Transcript: Deep Dive into Hedge Funds (EP.34)

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Patrick O'Shaughnessy, the CEO of O'Shaughnessy Asset Management and host of Invest Like the Best podcast, interviews Ted about his book, *So You Want to Start a Hedge Fund*. The conversation covers hedge funds past, present, and future.

Topics: Allocators, asset allocation, fees, fitness, funds of funds, fundraising, hedge funds, institutional investing, mediation, seeding, statistics.

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Show Notes

00:01:09 – Invest like the Best Podcast – Patrick O'Shaughnessy

00:02:15 (first question) – Since both are huge Joseph Campbell fans, Patrick starts by asking Ted how he discovered Campbell and the Hero's Journey retreats.

00:05:34 – A dive into Ted's backstory including his time at Yale and the formation of Protégé Partners.

00:06:32 – Pioneering Portfolio Management: An Unconventional Approach to Institutional Investment – David Swensen

00:07:12 – Lessons learned from David Swensen and his work in endowment management.

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00:40:12 – Ted talks about fee structures for hedge funds that mimic frequent flyer programs and why that could work for hedge funds.

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00:46:00 – A look at some unique styles of funds.

00:49:37 – Which of the edges would be most important to Ted in an investment decision: a strong pedigree, an impressive track record, or a unique idea?

00:51:48 – Patrick questions whether or not all of the folks who are "successful" are in fact talented or did they just become lucky to be a part of the right team/company.

00:56:08 – Advice to allocators in terms of over concentration vs over-diversification.

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Ted Seides: *Hello, I'm Ted Seides and this is Capital Allocators. This show is an open exploration of the people and process behind capital allocation. Through conversations with leaders in the money game, we learn how these holders of the keys to the kingdom allocate their time and their capital. You can keep up to date by visiting CapitalAllocatorsPodcast.com.*

Hi everyone. Hope you're gearing up for the holidays and are ready for an exciting leap into the New Year. I received several emails over the last bunch of months asking for my take on the investing world and the topics we cover on the show. Fortunately, I've had a chance to appear as a guest on a few other podcasts and I thought I would share some of those conversations here from time to time.

So to close out the year, the following conversation about hedge funds doubled as my introduction into the world of podcasting. About a year and a half ago, Patrick O'Shaughnessy interviewed me to discuss the book that I wrote on his amazing podcast, Invest like the Best. The discussion quickly turned to a deep dive on hedge funds, past, present, and future.

Since that day, Patrick and I have had to spend a lot of time together and he's become a great friend and confident. I've said more than once that meeting Patrick was the single best thing that came out of my writing the book. He encouraged me to start Capital Allocators and promoted the first episode to his massive audience. We subsequently recorded two other conversations. For the first, I asked him to interview me about the Buffet Bet. If you haven't listened to that already, you can find it either on my feed or on his. In the second, Patrick interviewed me alongside our friend and star micro private equity investor, Brent Beshore. You can find that entertaining conversation on an early episode of Invest like the Best. If you haven't already subscribed to Patrick's podcast, I strongly recommend you do so. It's the only podcast that I listen to every single week.

Please enjoy Patrick's conversation with me!

Patrick 00:02:15 **Alright. Thanks very much, Ted, for doing this. I'd like to start, as I sometimes do, with something completely far afield from investing, which was when we were corresponding to set this up. It came up that we are both huge Joseph Campbell fans. So maybe you can start by telling me how you discovered Campbell, and then maybe a little bit about the hero's journey retreats that you've turned me on to.**

Ted 00:02:38 Fantastic. Thanks for asking. A couple of years ago, I went through a period of my life with a lot of, uh, a lot of change and a lot of challenge, and a good friend of mine had once mentioned something to me called The Hero's Journey. I didn't know what it was. It just registered my brain as something that sounded cool that I wanted to do. And so when that was happening, I reached out to him and said, “What was that thing you were telling me about?” And he told me next to nothing. And I ended up going on a retreat to the mountains of West Virginia, which was a week long, completely disconnected. No phone, no email, experience set up by a psychologist in Pittsburgh in Michael Mervosh, based on the work of Joseph Campbell and an experience based on The Hero's Journey itself. And so, I don't like to say a lot about it, because it's really something everyone should do if they get a chance and they feel the calling to do that It is really a transformative experience for me. I continued to go for the last, say three years.

Patrick 00:03:35 **What would you say is the main—not getting into the specifics, obviously, because the whole point is that everyone's experience is unique and different—but kind of, at like the archetype level… what can you kind of describe what people are trying to get out of the experience, or the basic structure of what you do?**

Ted 00:03:51 Yeah. The aphorism that Michael used for the Hero's Journey, he goes to “Be the hero of your own life.” So it's really an experience designed around trying to get a deeper understanding of what it is you want and how to live your life, really fully and be truly alive, kind of every day. The experiences they create are there some elements of nature and being there and some elements of just processing where you are in your life. And, and the one that I've gone to, they have them for men and women, but it's just a group of men come from all over the world, with no rhyme or reason to why they're coming at that point in time together. Uh, but it's, it's an experience unlike anything I've done before.

Patrick 00:04:28 **One of the things that always struck me about Campbell, so basically what he did was, study mythology stories through history and across cultures and found a very common, he called it the mono myth, like the same exact storyline that kind of is the undercurrent of all these major myths that you've read or heard about it.**

Actually, this was the basis for Star Wars. So George Lucas's inspiration for creating the story arc he did was Campbell's work. And in the early phase of Campbell's monomyth cycle, there are several stages to what heroes go through, is this idea of crossing a threshold. And the threshold is basically saying, “I'm going to leave something or some environment, some set of circumstances that's comfortable and basically step into an unknown world.” And I really encourage everyone to check this out.

Whether it's going all in and actually doing the, you know, the week in the woods--which, you know, for me with two young kids would probably be harder to convince my wife of that than, than it would be to start a successful hedge fund—but if you don't do that, at least read the

book and realize the value of just kind of stepping into the unknown, just sort of jumping with blind faith and that's coming from an empirical quant guy.

So that's very cool experience and thanks for turning me on to that. Before we get into specifics around kind of current state of the hedge fund world, I'd love to hear kind of your own backstory. I'm so maybe starting with early days working at working at Yale.

Ted 00:05:49 Sure. Yeah. I graduated from Yale back in ’92, and it was a time where we were coming out of a recession. I remember interviewing at Wall Street and Goldman Sachs investment banking program had 18 global analysts. I think that's changed a lot over the years. Uh, I got lucky enough to be the one person that Dave Swenson kind of hired from my class to go work with him at the Yale Endowment. I did that for five years and that was really my formative learning experience in investing. There's a certain style of investing is really investing in managers across asset classes and thought I'd stay for two or three years and go to business school. I ended up… two became three, became five. And eventually I felt called to go to business school and went to Harvard and then did some direct investing for the couple of years after that.

And during that time, David had written his book and this obscure background I had now became sort of famous. And I had an opportunity to kind of go back to that particular style of investing and have an ownership stake in a business where all these people wanted to talk to me about hiring me to join a *fund of funds* or join another endowment or foundation. Because of my background. I figured it was an opportunity to try to monetize what everyone else was looking at. So I did that and back in 2001, 2002, uh, formed what became Protégé Partners, which still is a *hedge fund of funds* focused on investing in smaller funds and then blending regular kind of fund of funds investment with seeding of new hedge funds.

