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TOP HEDGE FUND INVESTORS

STORIES, STRATEGIES, AND ADVICE

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Top Hedge Fund Investors: Stories, Strategies, and Advice

Introduction: Cathleen M. Rittereiser, Co-Author

Top Hedge Fund Investors: Stories, Strategies, and Advice profiles nine top-performing, well regarded investors, each with a long history of investing in hedge funds. Co-author Larry Kochard best described the value of writing and reading about successful investors in the conclusion of our first book, *Foundation and Endowment Investing*:

> "Successful people in any field don't stick their head in the sand – they are always hoping to learn new ideas from other innovators and leaders in any field. And as investors we all want to do a better job establishing a disciplined and successful investment process and generating better returns on our portfolio, whether it benefits an institution or our families. We look forward to hearing their insights."

Top Hedge Fund Investors chronicles the challenges and rewards these investors face in selecting hedge fund managers, managing risks and constructing portfolios. By telling their stories, they describe their strategies and offer their advice for succeeding at investing in hedge funds. Readers will find:

- Overviews of the evolution of hedge funds as an investment and an industry; how and why hedge funds have become a bigger and more influential investment force.
- Interviews of top hedge fund investors - the pioneers and next generation; high net-worth individuals, funds of hedge funds and institutions – and nine revealing profiles.
    - Richard Elden, Founder, Former Chairman, Grosvenor Capital Management
    - Frank Meyer, Founder, Former Chairman, Glenwood Capital Investments
    - James R. Hodge, President and CIO, Permal Asset Management
    - Mark J. P. Anson, Managing Partner and Chair of the Investment Committee, Oak Hill Investment Management
    - Louis W. Moelchert, Jr., Managing Partner, Private Advisors
    - Christopher Fawcett, Co-Founder, Senior Partner, Fauchier Partners
    - Deepak Gurnani, Head of Hedge Funds, Investcorp
    - Kathryn A. Hall, Chairman, CEO & CIO, Hall Capital Partners
    - Ted Seides, Co-Founder, Protégé Partners
- Viewpoints, lessons, insights and advice beneficial to all hedge fund investors regarding particular challenges in the areas of due diligence and manager selection, growth and change of the asset class, proliferation of funds, headline risk, and balancing qualitative and quantitative factors when making an investment decision.
- Reviews the financial crisis of 2008, problematic hedge fund strategies, the Bernard Madoff fraud and previews how these recent events will influence hedge fund investors in the future.

Top Hedge Fund Investors will prove valuable to anyone involved in investing in hedge funds as well as to hedge funds seeking a better understanding of their clients.

Advance Praise for *Top Hedge Fund Investors*

"In *Top Hedge Fund Investors*, Rittereiser and Kochard profile men and women with passion, courage, intellect, tenacity, inquisitiveness and resiliency, who have helped establish a standard of excellence in hedge fund investing that all those who read this book will benefit from emulating. We are all richer for the authors' efforts to bring together this outstanding volume of Stories, Strategy and Advice from some of the best hedge fund investors in the business."

— **Mark W. Yusko, CEO & CIO, Morgan Creek Capital Management**

"A fascinating look into the world of professional allocators. I recommend any Hedge Fund Manager read this book to get inside the head of the folks that control where the money goes. Plus, anyone that is considering putting their money with a Hedge Fund will learn valuable lessons from these Leaders. Not only is this book insightful - it is also thoroughly entertaining."

— **Emma Sugarman, Head of Capital Introduction, BNP Paribas**

"This volume will be required reading for any fiduciary or investor serious about understanding hedge funds and their strategies. In distilling the investment philosophies of major thought leaders, the authors have constructed what will quickly be recognized as a durable intellectual anchor for investors."

— **Orin Kramer, Chair of the New Jersey State Investment Council, and Partner, Boston Provident, L.P.**

"An excellent overview and history lesson on the evolution of the global hedge fund industry with sound advice from successful investors. The foresight and persistence of these prominent investors in hedge funds provides a practical education from invaluable experience. They brilliantly articulate their successes and shortfalls with great insights for any hedge fund investor."

— **Glen C. Dailey, Managing Director, Head of Prime Brokerage, Jefferies and Company**

"Rittereiser and Kochard have distilled the essence of what drives some of the alternative investment industry's most influential leaders. They have coaxed these luminaries into revealing not only their investing strategies and outlooks, but also the personality traits and life experiences that make them tick. The result is a must-read for anyone looking for an edge in, or considering a career in, the alternative investment sector."

