FOREWORD BY **STEVE GALBRAITH**

TED SEIDES

SO YOU WANT TO START A HEDGE FUND

LESSONS FOR MANAGERS AND ALLOCATORS

WILEY

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FOREWORD

When I followed one of my mentors, Barton Biggs, in setting up my own investment firm a few years back I felt uniquely prepared to embark on that effort. After all, I had spent nearly a decade at one of the best run hedge funds in the business, a number of years at Morgan Stanley, one of the most important brokers servicing the industry, several years as a securities analyst covering the investment management industry and ten years teaching Ben Graham's Securities Analysis Class at Columbia Business School. Just through osmosis I got to know a number of folks who have built wildly successful investment operations. I even sat (and still sit) on the board of Rich Pzena's eponymous investment firm. What the heck else was there for me to possibly consider? Hang out my shingle, raise a few shekels and get on with it.

Well, before I rang that opening bell a friend of mine counseled that I should reach out and spend time with Ted Seides. I am glad I did. No one knows more about the start-up process for a hedge fund than Ted. He has become a key player in driving the growth of the modern hedge fund industry from its early stage as the popular new kid on the block, through awkward adolescence to the mature, institutional paradigm that dominates the landscape today. Ultimately, Ted not only became an important early investor in my fund but also a friend; I am immensely grateful to know him in both capacities.

Which brings me to *So You Want to Start a Hedge Fund*. Prior to college, I must have read every book ever published on baseball. Good (*My Turn at Bat*) or bad (*Super Joe—The Life and Legend of Joe Charboneau*) the combination of statistics and larger than life personalities sucked me in where fiction could not. When it became clear the Red Sox were not going to be in the market for a left-handed shortstop, I turned my literary focus to books on the investment world. I am not ashamed to admit it—I have read pretty much every book published on investing. From *People* magazine-like treatments of investment "stars" to the only true investment Bible—Ben Graham's *Securities Analysis* I must have read them all. Amazingly though, despite explosive growth in the hedge fund industry (there are now more hedge funds than stocks listed on the NYSE) and breathless coverage from the media that vacillates between fawning and *schadenfreude*, there have been virtually no insightful treatises on the inner workings of hedge funds. Until today.

So You Want to Start a Hedge Fund is the first book written by an insider that looks under the hood of the industry and offers thoughtful views on key success drivers and pitfalls—for asset allocators and managers alike. Effectively, through a combination of anecdotes, data and reasoned judgment, Ted has produced the first owner's manual for the hedge fund industry. Crucially though, this is not a cookbook. That is, there is no secret recipe inside that says start with a bag of dough, add some quantitative meat, season with experience and you have an alpha pie. As with picking stocks—while there may be basic True North principles in building (or selecting) an investment management business—there is also an immense amount of nuance to the process. Ted captures that here.

Ted has also seen firsthand virtually every mistake an investment entrepreneur can make. I now know—I made a bunch of 'em—most outlined vividly in this book. For the budding hedge fund manager—trust me—you will find your own creative and original mistakes to make, so you may as well use this book to avoid the more familiar ones. Indeed, one of my chief regrets is that Ted did not write the book three years ago so I could have read the galleys *before* I launched my firm. Not only might the knowledge imparted from *So You Want to Start a Hedge Fund* saved me time and effort—it would have kept me out of the damn book altogether as one of the proverbial cautionary tales.

Finally, while Ted accuses me of being one of the more likeable guys on Wall Street (which, to be clear, would merit a slander lawsuit from any number of today's hedge fund *Masters of the Universe*) it is obvious that *he* has to take the nice guy blue ribbon. After all, only Ted Seides could engender enough goodwill to get me to write a foreword to his first book after subjecting my firm to the financial equivalent of a colonoscopy in his due diligence process. What a wonderful business. It is captured superbly in the pages that follow—enjoy.

Steve Galbraith
Founder
Herring Creek Capital
Stamford, CT
October 12, 2015

ACKNOWLEDGMENTS

I want to take this opportunity to thank the people who influenced my career and led me down the path leading to this publication.

Many friends have been influential in helping me learn about myself, an essential characteristic for success in investing and in life. My parents, Jane and Warren Seides, have provided unconditional love and support through every mountain and valley on my journey. I am deeply indebted to Shari Greenleaf, Michael Mervosh, and Kali Rosenblum, each of whom has shared countless pearls of wisdom walking alongside me.

My investment education started under the tutelage of David Swensen and Dean Takahashi at Yale back in 1992. The building blocks of my knowledge came from their brilliant minds, scholarly approach, and teaching orientation. I was lucky to land in their offices upon graduating college and am grateful to have started my career working for a dynamic duo who imparted values of integrity, balance, and service that resonated strongly within me.

While at Yale, I met Charley Ellis, then a member of Yale's Investment Committee. Charley was one of the first investment luminaries who saw something in me I had not yet seen in myself. He encouraged me along the way, wrote a recommendation that helped me gain entry to business school, and overwhelmingly expressed his enthusiasm at this effort, just as he did when David wrote his seminal work 15 years ago. Charley is a masterful storyteller and a gracious man who knows how to make each person he is with feel like they are the most important one in the room; an admirable exemplar of presence to behold.

The team at Protégé Partners since its onset experienced these stories alongside me and contributed to my understanding of the lessons learned. I am indebted to my former colleagues for their hard work and challenging insights along the way.

Much of what I learned at Protégé came from our partnerships with money managers. Some are mentioned in this book and many others are not. You all know who you are, and you have my deepest gratitude for being the driving force behind Protégé's success.

INTRODUCTION

A little over two decades ago I had the good fortune to enter the working world under the tutelage of one of the world's greatest investors, Yale University's renowned chief investment officer David Swensen. David is a gifted teacher and provided an unparalleled investment education to everyone who had the privilege to work for him. His innovative investment ideas and disciplined framework established a foundation that my former colleagues and I built off in our own ways ever since.

