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TOP HEDGE FUND INVESTORS

STORIES, STRATEGIES, AND ADVICE

Cathleen M. Rittereiser | Lawrence E. Kochard, PhD, CFA

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CATHLEEN M. RITTEREISER
LAWRENCE E. KOCHARD,
PHD, CFA

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Preface

Foundation and Endowment Investing: Philosophies and Strategies of Top Investors and Institutions, the first book Larry Kochard and I wrote together, profiles 12 well-regarded chief investment officers at leading university endowments and foundations. Inspired by Larry's fruitless search for such a book when he became CIO of Georgetown University, *Foundation and Endowment Investing* chronicles the investment philosophies, strategies, and challenges of leading CIOs and shares their ideas and advice with investors.

Modeled on books like *Market Wizards* by Jack Schwager (Marketplace Books, 2008) and *Investment Gurus* by Peter Tanous (Prentice Hall Press, 1999), and published by John Wiley & Sons in January 2008, *Foundation and Endowment Investing* was reviewed in the July/August 2008 issue of the *Financial Analysts Journal*:

> *The investment success of other educational institutions' endowments and of some foundations has made the workings of endowments/foundations of growing interest. Kochard and Rittereiser have produced a well-written, enlightening book on the subject.*

The stories of such accomplished investors—most known only within a segment of the institutional investment community—provided readers with valuable information and ideas. Descriptions of their long-term investment process taught investors useful lessons about asset allocation, manager selection, and alpha generation. Their opinions and advice left readers with a better understanding of the top investor mind-set.

Larry Kochard best describes the value of writing and reading about successful investors in this excerpt from the conclusion of *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. 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.

Now that we know how much we can learn from interviewing different types of investors, we look forward to hearing their insights.

I too found the experience of interviewing and writing about such accomplished investors to be engaging, enlightening and, quite honestly, entertaining. Moreover, Larry and I agreed that our complementary skills and perspectives, and our format—overview, interview, review, and preview—would work well in books about other interesting and important investment industry insiders.

Having met and become colleagues and friends through our work in the hedge fund industry—Larry on the investor side and I on the marketing side—we already knew a group of investors who fit the profile.

Like foundation and endowment CIOs, the investors we endeavored to profile had expertise in a powerful, exclusive, and misconstrued industry segment. No other book told their stories, described their strategies, and shared their advice for becoming top performers, until Larry Kochard and I wrote the book you now hold in your hand or read on a screen: *Top Hedge Fund Investors: Stories, Strategies, and Advice.*

Most hedge fund profile books, like *Hedge Hunters* by Katherine Burton (Bloomberg Press, 2007) or *Inside the House of Money* by Steve Drobny (John Wiley & Sons, 2009), describe hedge fund managers, the men and women in the markets running money. In *Top Hedge Fund Investors*, we profile nine top-performing, well-regarded investors, each with a long history of investing in those hedge fund managers.

Once the province of wealthy individual investors, hedge funds have become more important market participants, more prevalent in investment portfolios, and more available to institutional and individual investors. Investing in hedge funds requires sophisticated knowledge, access, and experience. We believe an increasing number of investors will need to learn how to choose a hedge fund investment and would benefit from reading the different perspectives from a number of successful hedge fund investors.

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.

The following chapters provide:

- Overviews of the evolution of hedge funds as an investment and an industry, showing how and why this group has 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—resulting in nine revealing profiles
- 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 of the financial crisis of 2008, problematic hedge fund strategies, the Bernard Madoff fraud, and previews of 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.

Larry Kochard and I feel privileged to have worked with and learned from these leading hedge fund investors. We cannot express enough gratitude for their participation. Our goal was to capture their thought processes, so that we, and our readers, would understand their philosophies and gain investment insight. We believe we have achieved our goal.

Acknowledgments

Writing *Foundation and Endowment Investing: Philosophies and Strategies of Top Investors and Institutions* as first-time authors, we did not know what to expect. I felt privileged to work with a publisher like Wiley, learned a tremendous amount from our subjects, made new friends, and had new experiences. I found the process challenging, frightening, and gratifying.

Two years later, writing *Top Hedge Fund Investors: Stories, Strategies, and Advice*, I again learned a lot, met and worked with wonderful people, and experienced frustrating and satisfying moments. Yet enough had changed—namely, economic conditions—and enough had stayed the same—books take the same amount of time to write every time—that I had a completely different, humbling experience. But in the end, we have proudly produced another book about interesting investors that other investors and readers should find valuable.

Neither of us could have accomplished this project on our own, and we could not have done it without the people we recognize and thank here.

First, the extraordinary hedge fund researcher and author Alexander Ineichen deserves our praise. We relied on his work extensively. He delivers knowledge and historical perspective with edgy humor and authority.