— **Christopher Holt, Director, Industry Relations, Chartered Alternative Investment Analyst (CAIA) Association, and Founding Editor, AllAboutAlpha.com**

A Driver of Returns

Kathryn A. Hall, Chairman, Chief Executive Officer & Chief Investment Officer, Hall Capital Partners

As Chief Executive Officer and Chief Investment Officer of Hall Capital Partners LLC, a privately owned registered investment advisory firm, Kathryn A. Hall, known as "Katie" has become one of the most prominent and well-regarded hedge fund investors. Serving primarily wealthy families, Hall and her team manage approximately $18 billion in multi-asset class global investment portfolios.

Previously, she was a General Partner of Laurel Arbitrage Partners, a risk arbitrage investment partnership that she founded in 1989. Prior to that, she was a General Partner of HFS Management Partners, HFS Partners I, and Hellman & Friedman. Hall began her career at Morgan Stanley where she worked in both the risk arbitrage and mergers & acquisitions departments.

Hall chairs the Board of Directors of the Princeton University Investment Company ("PRINCO"), is a member of the Board of Trustees of Princeton University, and has served on a number of boards and investment committees in the San Francisco Bay Area. A Director of the American Century Mountain View Funds from 2002 to 2007, she serves on the advisory boards of several private investment partnerships. Hall graduated cum laude from Princeton University with a B.A. in Economics and earned an M.B.A. from Stanford Graduate School of Business.

Background

Katie Hall started her career at Morgan Stanley, then left to attend Stanford Business School in Palo Alto California. After getting her MBA in 1984, Hall returned to Morgan Stanley in the risk arbitrage department. "It was the public markets phase of M&A," an extremely active time in that market. She remained there for two years before moving back to Northern California to join "a brand new start up."

The firm, HFS Partners, took its name from the founders Hellman, Friedman and Steyer. Under the leadership of Hall's friend, former Morgan Stanley colleague, and Stanford Business School classmate, Thomas F. Steyer, the firm eventually became the highly regarded hedge fund firm Farallon Capital Management. When she joined, it was "less than a year old."

Risk Arbitrage Training

Risk arbitrage, Hall says, "Is the absolute best training for thinking about investments broadly. You need to understand the different strands, then how they weave together to make a specific decision." She elaborates, "It's a very disciplined framework: Identifying a critical path, understanding financials, understanding other aspects that could interrupt that critical path, integrating legal and financial vocabulary." Observing the way people made decisions and whether they trusted each other also helped her learn. She adds, "It was a great field."

Hall spent three years with the HFS organization, becoming a partner in 1986. By 1989, although she and Steyer remained good friends, HFS Partners was "his baby" and she "really had an enormous bee in my bonnet to have my own show." Montgomery Securities provided capital and fund-raising resources, and together they launched "classic risk arbitrage hedge fund" Laurel Arbitrage partners.

New Direction

During that period she got involved in helping a large, wealthy family "think about the whole universe of their investments." At the time, the problem she was asked to help solve – structuring a large charitable investment trust to invest in hedge funds - was uncommon. Having found the experience interesting, Hall realized her "training and framework, of identifying the problem, the solution and the probability," suited the task. The hedge funds and a legal team worked with her "to design a solution to meet the need. It was an accomplishment."

Hall finished the project in early 1994, as risk arbitrage "started to just pick up enough. I had to make a choice of what direction to go." She felt she had done good work during a boring time, but now "had an acute sense of the cyclicality of M&A opportunities." Deciding that she "wanted to look at things from a broader perspective," Hall liquidated her hedge fund, received capital from Warren Hellman and others, and started Laurel Management Company.

Although she "used different vocabulary at the time," in today's parlance, the firm was charged with "building global multi asset class portfolios of outside managers." As the firm has grown, it has changed its name twice to reflect changes in its ownership structure, but the approach has remained consistent. Through it all, Hall says, "We have had a relatively meaningful allocation to
hedge funds and other alternatives. That's not surprising because of my background."

When she started the company, Hall stopped managing money directly and allocates only to external managers across all asset classes. The policy serves as "a good cornerstone" of the firm to avoid conflicts and remains "an important tenet."

Although Hall built the business with a broader investment mandate, it has benefited from her market knowledge. "It's an advantage to have real life scars, and experience in the investment landscape. It makes you a better gatherer and consumer of information."

Return Patterns

Specifically, her experience managing money in active markets makes Hall "more critical, from the analytical perspective, of return patterns. I think I have a real understanding – it's a cliché, but – good returns can be as big a problem as bad returns, sometimes more so." This perspective enables her "to have a nuanced capability to assess the believability of returns," when hearing a manager describe the risks taken to achieve those returns. Her perspective serves as a "point of differentiation" for the organization and makes her investment team "push further" with managers to determine concentration and leverage and assess their sources of information. "It helps us go farther in trying to understand whether returns were generated by rising tides, a home run that went the right way, uncomfortable risk, or an appropriate path."