Patrick 00:07:14 **Maybe touch on some of the key formative lessons that you learned from Swenson specifically. We were talking a bit offline about how him publishing that book… Obviously it's a huge moment, monumental moment, in the history of certainly like the management of endowments, foundations. [It] created that endowment model that so many people followed, which may have eroded a bit of his own edge. But maybe a couple of key things that you took away from your time with Swensen that, that remained with you through your Protégé days?**

Ted 00:07:40 I think there are, there are a few things that are probably undercurrents in his book, but that are broadly applicable to any form of investing. So the first is having a structure and a discipline to understand philosophically what you're doing and then what strategy you're implementing to, to execute on that. And so for Yale, that was a certain asset class structure in a very rigorous rebalancing methodology, which was something back in the early nineties that endowments and foundations around the world didn't have. Really. If there was an asset allocation, it was a 60/40 mix. And what you would see was that there'd be this theoretical 60/40 mix and two years later you'd look and the assets would be 70 percent equities and 30 percent bonds depending on what happened in the markets. And that rebalancing strategy is really a disciplined form of buying low and selling high in assets relative to each other.

So, there was the overall structure, and for them it was an equity orientation and the importance of diversification. And that was really relative to the liabilities of an endowment which are next to none. And then the implementation was a lot about, sort of, how do you understand who's in your network and what your competitive advantages, and then, how do you decide to go about who you partner with and how do you do it. And what Yale did really brilliantly was create a set of rules that they thought, generally speaking, are conducive to success in investment management, and with very few exceptions stuck very rigorously to those rules.

Patrick 00:09:05 **Kind of like an Atul Gawande checklist manifesto take on this very early on, very where anyone was doing that.**

Ted 00:09:08 Very much so.

Patrick 00:09:10 **What were, maybe, you know... I'm sure this will be applicable throughout our conversation about from the allocator's perspective, finding worthwhile investments or managers. So what were a couple of those, those checklist items that seemed to work out more often than not in, in Yale and Swenson's favor?**

Ted 00:09:25 You know, to circle back on one that is talked about very broadly today, but nobody talked about 25, 30 years ago, which is creating a fair deal with managers. So in the hedge fund space for sure, you hear a lot about fees. You don't hear a lot about what should be an appropriate fee structure between a manager and investor. You just hear the fees are too high.

That was something that David and the team thought about back then. And in fact, almost all—if not all, I, I'm not current—but presumably all of their hedge fund investments have a structure to them that make a lot of sense and any investor would love to be part of, but they were able to do it by having a first-mover advantage and being there. So that was certainly one.

One of David's big ones is independent ownership. I have my own views on that, which has evolved. Being in the seeding business doesn't have that... So the notion of independent ownership is, as an investor you want all of the money that you're paying to go to the management team of that fund. And they stick very rigorously to that. I've seen lots of notable exceptions that we're fine with that.

Patrick 00:10:26 **What you said is your views on that one have evolved. So assuming originally you were in Swenson's camp, maybe moved a little bit away?**

Ted 00:10:30 Yeah. I think that being out of that environment gives you a little bit more of a sense of what happens in the real world. So, Yale has the benefit of having a tremendous amount of capital, tremendous credibility with their board and their governance structure that allows them to invest early on. So many of their investments are with relatively nascent funds. They can be so large and so important that they can effectively make the success of a firm and then structure that firm so it can best succeed: long duration capital, only really letting in certain types of investors. And that is no doubt one component of Yale's success and something that works really, really well.

The problem is, if that were the case and that we're the only way to get into business and have a successful business, you'd probably only have 20 or 30 investment funds in the world. Because very few people have the alignment, the capital, the governance structure, and the patience and duration to actually pull that off. And so in this day and age where it's very, very hard to get a new investment business off the ground, people have to be a little bit more flexible about how they're going to access capital. And so they can't necessarily just do exactly what they would ideally want, because very few of those people ended up succeeding.

Patrick 00:11:48 **From the first point, was Yale effectively a seeder of new funds? You said nascent, so that could mean literally that they are the first investor, or just a very early one. Were they kind of pioneers, also have this model of taking some sort of revenue share or some some arrangement? You mentioned the great economics or a mutually beneficial kind of structure. Can you flesh that out? What that structure tended to look like?**

Ted 00:12:13 Sure. Yale did not ever take economics in businesses. However, they often were very early--I'm not sure about first or very early—meaningful in the success of many of the funds that people know of today. And I think that's consistent with how David views of the world, which is he doesn't want to invest in an investment organization that has outside ownership and therefore he would rather just negotiate a better discount for Yale then to impinge on what he thinks is the optimal structure of investment organization. It's clearly worked very, very well for them.

Patrick	00:12:45	**What was their advantage then? Preferential fees?. Was it lower fees? What, what, what was the alignment that was different from paying two and 22 young manager?**
Ted	00:12:55	Let's start with the fact I'm very dated, and I left Yale 20 years ago.
Patrick	00:13:02	**Fair enough, sure. [Laughter]**
:04		… So, some of the examples that I think are very relevant today and not particularly talked about... So let's just start with hedge funds. In the early nineties, short term rates were mid-single digits. Seems anathema today. And a hedge fund structure—back then, it was *one and twenty*, so it's, you know, forget about what the media says today about two and twenty—but at a five percent short term interest rate, someone goes along the S&P and short the S&P and they make about four percent. So it doesn't make a whole lot of sense to pay 20 percent on the four. And so in the early nineties, Yale systematically went out and imposed cost of capital hurdles on their managers. And managers who understood those economics—most of which did they were the beneficiary of it—would do something reasonable because the supply and demand wasn't such that they couldn't then just say, "Well, if you're not interested, someone else will be." In fact, there really was excess supply of quality hedge funds compared to today where there's clearly excess demand. And so, you know, that doesn't matter that much today when rates are zero, but at some point in time, it may not be for a hundred or 200 years, but at some point in time we'll see four or five percent interest rates again. And it'll be interesting to see how the allocators respond because the notion of lower fees, and the notion that we're paying too much out relative to the return, is a little too simplistic because it's not really considering cost of capital. It's not really considering what's value add versus called Beta or whatever you can get exposure to in the markets. Uh, but that was one of the things that they yell did very early on, very successfully, and the combination of being early and important allows you to set terms and that's something that I worked with in the seeding business for a long time. If you want to go invest in the two, three, five, twn billion dollar hedge fund today and be the next marginal investor, you're always a price taker. But when you invest early on, you have the opportunity to be a price maker.
Patrick	00:14:48	**So let's move from Yale to Protégé. So in, in the time that you were there, ballpark, about how many seed investments or investment manager investments did you make?**
Ted	00:14:59	So let's, let's define seeding. How many people would say Yale was a seeder, but they, in fact they didn't take no economics. So Protégé did take

economics—does take economics—in the funds they seed today. In my 14 years at Protégé we seeded about 40 different hedge funds.

Patrick 00:15:12 **Okay. How big is that world? How many seeders of similar style or economics taking of scale are there out there? What's the competitive landscape like for Protégé's competitors?**

Ted 00:15:22 Yeah. It's a really interesting question because when new hedge funds look to get into business, they think of seeding as a great avenue to start their initial distribution strategy. In fact, there are no more than the handful. And you can effectively name them. It's Blackstone, Reservoir, Protégé, Julian Robertson, Grosvenor Fund of Funds Chicago is doing some of it now, and their families here and there that you hear about—family offices that do that around the world. But for the most part there are very few seeders. There's a fair amount of capital there. Blackstone has a lot of capital. Reservoir has a lot of capital. Protégé has a lot of capital. But there are very few entities who seed hedge funds, which makes it difficult because there are so, so many hedge funds that are trying to get into business and it makes it very competitive landscape even to attract the seed capital.