A number of individuals helped us identify top hedge fund investors to serve as profile subjects, made crucial introductions, or provided the means for us to make important connections and promote the project. They include the following:

Susanne Gealy, Teacher Retirement System of Texas and Preston Tsao, founder, Metropolitan Circle of Private Investment Offices in New York, introduced us to subjects and helped us network in the family office community.

Frank D'Ambrosio, a senior hedge fund marketing executive then at SkyBridge Capital, proved instrumental by introducing me to his colleagues. Anthony Scaramucci, managing partner of SkyBridge Capital, asked the firm's advisory board member, Frank Meyer, to participate, and along with partner Victor M. Oviedo, invited me to interview Meyer live, onstage at their SkyBridge Alternatives (SALT) conference. I am forever grateful.

Others who offered suggestions, support, and substantiation include:

Roger Ehrenberg, IA Capital Partners; Ken Grant, Risk Resources; Dr. Nicola Meaden-Grenham, Dumas Capital Limited; Rick Sopher and Brad Amiee, LCF Edmond de Rothschild Asset Management Limited; Thomas Munster, CapitalRock Advisors; John Watras, Concept Capital; Louise Wasso-Jonikas, Angelo, Gordon & Co.; Maarten Nederlof, PAAMCO; Charlotte Luer, LJH Financial Marketing Strategies; Virginia Macias, Lim Advisors; Brian Moss, Optima Funds; Tanya Ghaleb-Harter, Bank of America; Tracie Gunion and Barbara Tollis.

Several media outlets, conference organizers, and industry associations offered their support to this project and to *Foundation and Endowment Investing*:

David Stewart, Global ARC; Amanda Rodrigues, GAIM USA; Lisa McErlane Yao, Institutional Investor Conferences; Lisa Vioni, Hedge Connection Inc.; Elana Margulies, HFMWeek; Connie Adamson, NACUBO; and the entire team at O'Reilly Media.

Particular thanks go to Mohan Virdee and David Griffiths, at Markets Media for having me chair their inaugural *Eye on Endowments and Focus on Foundations* symposium in October 2009 and edit the follow-up *Review and Outlook* magazine for endowment and foundation investors. The investors, colleagues, and industry experts—too numerous to mention—who participated in and supported the projects also deserve thanks.

The Georgetown University Investment Office provided valuable assistance throughout the process. Larry also thanks the members of the Georgetown Investment committee for their support and his students, past and present, for their inspiration.

Rose Fiorilli, executive coach and founder of Rubicon Advisory Group, provided me with clarity, focus, and inspiration. Friends Kimberly Blue, Rebecca Randall, and Carey Earle helped me through one of the most challenging years ever, and Barbara Selbach and Jeff Skelton set the wheels in motion over holiday dinner in December 2001. Thanks also to my best little buddies: Tyler and Andie Stolting, Ellie, Tim, and Will Anderson, John Rittereiser, and Charlie Rittereiser.

Thank you to Kevin Commins, Meg Freeborn, and Kate Wood from John Wiley & Sons for providing the platform and support, being gracious and patient, and reminding me I have deadlines and a conscience.

Finally, we thank family, friends, and anyone we missed.

On behalf of Larry Kochard and myself, with great appreciation,

CATHLEEN M. RITTEREISER
December 18, 2009

About the Authors

Cathleen M. Rittereiser informs and educates institutional investors as a writer, speaker, and consultant. She chaired the Markets Media Eye on Endowments and Focus on Foundations symposium and edited the *Markets Media Annual Review and Outlook for Endowments and Foundations*, a magazine published in January 2010. Rittereiser is the co-author, also with Larry Kochard, of the book *Foundation and Endowment Investing*, published by John Wiley & Sons in January 2008.

An alternative investments marketing executive with more than 20 years' experience in financial services, Rittereiser has held positions with leading asset management, research, and brokerage firms. Her hedge fund experience includes stints in marketing and business development for Alternative Asset Managers and Symphony Asset Management. She began her career with Merrill Lynch.

Rittereiser received an AB from Franklin and Marshall College in Lancaster, Pennsylvania, and an MBA from New York University's Stern School of Business.

New York Times technology columnist and author David Pogue chose three of her submissions for his book *The World According to Twitter* (Black Dog & Leventhal, 2009). A New York City resident, she can be found on the Web at www.cathleenrittereiser.com.

Lawrence E. Kochard, Ph.D., CFA 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, Kochard 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, his background was in corporate finance and capital markets, concluding with Goldman Sachs. He currently serves on the board of Janus Capital Group and as chair of The College of William & Mary Foundation Investments Committee.