Manager Selection

Even though Hall is "really not a label person, and resists them in any way shape or form," To describe the managers she prefers, "If you had to slap a label on, it's 'Concentrated High Conviction Investors'. I would probably add a value modifier onto it as well." The broad description serves as a "bit of a road map for thinking of managers generally."

Specific Strategy Criteria When they begin considering a specific strategy, they need "good reasons why the investment has a high probability of being successful." Hall says, "We re agnostic," about the strategy type and execution, it can be "complicated; simple, global, domestic, we're broad minded about that." But in questioning the manager and evaluating the strategy they "will come back to the succinct driver of return. Why will it persist? Why is the market giving you the opportunity?"

On the surface, her "only absolute other rule" sounds like a test of the manager's client service policies. Some shortsighted hedge fund managers may see it as such, but it becomes clear that it has more to do with assessing the manager's mindset and attitude toward co-investors and limited partners.

"We have to be able to speak to the investment decision makers. It doesn't mean we will do it all the time or abuse the relationship, but it will permit us, when needed, to actually get to the person that is making the investment decisions. We won't make the investment if we don't believe we can get that call through." The policy "keeps us out of certain investments, good and bad," she says, but she has a "fundamental reason" for adamantly abiding by it.

Personal Characteristics Hall cares less about liking a manager personally, since deciding whether he is a "good guy" is such a "subjective assessment," and focuses more on finding him trustworthy. "If we think a manager cuts it close from a legal and ethical standpoint, no matter how good the returns are, we don't care. We just won't invest with him. People do draw different lines, we draw a brighter, hard line."

Similarly, recognizing the difficulty of making a subjective assessment of a manager's ethics, they work to find a systematic way to make that determination. They review and evaluate the incentive program to make sure it "rewards the manager to do the right things, as opposed to stretch." The team will analyze the program and cross-reference it against other information and observations, looking for signs the incentive program could foster questionable ethical or risk-taking behavior. Some organizations "give big rewards and disproportionate payouts" that may lead to behaviors like "stretching".

Due Diligence Hall prefaces her thoughts on due diligence practices by reminding investors that effective hedge fund investing requires more than knowing some tactics. "This business is an apprenticeship business, a cumulative knowledge and experience business." Although her firm has as "thorough an approach as possible, in the end, the ability to make judgments good or bad, is the sum of those experiences."

When they evaluate a manager, the due diligence analysis encompasses the entire firm. "Having multiple points of view and insights within the organization deepens your understanding. If you have conversations with junior analysts, the CFO, a midlevel person, you learn a lot." The approach helps them determine the fund's decision-making process, the people doing the work, the pace and objectives of the work, the ways and topics they're communicating and "obviously the set of references."

They cross reference the information in multiple ways "in as an authentic way as possible." Investors need to do "classic reference checking to not miss anything obvious" and to have the "broadest network possible as a source of confidential references." While the latter tactic "may be controversial", Hall finds it necessary. "People might be cautious about answering questions. They are wary of making negative comments."

Portfolio and Risk Management

Hall identifies "permanent capital loss" as the real measure of risk. "That is the single most important risk we focus on." She believes investors "can't avoid the risks associated with human behavior and other external consequences" and says those risks are "typically encapsulated in some discussion of volatility." In other words, while some investors consider volatility a risk, she says, "Volatility per se is not a risk in my book. It is only a risk in that it magnifies human behavior or changes external relationships to other investors and funding sources."

Liquidity Risk During the 2008 financial crisis, illiquid investments caused problems for long term investors like endowments, and put liquidity risk in the spotlight. Liquidity risk is not a young ingénue making her debut, but an old pro making a comeback trail.

"I would not identify liquidity or illiquidity as a new risk, although I think some people are acting like it's a new risk. Having a really good understanding of the liquidity of the underlying investments, the appropriateness of the terms being provided, and their consistency or inconsistency, is very important, but that's not a new insight." People seem 'shocked, shocked" that managers investing in illiquid securities "put up gates when they had high withdrawals." Hall seems more shocked others were shocked and asks, "What's surprising about that?"

She offers an explanation. "Most people were not being harsh enough. They were complicit in kind of a deal. 'I will invest in a bunch of stuff and get returns, as long as I get quarterly liquidity when I want it.' They were almost demanding an asset liability mismatch, and then were unhappy when it happened."

Multiple Asset Advantage When asked if investing in multiple asset classes enhances their hedge fund investment process, Hall responds, "You're talking my own book!" Elaborating, she says it is, "incredibly valuable to be talking to people across multiple asset classes," because it keeps investment team members from getting mired in an asset class mindset. For example, "I'm a private equity guy so that's what I'm investing in." or "I have to invest in it, because that is how I get paid."

Portfolio Themes

A significant theme stems from their "viewpoint that the market is permitting us to be simpler. We have less need to be in complicated strategies, and don't need to use leverage at the manager or investor level. Simpler, blunter strategies are providing as good or better returns."

