesdropper from the corner of his eye. When the young man had passed, the manager turned back to me. "In China," he said, "the losing side doesn't get to sleep at night."

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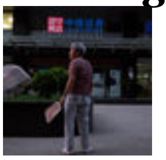
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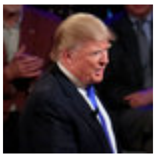

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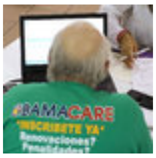

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