Patrick 00:16:12 **So 40 over the course of 15 years or so. Roughly speaking, what was the hit rate? O the 40? I'm assuming… everything I've read… And I'm fascinated with kind of power law distributions of outcomes, where you see like in the book. When I wrote a book, I learned all about the economics of publishing where effectively the winners, the couple books that make the publishers year actually subsidize the long tail, right? Because if I had those author self-published and achieved similar success, they would've made a lot more money, and most of book publishing is a failure. And most startups event in any field, but certainly in hedge funds, are failures. So there seems to be this, this power law that governs outcomes. So did that apply at Protégé across those 40?**

Ted 00:16:56 I would define it quite differently, because Protégés investment model was one of trying to achieve a certain rate of return relative to the risks that the investors were taking. And in a diversified portfolio that was relatively modest risk. So we used to define success based on the rate of return of the fund we seeded, not whether they achieved great commercial success and therefore added extra returns. The seeding was a way of defraying the extra layer of fees that Protégé charged their investors. And to that end it was very successful.

The easiest way I could measure it was comparing the funds that Protégé… the returns on the fund that Protégé seeded to the returns on the funds that Protégé invested in that weren't seeds. Because if those returns… if there was no real cost to those returns, then you're achieving this potential upside for free. And that fact is what happened over the years,

		that, more or less, it was very hard always to create apples to apples comparisons. But for the most part, the funds that Protégé seeded in my time there had roughly the same returns as the funds that president invested in that weren't seated and then you sort of had acquired this optionality for free.
Patrick	00:18:04	**How many different... Was there, was there focus in style? There's a million different flavors of hedge fund. Were you experts at kind of the qualitative diligence parts for a certain specific, say, long-short equity, futures and any particular style that you tended to focus on?**
Ted	00:18:20	More of what—and this may be changing now after, after my time there—but more of more of the investing we did was predicated on a little bit of what I experienced at Yale. So more fundamentally driven strategies tend to be equity and credit focused.
Patrick	00:18:34	**What was the—in broad strokes, obviously not getting into specifics with any one investment, but in broad strokes—what does the economics that a seeder takes in a hedge fund tend to look like?**
Ted	00:18:45	Sure. It's been an interesting development over the years, because in the early naughts when we seeded, we might put $25 million into a fund and today those tickets are probably $75, 100, 150 [million]. But the economic, which was tended to be a revenue share, didn't change much at all. So in a broad range, I would say, that it's probably 15 to 25 percent of the top line that a seeder takes in exchange for providing that initial capital… Tend to pay full fees, but then receive that revenue share as sort of a discount on their capital and that… those was economics might stay the same or they might change with the growth and success of a firm sunset. There's all kinds of different clauses that go into those arrangements.
Patrick	00:19:26	**So. So let's get into the particulars of what you looked for, your checklist items of your own, if you will, commonalities across the managers with whom you've made investments. If you had to kind of start for maybe for most important, and we'll work our way down, what were the most important attributes of a potential manager?**
Ted	00:20:46	Well, it's a people business, so ultimately you're, you're making an assessment of the individual. Typically that's about to lead this organization. I think if you're simplifying it, you would look at, is this person a talented analyst? If they are, are they going to be a talented portfolio manager? If they are, are they going to be able to build a business out of it? There are many, many things you could imagine that go into the assessment of each of those. And there's also a function of the environment. So in again, when Protégé started, you didn't really have a lot of people that had experience as hedge

fund portfolio managers, so oftentimes you'd have someone spinning out of a big hedge fund, in quotes, then big—probably the largest, we're probably $1,000,000,000 in assets—and that analysts typically never had real training as a portfolio manager. Today, you see not only people who have maybe managed a sleeve at a big fund, some people who have started their own. And at times you have people that have run successful hedge funds and for one reason or another, gave back to capital and want to get back in business, and then getting back in business capital is so scarce, they look for Cedars. So there's all kinds of… now you tend to have experienced portfolio managers. In some instances, even have people who've built successful businesses in the past looking to do that again.

Patrick 00:20:57 **So let's get into the business part a little bit, because obviously you need someone with investing skill if they're going to ultimately be successful. We can of course debate whether that skill exists at all. But assuming investment skill, and let's say even a repeatable process, which is kind of seems to be on everyone's checklist these days—that it can't be a shoot from the hip instinct, "Soros' back is hurting" kind of manager--how often was the business side of things an issue in early days?**

Ted 00:21:26 The business side is always… it's always an issue. It's a question of what type of issue it is. I think that there's really, you could probably break it down into two components. One is operations in the successful running of operations, and the second is the time allocation it takes to build a business. And, and uh, on the former, there was a study that said 50 percent of all hedge funds fail because of an operational, something in the operations that went wrong. I always thought that was a bit of a simplification of something that was actually happening. So what tends to happen is that someone who's used as dedicating all their time to investing now has to take a significant percentage of their time and either build or oversee operations, build, manage people, spend a piece of their time talking to clients or trying to raise money from new prospects and that diverts some of their… necessarily diverts some of their time attention from investing. If they don't spend the time on operations, something operations could go wrong, but more likely they spent a little bit less time investing. The results aren't as they seem and then they blame it on the operations.

I think operations are similar to going to the dentist, and that when you go to the dentist office, you have expectations and the very best to dentist will ever do is meet your expectations. But if they, you know, if the dental hygienists tweaks your gum or something like that, you know, people hate the dentist because of that. Hedge fund operations are the same thing. The investors have no patience, especially in this day and age, of anything going wrong. And so it's incumbent on someone to make sure the operations are done properly, if not best in class. And that, again, just take some time and attention away from what would be sort of full time investing.

Patrick 00:23:09 **So you mentioned the investors, obviously the key ingredient in all this. If we were to back up to the founding of Protégé, how did you… maybe tell me a bit about how you got your first investors to launch this idea?**

Ted 00:23:22 Yeah, you know, I was fortunate at the beginning of Protégé, that I had a business partner who had managed money for some wealthy families and had some terrific relationships. And through those relationships there were some initial capital that came in, and the family he had managed money for and a couple of other families. And then early on we took on a, a seed investment from a large—I think it's public—University of Texas back in 2002. So the combination of that got us off to a flying start. We just went from there.

Patrick 00:23:49 **So now, this is obviously a huge issue. There's 7,500 hedge funds and everyone wants capital. It's hard enough to get in front of one of these seeders. That small handful that there are, probably don't do that many deals in a given year. So a lot more demand for capital from these people then, maybe, supply. Can we talk a little bit about raising money? I've, you know, being in this business, having done that aspect of this for a long time, it's harder and harder, a lot harder maybe than even five years ago because of pressures from just going passive. Right? So I was at Vanguard on Friday, which is an incredibly incredible place, and their frugality is inspiring--and I want to get into fees after this—but what do you think the current state is of fundraising? If you're one of the 32 to 38 year olds that you kind of describe as the archetypal type in your book of people looking to start their own fund, how should they think about the challenges of raising money?**

Ted 00:24:46 I think you laid it out well in how much more difficult it's gotten over the last couple of years. To give a broader... a little broader perspective so people understand. One of the things that always shocked me and seeding hedge fund managers—let's specifically talk about long short equity—these people are in the business of analyzing other businesses and industries and yet almost never would turn and say "What's happening in this industry?" And unfortunately for people who want to start, if you did that, what you would see is a mature industry where the demand for the marginal hedge fund is much lower than it used to be. And one of the things that's it's been sobering in the year after I left Protégé is the number of people that reach out to talk about some aspect of their business or strategy, and underlying all of it is this desperation for "How can I raise money?"

And I really wish I had a silver bullet. But nobody has a silver bullet. Because this is a question of supply and demand. And so, what you see is that fewer and fewer funds each year are able to get traction and grow. And the ones that do have everything right. So they have the right pedigree, they might have the right track, or they might have the right initial investors. They might have the right strategy, which doesn't mean it's their particular strategy, it means that in the last two years, the investment area and the strategy that pursuing happens to have done well. And those tend to be the funds that grow. But again, there are fewer and fewer of them, and I think that's probably more of a secular change than just the cyclical one for the hedge fund industry.