Managers and investors that own assets outright, without leverage, will generate good returns and protect their portfolios from "other people's problems", such as failing counterparties and panicky co-investors.

Allocations to Alternatives

The firm still has a significant allocation to hedge funds, largely because "in a time of great uncertainty, I think the managers are more comfortable making decisions with a more visible shorter term payoff, particularly in the credit area. You can have a high probability of an expected 2 to 3 year return, as compared to equities with a high probability of a 5 to 7 year return, with no opinion of whether you are actually going to get that."

They have allocated significantly more to both hedge funds and long-only public market funds than they have to private structures. “The cost of the illiquidity in private structures is high. In the areas I think will be the most interesting, you have yet to see enough price adjustment.” Hall names oil and gas and real estate private partnerships as targets for allocations when prices adjust.

Many endowments reportedly suffered their liquidity problems due to excessive private equity commitments, leading to some secondary sales and rumors of more to come. Hall says, “So much discussion about it and so little trades. The private equity placement firms are talking about $100 billion of overhang. My instincts are that the number is significantly inflated, that there are substantially fewer distressed sellers than people thought. At the right pricing, I think people would adjust their portfolios, but they’re not distressed enough to give it away.”

They have looked at secondary hedge fund sales in the past, but “when we want to transact, we haven’t been able to.”

Lessons of the Financial Crisis The overarching investment lessons from the financial crisis are not new lessons, says Hall. “We just get to learn them again. How many times do we have to learn that leverage cuts both ways? Leverage absolutely imports other people’s problems into your portfolio.”

Hall says we re-learned “the importance of having ‘robust businesses of the businesses’, to be able to get through challenging times. “The incentives, maturation, sophistication, experience and calm of the guys at the helm,” became glaringly important during the crisis. “Those that had the most difficulty compounded the hard environment by freaking out themselves.”

Lesson from the Madoff Fraud A client told Hall about a “great investor, we should invest.” She said, “Great, let’s learn about it, send us some information.” The great investor, Bernard Madoff, replied “No.” For Hall, it was “dead on arrival, on the ‘won’t talk to us’ list.” Another client had an indirect investment through a different advisor. When the client asked Hall her opinion of it anyway, she told him, “a. It’s dead on arrival due to the behavior, b. The numbers aren’t believable.” She explains, Numbers don’t work that way. It goes back to experience. Nothing has the kind of consistency that he was purporting to return. Thankfully, the client reduced the position.”

Hall saw the biggest red flag almost immediately. “If any organization is not willing to engage in a very professional conversation with an adviser about the sources of returns, because ‘it’s so exclusive’ people should never invest, period, regardless of what the returns are.”

Global, Diversified Investor

As world economies and opportunities evolve, “How are you going to make money?” Hall says managers and investors need to develop “flexibility” or risk they “will miss something big.” She urges more managers and investors to approach all they do “with as clear a view as possible.”

Clearly, Katie Hall is a role model for all the investors in the industry.

About the Authors

Cathleen M. Rittereiser informs and educates institutional investors as a writer, speaker and marketing consultant. Rittereiser is the co-author, with Larry Kochard, the Chief Investment Officer of Georgetown University, of the books *Foundation and Endowment Investing* (Wiley 2008) and *Top Hedge Fund Investors: Stories, Strategies, and Advice* (Wiley 2010).

An alternative investments marketing executive with over twenty years experience in financial services, Rittereiser has held positions with leading asset management, financial information and brokerage firms. Her hedge fund marketing experience includes stints with Alternative Asset Managers and Symphony Asset Management. She began her career with Merrill Lynch. A member of 100 Women in Hedge Funds, Rittereiser received an AB from Franklin and Marshall College in Lancaster, Pennsylvania, and an MBA from New York University's Stern School of Business.

Lawrence E. Kochard, PhD, CFA is co-author of *Top Hedge Fund Investors*. Larry Kochard was appointed Chief Investment Officer at Georgetown University in June 2004. In addition to serving as CIO, he teaches investment courses for the McDonough School of Business at Georgetown. Previously, Larry was Managing Director of Equity and Hedge Fund Investments for the Virginia Retirement System (VRS) and Adjunct Professor of Finance for the McIntire School of Commerce at the University of Virginia. Prior to joining VRS, he was a full-time faculty member at UVA. Before his return to academia, Larry's background was corporate finance and capital markets, concluding with Goldman Sachs. He currently serves on the board of Janus Capital Group and as Chairman of The College of William and Mary Foundation Investments Committee.

Larry holds a BA in Economics from the College of William & Mary, an MBA in Finance and Accounting from the University of Rochester, an MA and PhD in Economics from the University of Virginia, and is a CFA charter holder. He is co-author of *Foundation and Endowment Investing* and is married with four children.

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