Kochard 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 Ph.D. in economics from the University of Virginia, and is a CFA charter holder. He is co-author, also with Cathleen Rittereiser, of *Foundation and Endowment Investing* and is married with four children.

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PART One

Evolution of the Hedge Fund Industry and Investing

CHAPTER 1

The Truth about Hedge Funds

From Misunderstood Investment Vehicle to Household Word

If you read the business press, watched television, or eavesdropped on a congressional finance committee hearing at almost any point since 1999, but especially in 2008, you might define hedge funds in several ways:

- Mysterious, secretive, risky pools of capital managed by swashbuckling, cowboy investment managers.
- Lying, thieving, Ponzi-scheming criminals.
- The cause of the whole breakdown of the financial system.

Alexander Ineichen, a leading research analyst and author, has said, "The reputation of hedge funds is not particularly good. The term 'hedge fund' suffers from a similar fate as 'derivatives' due to a mixture of myth, misrepresentation, negative press, and high-profile casualties."[1]

Ineichen made a similar observation in another publication: "There is still a lot of mythology with respect to hedge funds. Much of it is built on anecdotal evidence, oversimplification, myopia, or simply a misrepresentation of facts."

But in that instance, he asserted a hedge fund definition that is simpler and more germane to serious, sophisticated investors: "Hedge fund managers are simply asset managers utilising other strategies than those used by relative return long-only managers."[2]

While the term *hedge fund* is used broadly, it is often used to describe a vehicle with a 1 and 20 fee structure. In our book *Foundation and Endowment Investing*, we summarized hedge funds as follows:

> *Hedge funds are private investment vehicles structured as limited partnerships with the investment manager as the general partner*

and the investors as limited partners. "Hedge funds" is not a traditional asset class but rather an amalgam of investment managers and traders who are compensated by a performance fee, have an opportunity to invest in any number of strategies across various asset classes, and use return-enhancing tools such as leverage, derivatives, and short sales. The defining characteristic of hedge funds is their goal: to generate an absolute return over time with little systematic or public equity market exposure.[3]

This chapter will further define and describe hedge funds, provide historical context behind their rise to prominence, and discuss issues facing the industry and investors in the future.

HEDGE FUNDS IN THE SPOTLIGHT

Hedge funds have become part of the collective consciousness not just because the media can easily exploit misinformation, but also because they have grown as an investment allocation in institutional portfolios. They now comprise a larger percentage of portfolio asset allocations and investment industry assets under management and influence most market trading activity.

Institutions Spur Hedge Fund Growth

Foundations and endowments led institutions into investing in hedge funds in the mid to late 1990s. At the end of 1999 total hedge fund assets under management were estimated at $450 billion.[4]

Writing *Foundation and Endowment Investing* in mid-2007, we said,

The main reason hedge funds have received so much attention in recent years is their performance during the equity market downturn of 2000–02. At that point, ten-year average returns ending December 2006 beat both the US Public Equity (Russell 3000) and Bonds (Lehman Aggregate), by 200 and over 400 bps per annum, respectively.[5]

Observing the success foundations and endowments experienced in hedge funds and the ability hedge funds had to perform in adverse market conditions, pension plans began allocating to hedge funds in greater numbers. Broader acceptance of hedge funds among institutions representing much larger pools of capital fueled the growth of hedge funds.

Greenwich Associates reported that by 2007 45 percent of all U.S. institutional investors had invested in hedge funds, accounting for 2.6 percent of total institutional assets and close to double the number reported two years earlier. European and Japanese institutions had embraced hedge funds even sooner than those in the United States, with U.K. and Canadian institutions lagging.

The velocity and size of the growth in assets meant that by mid-2008, $2 trillion was estimated to be invested in over 10,000 hedge funds. At the end of 2008 hedge fund assets under management stood at approximately $1.8 trillion.[6]

Hedge Funds Are Here to Stay

In *Foundation and Endowment Investing*, we wrote, "Although many individual funds have underperformed, as a whole they (hedge funds) truly have provided an absolute return due to a neutral exposure to the equity market."[7]

Despite the extreme market upheavals and hedge fund losses since then, that statement still largely captures the reasons why hedge funds have become so important and why investors want to understand them and learn how to invest in them.

More investors need to know about hedge funds, because more investors have either invested in them in some way—even if only through a company pension plan—or will decide to invest in them. Since hedge funds play such a large role in the markets, investors that have not or will not become hedge fund investors need to know how hedge funds impact their existing portfolio.

WHAT IS A HEDGE FUND?

Hedge funds are almost easier to define by what they are not, rather than by what they are. Put another way, they are best defined at every level—from philosophy to legal structure—by what they are relative to traditional long-only investment strategies.

Philosophy

Hedge funds differ from long-only strategies at the philosophical level in terms of their investment objective, manager's skill, and approach to risk.