Patrick 00:26:18 **Yeah. So it seems as though launching into this environment, in this trends toward… we'll call either passive or low cost, I guess you could call it. Outcome here is secular, right? In 20 years it's going to be a lot higher than it is today. So maybe touch on the role of charisma in raising money and then having a successful hedge fund launch and ultimately successful hedge fund business.**

Ted 00:26:43 Great question, great adjective. It's essential. The people who do raise money are the ones that not only have some proven experience for pedigree that show that they're likely to generate returns in the future, but also have charisma. They, they are able to connect with people, they are able to understand other people's needs and have a product that sort of fits into those needs. And more and more they tend to be likable. I think that allocators would like to sleep well with the partners they have, knowing that everyone's investment challenges are the same. The days of the sort of squash buckling manager who's so much smarter than everyone else and doesn't treat people well… I think those types of people are going to have a harder and harder time building businesses than they did in the past.

Patrick 00:27:27 **Yeah, it's amazing how sales ability, and narrative building ability, can really affect the outcomes. I guess this is true in every business, right? But certainly in this one as well.**

Tell me what you think about the state of fees. This is probably the most important question. One of the things that really stuck struck me in your book was, two sides of the same coin. One that every single thing has been tried… you know, there's nothing new under the sun, so to speak. That every combination of incentives and deals and strategies…. someone's trying it and they may have failed, that it might still work in the future, but you don't, probably, have a novel idea.

And then the second thing is that, from an allocator's perspective, they've seen it all and yet the fees in aggregate charged by hedge funds—I don't know what exactly they are, maybe you have a better idea—but they're high obviously relative to an S&P 500 index fund. So what do, what do you think, how valid is this concern over fees? How much do they need to come down? What will they look like, you know, in the future?

Ted 00:28:30 Let's just start by calling fees what they are, which is a clearing price for supply and demand. And what's happened over the last 10 or 15 years is that the investors have gotten more sophisticated about what they were buying. So part of the reason if you look to pre-crisis, the fund of fund investments in hedge funds constituted something like 50 or 60 percent of all the industry's investments in hedge funds. And that was probably higher, certainly higher than the long-term natural audience for fund of funds. But the reason was that hedge funds had this, this sort of opaque quality and the governance boards of pension funds were afraid of hedge funds and so they thought having a blocker would help them. And so just that simple part of what's a hedge fund or that's something we want—in part thanks to Dave Swensen's book and sort of the stamp of approval that he and CALPERs, when they invest in hedge funds for the first time in 2000, gave hedge funds—so you had this period of time where just getting there was okay.

Clearly that's changed and people understand more and more what it is they're buying. You have firms like AQR, who have made it a business to try to educate investors and show them the components of a hedge fund, and then give them a cheaper alternative to get access to some of those components. So, as those things have happened, you have more scrutiny over fees.

Some of the scrutiny is simple and is backwards return-looking and saying, you know, let's say the number's one and a half and twenty. That's probably about right today. That's too high if a hedge fund can only make six percent. And that's fair because some percentage of what you're paying out now that's not reflective to what's that six percent. Is it six percent alpha? Hey, that's pretty good. Uh, we're in a zero percent interest rate environment. Hedge funds actually have to pay to play as opposed to four or five percent interest rate environment like in years past.

And so, that's where we stand today. If I had to guess and look 10 years out because I think that's looking at the long game of this is what's most relevant… It always baffled me that a hedge fund—let's just simplify it, let's call it a long short equity fund because that's easiest for comparison. A long short equity fund that's charging one and a half and 20 today in some sense is competing with a long only fund where fees have also come down in active management, and maybe that's an 85 basis point or an 80 basis point fee and the only difference is there's a pile of shorts that have added very little value over the last couple of years.

So I think what you're likely to see is ten years from now there'll be an active management fee on the long side and the hedge funds that are charging a 20 percent incentive fee, they're really going to be charging a fee on what's truly value added. And that will get measured in lots of different ways. In the equity world, it might be Alpha. It's a little bit harder in the strategy like, say, distress debt, where maybe there's some correlation to high yield, but the underlying activity is so much different. Almost impossible in macro and CTA type investing to say "What's that other than a trader's edge?" And maybe that is worth 20 percent, but as the fees of what's truly excess return come in, I think you'll see more and more of the fees come in. The challenge is, today, there's two or three trillion dollars invested at an embedded fee structure and it's going to take a long time for that to evolve.

So to give you an example, I had a conversation last week with a very dear friend of mine who runs a multifamily office, and we were talking about a midmarket distressed fund. And he gave me all of the reasons why it wouldn't make sense to pay a 20 percent incentive fee for the activities that they had. But at the same time he had two 15 year old relationships with very large distressed firms, where he's paying all that and probably getting much less value added. And this is one of the smartest guys I know in the business. And so what you see, I don't know if that's a behavioral pattern of…

Patrick 00:32:14 **Inertia, right?**

Ted 00:30:15 Inertia. And so it will take time for people to evolve through the existing relationships. That kind of high-fee relationship they have long time.

Patrick 00:32:20 **I've thought a lot about this, about what you… from the perspective of the investor, what would be a truly fair fee, right, for, for an active strategy? And there's all sorts of things. It could be, it could be, you know, the lowest overall management fee and that's it. It could be, I've seen a zero percent management fees with higher incentive fees, maybe managed over a longer term cycle. The problem with those kinds of arguably innovative structures like that where there's a cleaner alignment of long-term incentives is, you've got to run the business and you need to attract talent. So what if any unique fee structures have you seen either implemented successfully or at least in the discussion phase that you think are intriguing beyond, say, low management fee or the traditional one and a half and 20th. Is there any innovation happening on the fee side?**

Ted 00:33:11 Yeah… let's with the baseline, and I think the appropriate baseline for hedge fund strategies is a management fee that roughly covers the cost of doing the business. It's a tough definition, but it covers the cost of doing the business, including salaries. But not get rich salaries. Sort of stay-in-the-business salaries. And then, an incentive fee that rewards those people for taking risks that can't be achieved cheaply in the marketplace.

For a long short equity fund, that might mean that a management fee—again, we'll come back to that number because there's some interesting dynamics and what the cost of running the businesses is—and an incentive fee that might be tied to the return, excluding the Beta sort of in the strategy itself. It could be 20 percent of that, a fair number.

Let's talk about two pieces of that. The management fee, one of the things that's happened in the last 15 years that I don't think anyone anticipated was, as assets came into hedge funds and hedge funds, growing at a fixed management fee, the cost of acquiring talent went up. Because larger and larger hedge funds could pay more and more people. So then you can ask the question, "Wait a minute!" As wage inflation, something that is driven by the cost of doing business--and it has been, it's just been a reality and I don't know that that changes… It's a difficult question because you didn't know that the founder doesn't have to get rich, but in fact they have to pay their people so much that it looks like the people that are working there get rich. And then the other comparison I think a lot about is, let's talk about a traditional long only mutual fund. A big shop active manager that data has shown is really an index tracking fund. And so, if that fund has an 80 basis point fee and 80 or 90 percent, probably 90 percent of the return investor gets, it's really just the market return…. So there's a 10 percent active risk and maybe a heroic long only manager used to make one percent a year. Well you're actually paying--let's say vanguard charges 15 basis points. That's probably generous. It's less than that--you're paying 70 basis points to get one percent. And so the active equity world that people are still comfortable with charges egregiously high fees relative to true value add, and it makes the 20 percent hedge fund fee, if it's appropriately calculated, actually a fair deal.