From those early years in my career, I developed a passion for investing in people. One of Yale's many levers of success has been its extraordinary ability to partner with top managers across all asset classes in the start-up phase of their businesses. Helping someone at a key moment in their career and serving as a catalyst to realize their dreams resonated so strongly with me that it carried through my post-MBA path to the formation of Protégé Partners.

I have met so many passionate, intelligent, and high-quality people through my work the last 20 years that these pages could not give the vast majority justice. Some of these folks have become world famous—from my first manager meetings in 1992 with Jeremy Grantham and Tom Steyer to what became an infamous charitable wager with Warren Buffett. Many others have demonstrated fantastic investment success while maintaining a low profile in the investment world and next to none outside of it. Many more never achieved their lofty aspirations despite herculean efforts.

My role in this ecosystem afforded me the privilege of working with those I believed would be the best of the best and fostering those relationships over time. It should come as no surprise that many also have become friends. As I once told Warren, I invest in people—the smartest, hardest-working, and best ones I know. He responded, "I do the same thing."

THE SECRET SAUCE

I wish after all this time that I had a secret recipe to deliver success to deserving start-up investment funds. Unfortunately, no such recipe exists. A new fund in today's market faces an intensely competitive landscape in an industry with a preexisting cornucopia of products. Differentiating based on product or price has been tried in just about every way, shape, and form already.

A number of managers nevertheless launch successfully every year, thereby defying the odds for start-ups in aggregate. These firms create meaningful businesses that reward their clients, employees, and ultimate beneficiaries over time. The checklist of essential ingredients for the winners in this game appears generic on the surface—a record of success throughout life, ability to raise money, skill to generate excess returns, development of repeatable processes, creation of suitable infrastructures, attraction and retention of talented investment staffs, temperament and grit to weather challenging times, and good luck. This same set of characteristics describes more failures than successes, so the subtleties in executing each facet of the business matter.

This book seeks to describe some key lessons about the opportunities and risks facing start-ups using historical examples. These stories are not those you read about in the papers. Billionaire hedge fund managers who have reached the economic pinnacle of a lucrative field for the most part don't grace the pages of this book. Instead, the principals whose firms I discuss are all highly educated, well trained, talented, and competitive people who gave it their very best and either achieved success or fell short in its pursuit. I have focused on a slice of a fund's life when success was far from a forgone conclusion.

While I believe this work may prove useful to many, we all need to walk our own paths in investing and in life. As much as I have learned to rebuff the words *should* and *ought to* in following my path, these same words creep into this book frequently. Please take these words with a grain of salt—they are as much a reminder to me in my daily practice of investing as they are intended to be helpful tips for you.

Importantly, throughout the book, I have used male gender pronouns. The hedge fund industry is populated by more men than women, but the convention is intended solely for simplicity. Many high quality female managers and allocators pervade the industry as well as men.

WHY NOW?

The hedge fund industry is at a significant crossroads for both managers and allocators. The industry is maturing, aggregate growth is slowing, and competition is shifting from industry-wide growth at the expense of traditional asset classes to market share capture across hedge funds. The structure of the hedge fund industry is highly concentrated in the largest funds, and the big have been getting bigger. According to Hedge Fund Intelligence, only 305 hedge funds out of the 7,500 comprising the universe manage more than $1 billion.[1]

This increasing concentration is a consequence of the late-stage development of the industry. The money at the margin entering hedge funds tends to come from large pension funds. These pensions need to invest substantial dollars and face limitations on comprising too much of a single manager's business, leading them to focus only on large funds.

However, many of these large funds are overseen by a founder who generated substantial wealth for himself and is approaching retirement age. Firms with leaders older than 60 manage one-third of the assets in the industry and those with principals in their 50s comprise another third.[2] In time, some of these big funds will not survive their founders, and large sums will get reallocated to different managers. Most hedge fund organizations see this industry landscape evolving and try to position themselves for future growth. The lessons in this book may help small existing funds push the proverbial boulder up a challenging hill.

Each year, more managers try to enter the fray as well. A new coterie of talent, typically in the age range of 32 to 38, find themselves with the requisite knowledge, experience, capital, and hunger to strike out on their own. These budding entrepreneurs may have a mentor and some peers with whom they consult, but rarely have access to a wide assortment of prior mistakes made and lessons learned. I hope that sharing these stories will help new funds avoid the errors of some of their predecessors.

For allocators, "retirement risk" has created a need to rethink the composition of increasingly stale hedge fund portfolios. Existing investors in hedge funds across endowments and foundations, pension funds, sovereign wealth funds, financial institutions, family offices, and high-net-worth individuals will have quite different allocations to managers 5 or 10 years from now than the ones they have today. Allocators will need to assess funds in an earlier stage of development than they have historically to build a next generation portfolio. In its most recent annual Investor Survey, J. P. Morgan's Capital Introduction group noted this shift in attention.

> *In their search for alpha, institutional investors have moved down the assets under management ("AUM") spectrum, with three-quarters of respondents willing to invest in a hedge fund with $100 million or less. Along those same lines, approximately 70% of respondents are willing to look at a hedge fund manager with a track record of one year or less.*[3]

A dynamic, evolving hedge fund organization faces different challenges from a mature, large firm. Allocators are accustomed to recognizing the issues in large firms, but are less knowledgeable about those in smaller ones. In time, allocator behavior will shift away from the buy-and-hold investment decisions that have served them well with large funds. The stories in this book may help allocators avoid some of the mistakes I have made along the way.

My work in the past 14 years has focused exclusively on hedge funds, but this book takes no position on the