Patrick 00:35:25 **One of the things that we talk about a lot is this idea of active share in the long only side, and adjusting fees for active share. So, if you're running a, you know, closet index fund and your 30 percent or 70 percent overlapped with the S&P. that fee that's being charged on the active portion is a lot higher than it looks at the state of management fee level. And we see this with this whole phenomenon of Smart Beta, where Smart Beta might be the industry's way of capturing a little bit more rent on the world's invested assets. But effectively what a lot of those things are, is 70 or 80 percent S&P, 20 percent something unique for 30 basis points, which sounds low. But when you do the math on the active portion, it's approaching one percent. So it's, it's always important to dive into what are you really, what are you really paying for? One of the goofy things about all this, and I hadn't really thought about it until you just described it that way… when Michael Maubassin was on the podcast, we were talking about this paradox of skill. That what matters is not absolute skill, but how the competitive landscape, how talented**

are these managers relative to one another because it's in some ways a zero sum game. So we've got lower and lower relative skill that costs more and more because of these industry dynamics. That seems to me like, if you were just an alien landing on the planet, like a recipe for disaster. That this environment could crash in a way that markets crash. We're like, so everyone wakes up and realizes this is insane. We're paying more for a lower probability of achieving the thing that we think of hedge funds as delivering. Do you think that that's possible? Is there a scenario where this, this whole kind of hedge fund world just comes crashing down, but maybe it started already.

Ted 00:37:12 It may be. I don't think so, but let me try to explain why. Because I've seen a lot of hedge funds, have seen a lot of long only funds over the years. Private equity is a whole other animal. And even if you look at the academic data that consistently maligns hedge funds, what you find is that for whatever reason, this universe of hedge funds on a gross basis adds value. And far more value than the traditional long only does, on a manager by manager basis. The problem is that it's being paid away in fees. So one of the reasons why these fees have come up when the competition has gotten higher and therefore, you know, relative skill is harder to assess, is that the required rate of return on a hedge fund portfolio has just gone down and down and down.

So let me give you some examples. In my early years at Yale, Yale had, and still has, a bucket they call absolute return. The idea was equity, like expected returns with less risk and certain less correlation to equity markets. And back then maybe that was a five or six percent real rate of return. That was the benchmark. About 10 years ago I saw Dave Swenson give a speech, and someone had said to him, very appropriately, “Your benchmark for this asset class is, let's call it five percent real. That's a seven percent rate of return for 10 years. You have made 12 percent. How do you explain that?” And he sort of shrugged his shoulders. The point being, you don't need to make 12 percent if your required rate of return is only seven. That's, and at seven percent, that's real. If you think about that, five points of alpha’s really tough.

Around that time, the notion of... you have risk parity and portable alpha come into play. And so you had… pre-crisis, you had a bunch of pension funds and other institutions that said, “Now we're going to invest in a hedge fund portfolio and effectively buy the beta that we want and we're going to put this on top.” And if you think about what that means, the required rate of return on the hedge fund portfolio dropped from a day when Yale had it at six percent to something that just barely covers the cost of capital. So today that would mean the required rate of return of a hedge fund portfolio might be one percent or two percent. And so, even though in the paradox of skill, the relative competition is tougher, sort of the relative… the ability to generate the sort of performance relative to other more skilled practitioners is harder. At the same time the required rate of return that many institutions have for their hedge fund portfolios just gone down and down and down and down and down. So that the large pension fund who is using hedge funds not as an asset class, so they're not taking money and allocating it, they're just putting it on top of their long only equity portfolio that they manage risks the right way and they make two percent, they're super happy. And those are huge pots of money.

So it's hard. There's this other dynamic. It's not just the fact that yes, it's tougher; yes, competition's higher; yes, returns have come down; all of which is true. It's just that the investors don't require the same types of returns they did to invest in these strategies.

Patrick 00:40:07 **Do you know of any examples of managers that…? Again, I'm fresh off of a discussion with the guys at Vanguard, so my thinking is a bit colored. Because I think one of the most genius things that they did, obviously, was this mutual structure, where the funds own the company and so the alignment of incentives is perfect for the long-term investor. Right? Are there hedge funds that think like that? Could that thinking being incorporated into… Let's say we've got a guy or a girl that's got phenomenal talent and is a, you know, a stock picking genius. And they want to set up a two decades, three decades, four decades, multi-generational successful hedge fund business. Is there a way that we could incorporate that thinking, that kind of mutual thinking, into a business**?

Ted 00:540:57 There is. I actually wrote a paper a couple of years ago about a fee structure that I thought was different and hadn't been used. And to do that you have to get outside of the investment industry. As we talked about, pretty much everything has been tried already. And I thought of frequent flyer programs. So there wasn't, to my knowledge—and now I only know of one or two that exist—a fee structure that would go down over time based on the duration of an investor's time with the manager. So, you have seen discounts for size that you have seen early discounts. Once in a while—I know of only a few examples—you have seen managers reduce their fees for everyone to assist their business grow. But the notion of almost a frequent flyer discount is obvious on the surface, because everyone goes in thinking they are a long-term investor, but we know that the data shows that's not the case.

But there's also a governance issue that comes into play, which you can imagine. Let's say an allocator has money with a manager for five years. Everything is going well, and then the manager goes through a soft spot of performance, but because they've been there for five years, their fees are lower than they will be for a comparable manager. Well, in that board meeting, there's going to be another… there's going to be a marginal reason why it might make sense to hang around. And that mostly doesn't exist. The switching costs—and certainly in the hedge fund industry and probably all of asset management are just way too low—now that… One of the things I learned was the number of people who said to me, "Wow, that's a great idea, but there's no real innovation unless, it's in a new fund." And that's because people have embedded fee structures and if you start offering, uh… You know, imagine you're Och-Ziff and you have 30 or 40 billion dollars—let alone the other problems they may be having now—and you want to reward your investors for loyalty discounts. Well, tomorrow you're going to have to slash your fees for everybody because so many of the investors had been around for a long time…

Patrick 00:42:42 **Back to the cynic entrenched this inertia, right?**

Ted 00:42:43 Yeah. Tremendous amount of inertia in the existing biz. But it's also a rational business decision, right? You may say, "Hey, over time, this is a great fee structure", but once someone's been managing a certain amount of money and they build a cost structure that supports it, it's really, really hard to dramatically reduce the revenue base almost no matter how high the fees are. People get accustomed to spending into what their management fees are. So it is a real business challenge to make a dramatic change that's just going to slash revenues in the next year.

Patrick 00:43:13 **Yeah. It seems like a classic dilemma where the first mover may not… People are so used to a certain structure, and there's so much inertia that it would be an irrational decision from a business standpoint to offer something really innovative. Even if it's great, because innovations diffuse slowly, often. And early in the innovations don't work and the mindset is hard to change.**

Ted 00:43:47 That's true generally. In the asset management industry, what you find for reasons that are a little bit confusing, is if you think of just normal business strategy, sort of one of Porter's models of price differentiation and product differentiation… Investors really, for the most part, do not select their investment managers based on price. It's much more about perception of quality. and so the manager who's launching, who says, "Okay, I do think I'm great and in addition to that, I'm going to create a fee structure that's going to be much more sustainable, … that's going to reward people over long periods of time", that in and of itself, even if that's the only fund that has that, that does not get money in the door.

Patrick 00:44:20 **What about something radical…? And this may not even be legally possible, I don't know, but knowing what we know about psychology and certain biases, there's this endowment effect where something you have, you think is more valuable than when you didn't have it. What if instead of discounting fees over time—sort of the frequent flier thing—**

what if you took the discount at each stage, carved it off, and put it in some sort of side vehicle that you kept investing on behalf of the investor. But, they only gained like… it's some sort of reverse vest where it was theirs, but they didn't get it if they left on some schedule… so if they left quickly, they sacrifice the assets that had accumulated in this side pocket fund. I don't know how this would even be set up, but you see where I'm going. Like, carve off a part of their fees, keep investing it for them, and then effectively they earn into that over time if they're patient and they… and there's true high duration capital.

Ted 00:45:20 That's a really interesting concept. And, and uh, for the reasons that you described, probably a better version of the product that I thought about. If it didn't get traction, I would guess it's because those amounts are just going to be too small for a long time to, sort of, notice. It's one thing if it's an endowment, it's another thing if it's like a penny that you're calling an endowment.

Patrick 00:45:41 **Yeah. It just seems like… God, there's got to be some way of, of alignment that can make this work. Because it's true. Like, so much of the real talent is in, over the last 15 years is left long only, and it's in the hedge fund world. Certainly some of the most interesting people that I meet, why wouldn't they go into that structure? It makes more sense from a business standpoint.**

So maybe we could talk a bit about some unique styles of funds. One of the things that we've realized—and again our business is long only, so it's different—is that just the standard, you know, people need another large value manager like they need a bullet in the head. And maybe the same thing with the long… plain vanilla, long short equity manager. There's just a saturation of these styles.

One of the people and styles that I've always been fascinated by as Jim Chanos, because he is saying "I'm going to meet a different need. It's not necessarily absolute return. I'm going to be a true hedge." I think he even says like, "My role is to allow my investors to be more responsibly long. That I'm going to do well in environments when they're, you know, their beta, basically, portfolios are suffering. And then I'm a true, true hedge."

Do you think that that's maybe a pocket of opportunity for more people? Maybe they have and I just don't know. I don't know the world like you do. Have more… have others emulated that style where it's, it doesn't even need to be a broad market hedge? Maybe it's something really specific within, you know, someone's levered long to consumer stocks and they want to short consumer book or something like that. Does that exist? Is that just too niche?

Ted 00:47:19 Well, everything exists. Talked about that before. The short selling as a product has had some structural challenges over the years. And they're really two fold. One is that most of the time markets go up and it's 60 or 70 percent of the years, and therefore 60 or 70 percent of the years you lose money, and if that's not properly thought of, people get tired of it. Usually right before the big moment that you need it. That's the sort of obvious… and what you saw with dedicated short sellers through 2008 in the subsequent years was sort of great testament to that. There really aren't that many anymore.

The other challenge is a little bit more subtle, which is managing a short only portfolio has a real rebalancing issue. And if you just think about the fall of 2008 and early 2009, dedicated short sellers that might have been… typically run, call it 80 or 90 percent short. You go into the fall of ’08, and as they're making money, the short position shrink and so they get less and less net short, and so the hedge that you want gets less and less more impactful.

And that ended up being fine through 2008, and many of the dedicated short sellers were only 20 or 30 percent short going into 2009. And you think about 2009, you say, well that was great, right? Well not really because in January and February 2009, the markets drop 20 percent. And so those managers were so far behind and had nothing to do with their short selling skill. It had to do with the fact that it's just really hard to keep putting out shorts when the markets are crashing.

So even Chinos had a dedicated short selling business in the early nineties that really failed once or twice. And my understanding is they may have short only, but eventually they created a product that was the short selling expertise against a factor neutral long portfolio. Because as a business, it's just hasn't been sustainable to be a dedicated short.

I have seen, and Protégé has certainly invested in a few short strategies that were targeted to a particular opportunity set. There was one in the for profit education sector a couple of years ago that worked out incredibly well. There's one in Chinese reverse mergers that worked incredibly well. So there are pockets of opportunity where you see something, and you think you can make money. Subprime shorting obviously in 2007 and 2008. But as a dedicated short pool, Darwin has shown that that is not a species fit to survive.

Patrick 00:49:41 **Yeah, fair enough. Let's say you were faced with a group of managers with whom you could make a seed investment and you knew you had one edge, if you will. And the three options are, a fantastic pedigree, so let's say, let's call it notable success at a big hedge fund; the second would be an early track record that's good, let's say they've got a one or two year track record that's really strong; or three, a strategy, which is,**

we've already touched this, that there's nothing new under the sun, but maybe a strategy that on the sliding scale is very unique. Is one of those three more fertile ground than the others? Do you think for finding interesting opportunities from an allocator's perspective?

Ted 00:50:22 That's a great question. I think you have to start with what's the allocator's interest. Because on the end, and there's no right or wrong answer to this, but depending on the allocator's disposition, you will have three different answers.

So let me walk through that. An allocator in the seat like Protégé was, where the investing was really driven by the investment returns on who the seed was, the middle manager who just had a good track record is the least useful. They may be the most useful in terms of short term being able to grow assets, but the least useful because you know we don't even know what we're talking about, what the strategy is, and why they got there. But oftentimes with someone who's had outsized performance, they may revert and that's sort of the worst thing you could do. Now you're left with a pedigreed person and someone in an esoteric strategy. Well, that esoteric strategy is particularly interesting for some structural reason that might may well be the right place to be.

Now, if you're a seeder who views the business interest as valuable as the investing—which many do not that they discount the investment returns on their capital. It's just they're also looking at as a business—the esoteric strategy probably falls short because usually it's capacity constrained and therefore you can't scale a business out of it. Now you're left with a pedigree versus someone with a great track record. Both can have merit. Again, it depends on who it is and why and what the charisma… the charismatic elements of those two people. The guy with two great years that can't talk his way out of a closet, isn't going to raise any money. So there are a lot of factors that go into it, but you really have to marry what that allocator seeder is trying to achieve with the particular merits of the different…

Patrick 00:51:56 **One of the things that I find interesting is the portability of skill and the pedigree is... The idea behind pedigree is to say, well, they've got typically great mentorship, a proven track record. They're probably going to do well. And to use an analogy from another industry, this has been written about a lot recently… If you think a Marissa Mayer's tenure at Yahoo. She left Google, and this happens all the time, with a sort of halo effect. And now in hindsight—and of course there's counterexamples to this—but you often find people whose success, in hindsight, seems to be as much because of the institution that they were a part of before, as their own personal abilities. Is that an issue that you came across often with kind of the pedigree type investor? That their independent success**

was less than success supported by these incredibly sophisticated, you know, tool laden parent hedge funds?

Ted 00:52:57 That's a fantastic question. I do think you run across just about everything. So it's hard to…. I'm thinking in my head, you see, like staring off into space as you're asking the questions on what are the examples of each. I remember specific examples of people who came out with great pedigree who couldn't really replicate it on their own. And if you want to take a broad brush, now they don't even exist. The old SAC was a great example for many, many years. SAC generated phenomenal returns on the capital and yet, with somewhat some great consistency, the people that spun out couldn't come anywhere near replicating it on their own. And back then SAC was really opaque, and now I think people have a better understanding of what a multi manager platform hedge fund is and why… what the success factors are.

And in contrast, you had the old Tiger Management were almost… There were people that, if you did your due diligence back in the day, were not well liked at Tiger and were not thought of as good people or talented investors, and then turned into uber-successful hedge fund managers. So there was something about the training ground at Tiger that was repeatable.

And I could reflect on my own background at Yale. There is something to the structure of what Yale did, and the discipline that has been proven, that David has been able to teach other people. Seth Alexander, who I worked with, and Paul Volent at Bowdoin, and Andy Golden to Princeton, and Peter Ammon at Penn, and now Rob Wallace at Stanford. All of them have varying degrees of skill. They're all very smart, very good people, but they've all been successful, and more successful than the rest of the endowment foundations. And there is something to that in a training ground. And as I said, so one of the things that we used to do was spend a fair amount of time trying to understand the history of people, and often you had limited data points, but the history of people that came out of a particular organization and… Did they tend to have attributes that are repeatable on their own or was it more a function of the timing and the environment they're in?

And you saw both, but there were certain…. you'd take an organization like Tiger that people knew well. My favorite corollary to that was there was a hedge fund. The very few people knew called Siegler Collery. It wasn't a scaled big hedge fund and I think that one of the guys still manages money—Peter Collery still manages money—but Scott Balmer, who had a great funded at SAB, and David Einhorn from Greenlight came out over there, and you had three or four people that…Curtis Macnguyen they had three or four people that were really successful. They came out of the same fund that wasn't as successful. So over the years you had all different kinds of iterations of these, you know, houses of wherever people were emanating from, and so it's always an important question to ask sort of what created this person's success, what part of the pedigree is repeatable and what's not.

And then a big one that we haven't talked about is when people stumble, and "Have these people stumbled?" A lot of times, if you're 32 to 38 years old as we talked about in the book, and it happens to be the right time to start a hedge fund, those people are on the track, or they've gone to the right school, they've had the right job. They've had great success in their career, and some people just continue on that path throughout their life. But most don't. Most at some point in time struggle and stumble. And sometimes there's only at those moments in time where you start to see things like resilience and tenacity that some people can make it through that, and others have a harder time.

Patrick 00:56:14 **One of my favorite lines from the book is you go through the checklist of attributes of successful managers. And then at the end of it you say, now this of characteristics describes more failures than successes. And, coming back to this idea of luck and random outcomes, where two guys or two girls with the same exact pedigrees, one works and one doesn't. It's got to be a huge challenge from the allocator's perspective. So when you think about advice to allocators, how much diversification should there be across…? The whole idea behind a seating businesses, you're diversifying, right? You're capturing that phenomenon that, you know, hopefully you hit some real big wins from an investment in business standpoint and acknowledge ahead of time you're going to have losses. So what's the right mix if fewer people are doing this these days? If an allocator has a dedicated hedge fund or alternatives allocation, what's the balance between over concentration and over diversification?**

Ted 00:57:17 I don't know the answer to that. It's really a function of the risk tolerance of the governance decision-making body. So for some allocators, that might be a… for a fund of funds, that might be their clients. For endowment foundations, it might be their board. And risk tolerance isn't something you just, "Hey, let's have a questionnaire…. Oh great! So we know we can withstand 10 percent drawdown." But through time and experience, you start to get a sense of the losses that people are comfortable with. And that renders itself to the level of, let's call it concentration.

What we know is that more concentration is better. That has to be dovetailed with some level of scale, right? If you have no skill, concentration is a lot worse, but then you probably should just be indexing. So, if we assume there's some level of skill, whether that's an allocator's ability to pick a manager or the manager's ability to pick securities, the data and research has shown that concentration is better. But it also comes with more volatility, and so I don't know that there are specific numbers, but that's the equation people have to understand is, sort of, what's their conviction in their skill. The more conviction you have or the more skill you have, the more you should be able to concentrate either in your best manager picks, or the manager and their best security picks, and what are the consequences of that in the periods of time when you're wrong.

Patrick 00:58:28 **Can you tell me about the most memorable investment in the Protégé days? So of the, of the 40, let's call them, what one sticks out and what's the story behind it?**

Ted 00:58:40 Well, the one that obviously sticks out isn't one of the 40 and Protégé probably made 200 investments; forty were seeds. The most obvious one that sticks out was Protégé was the largest Day One investor in John Paulson's subprime fund. The reason it sticks out for me isn't just the sort of windfall that came from it, but I was always more amazed at other people that invested in that fund. Because our pattern to get there made a lot of sense. We had had very bearish views on high yield debt starting in 2004, and had been short high yield debt with a manager on a risk reward that you take it… "We're paying six percent. Then it became five percent. You're paying out four percent and if it really worked, you're going to make 20 or 30 points." And then someone comes in with a presentation that says, "You're going to lose eight percent a year, and if you're right, you're going to make 10 times your money. And we now know all the reasons why, but at the time it didn't take a lot of work to start calling around and saying, "Are these things real?" These no-doc loans… that just all this crazy stuff that Michael Lewis and now movie theaters everywhere show. But it was a lot different to say, "Hey, we have a risk reward in a view that we already have that says we're going to make four up for one down," and now someone's showing us a thousand up for one down. What do you do?

And living in the Northeast, it is pretty tangible to feel the growth and the real estate market. It's just anyone who owns property, the prices just seemed to go up and up and up and up and up. And you could see the data. So the notion that that would slow down, especially if you're trained as a value investor and believe in reversion to the mean, it wasn't that much of a stretch to get there. But that was… watching it… I remember having a conversation with J.P., John Paulson, about a year later. It was the fall of 2007 and we had his deck that showed if housing prices just stabilized, let alone went down, we were going to make like 10 times our money or something like that. And there was one slide that showed the risk reward, and we put the site in front of him, and he looked up and he said, "Yeah! It worked." We're like… there was almost this…. This was before the end of 2007, before he had collected the billions of incentive fees that are earned.

And so that was one because, yeah, I and probably many other people struggle with the notion of trying to be perfect, and dealing with my own imperfections in life. But that actually was a perfect investment. And so it's hard, because once you do that you have this tendency that you can go look for it again and you'll probably never find it again in your career.

But it was such an obvious one that stands out. There are many, many other stories and other great investments and other failed investments. But it's hard when something like that happened and you were a part of it, to not have that be the most memorable.

Patrick 01:01:09 **So getting down to brass tacks. If we have somebody out there that is entrepreneurial and interested in starting a hedge fund, how would you counsel them generically? Is it just getting too hard? Or is there some circumstance that it still makes sense? And then we'll do the same from the allocator's perspective of investing in these funds.**

Ted 01:01:30 Yeah, so I would start by saying it just getting too hard. It's very hard to counsel one person not to follow a dream they have, but I think the probability of success of a very smart, very talented, very well trained person with a strong pedigree is much lower than it was five or 10 or 15 years ago.

Part of the reason I wrote the book was, I was in a unique chair that not that many people were in where I had lots and lots of experience with startup hedge funds, and I had seen these patterns of mistakes that people make that are repeated because they don't know that other people have made those mistakes in the past. And at the same time I thought it was going to be sufficiently difficult going forward to start new hedge funds that I realized I had to shift my own life and my own career.

So I had this body of knowledge, but I didn't want to spend my time pursuing that anymore. So I figured what better thing to do than to share it because there are people who will go out and do this and be successful.

I think if there is one piece of advice that I've tried to tell people it's they need to think about their own hedge fund as the entrepreneurs did 20 or 30 years ago, which was if you got to 25 or 50 million dollars, that could be a great life and you manage that money. If you can compound it, one day it'll be a hundred million dollars. And one day it will be a hundred and fifty million, and without this wage inflation that's occurred. That's how today's twenty-billion-dollar hedge fund started. There is no promise, nor was there back then, that the hundred million dollar hedge fund, whatever, would grow to something more meaningful. So when I talk to people, that's how they need to think about it. And if they're so passionate and so entrepreneurial that they really want to do that, they should go ahead and do it. The difference today with 20 or 30 years ago is the opportunity cost is much, much higher. So that that talented person that might be able to get 20 or $50, million dollars and therefore get three or four or five hundred thousand dollars of management fee income can get a job that pays that, or presumed will be much more than existing hedge fund today and so people have to make that assessment for themselves.

Patrick 01:03:30 **One of the things that I think about a lot when I think about allocating to managers, being one, is the same phenomenon we see in value and growth stocks. So, people overpay for growth. That's the, you know, the M.O. of markets for 50, 60, 70 years. Everywhere we look, we see the same phenomenon and, you know, it's the classic Alexander Pope, "Hope springs eternal in the human breast," and for every moonshot growth winner—of which there are a lot more than value stocks to be, to be fair, so more kind of winning tickets come from that growth universe than from the value one. But in aggregate it seems to be a mistake to be a growth investor unless you get really lucky. I wonder if there's some of this that will always sustain, the same cycle, the same psychology that will always sustain the hedge fund world, because it is the most talented, smart, charismatic people with probably the greatest potential upside.**

It sounds to me like a growth stock in a person or a small group versus a, you know, a public company. And some of the workout phenomenally well. So the question is, I would argue that people shouldn't buy growth stocks, now that means you don't get to participate in the most fun names. And you could port that argument over and say, from an allocator's perspective, "We shouldn't invest in hedge funds because we might get lucky and we might have, you know, we might be the first investor in John Paulson's fund that goes up and unbelievable amount. But the odds suggest that the, this as a group, our allocation as a group is just not going to be able to earn the fees relative to the S&P 500 from vanguard." So what do you think from an allocator's perspective, is it the same answer or is it getting, is it getting too hard? How should we think about this?

Ted 01:05:18 That is a very reasonable comparison? You have seen certain institutions abandon hedge funds and if, if I looked at those institutions, they tend to be large pension funds with challenge and Governance bodies where the hedge fund allocation was fairly material anyway, but the noise around fees was high. I think that the default to have an allocation to hedge funds in a portfolio probably doesn't make any sense. Uh, and the same way that we could say the default to have to buying a bunch of growth stocks doesn't make any sense.

But hedge funds structurally have done two things over time, only one of which we've seen in almost the last decade that you don't get access to in the long only world. And so the first is manage risk. So well managed hedge fund, even a long short equity hedge fund. The way that returns have generated equity like returns over time is by underperforming in the up markets and protecting capital in the down markets. But with a positive skew. We've had such strong equity markets that you would expect hedge funds to underperform, but we haven't seen that period of time. And there have been pockets. There have been months where hedge funds look like they're crowding over each other. And you know, the downside returns aren't what people expect, and so that might be the case.

But the other piece is this notion of innovation in the capital markets. And there've been so many pockets of opportunity, subprime mortgages being one, where if there is something a skew in the capital markets, it is hedge fund managers that find it, and sometimes en masse. And we just haven't seen that in a long time, and certainly anything on the short side. So there's a lot of people that are, you know, crying ‘Doomsday!" right now. You hear warnings from so many different well-thought-of practitioners and yet the only way to capture that value is to be short something. And it's really the hedge funds that do that. So I'm not sure this is the right time for people to say, given the pricing of equity and credit markets to say, "Hey, this is what we should abandon." People have to think carefully about the price they're paying for that service.

Patrick 01:07:19 **Now, to flip what I was saying earlier, it reminds me of… in the long run the world that the phenomenon of value suffering such a really bad six, seven year run, and interesting arguments—impossible to confirm or deny, but, but interesting nonetheless--that the Fed's actions, zero interest rates in general, sort of a perpetual bid that's been created in risk assets, has removed what worked about value investing to a large extent where, you know, things would correct often overcorrect. You know, we've had this perfectly straight-up line, pretty much. And when that happened, when those overreactions happened, value investors would be a backstop. They would swoop in at preferential distressed prices, and ultimately benefit from that. But that opportunity just really hasn't happened. Certainly not in large cap stocks, maybe more in special situations, smaller companies. But as you point out, the timing sometimes can be everything. And, uh, we are at the end of a historically, maybe not, but certainly to this point is that historically bad run for, for this kind of vehicle.**

So fascinating stuff. Really, really, uh, love hearing about the world. Maybe what we'll do is to close coming full circle with books. So, we talked about Campbell and the impact that he has had on me, and probably even more so, you, having done an actual experience which I'm dying to do.

Are there other books? It doesn't even need to be a book. It could be an author, resources, that have been formative for you over the years that that you would suggest others check out, with bonus points for something a little under the radar or unknown. Because what I've found is I ask this question and a lot of the same best books have influenced a lot of people. Which is great, but if we're in… if we're trying to discover something new, you know, maybe some bonus points for deep cracks so to speak.

Ted 01:09:10 Let me go with two, and the one is not new, but there's a caveat. So, in the last couple of weeks for the first time I have been reading Dale Carnegie's How to Win Friends and Influence People, and it's a book I've known I should read forever. In fact, I probably read the first 10 or 20 or 30 pages a whole bunch of times. But I've actually started to read through it and it's so good that I think sometimes you look at other people's classics and you say, "Oh yeah, I should probably read that or it shouldn't," but that it's, it's incredibly powerful and it's one of those things where I said, "Boy, I really wish I had read this long time ago." So that's not new. But the notion of, hey, if there's a book that other people seem to be saying is really good, go read it anyway, you know, don't read the cliff notes.

And the one that I have, in the last year, read, and have mentioned to a lot of money managers and for some reason this book has not gotten the traction that it should have, is a book called Big Data Baseball. It is effectively Moneyball 2.0, written by the beat journalist for the Pittsburgh Pirates in and around the Pittsburgh Pirates. I think it was 2013, 2014 seasons. And, it won't have the same impact as money ball because that was sort of the revolutionary concept, but if anyone is interested in baseball generally in statistics and in thinking deeper about, "Okay, now that the first big discoveries made, what do you do from there?" the book is unbelievably good and everyone I've recommended it to, have all been in the money management industry. Every single person who's read it, usually two or three months later when they get around to it, has sent me an email saying, "I can't believe I hadn't heard about that before." And my recommendation shouldn't be much of anything; I heard about the book from Seth Klarman. And so, for those who care more about what Seth says than what I do, which probably includes me, he was the one who first recommended it to me and it's a phenomenal book.

Patrick 01:10:58 **So you're now the third person to recommend that book to me and I still haven't read it. So you'll probably get that email from me in a few months. And I will totally second the Carnegie recommendation, where that was one of those books were, it just seemed kind of hokey and maybe even be asked to me when I first heard about it. But the principles are so simple and it's basically one of ego destruction and lots of small good deeds adding up to something really big over time. Which is totally a mindset change, right? You have to buy into that concept for it to work and it needs to be a… it's not a diet, it's a habit. It's an everyday occurrence.**

So then, that leads to my second to last question, which is, what are the things—and these may be changing as a result of Carnegie—but what are the things that you do every day? Habits, I guess you could call them, that you feel are most important or have most positively contributed to your wellbeing, to your general experience?

Ted 01:11:57 I started that by saying I've found that the only time of day where I have consistency is first thing in the morning. And so what I do first thing in the morning ends up being those things that create the habits, and I would say there are two, not every day but most days.

One is a short meditation so I was not a meditator until, you know, in the last year. And the concept of sitting down for 40 or 50 minutes, I just couldn't imagine it. But I use the Headspace app. I do 10 minute meditations every day and that's been I think hugely beneficial.

And the second is some form of working out. And I've always been kind of a workout nut and a fitness nut and everything from running to high intensity stuff, cycling or whatever it is. But there's been one change in the last bunch of months and it came from having watched Tony Robbins documentary. Fantastic one-hour documentary. And the thing I picked out of it was, before Tony goes on stage or in the morning, he jumped on a trampoline for like five or 10 minutes to get his body going in the morning. And I don't work out every day. I wish I did. It's not a great word. I just, my life hasn't evolved in such a way that I do get a real great workout in every day. So what I started doing was in the days that I wasn't working out, I get up and I do for me the equivalent of his jumping on a trampoline. I do 50 jumping jacks, 30 pushups, sit ups, 30 squats and I'm done. And it's not a workout, I don't view it as a workout, but it gets my body moving. And so those have been hugely impactful.

Patrick 01:13:24 **So Headspace is a really neat app. And meditation is the, it's kind of like the Mark Twain talked about, the classics that everyone says they've read them, but actually haven't read them. Same thing with meditation.**

It seems this is this really popular meme that everyone wants to do, and it's incredibly, having followed the same story, it's incredibly hard to do consistently. And Headspace really works! I'm curious what… you said it's been beneficial. Can you, can you flesh that out a bit? What about it has been, has been helpful, or good, or joyous, or whatever the adjective might be?

Ted 01:13:59 It's cumulative benefit type circumstance. I think if anything there's a marginal increase in the sense of calm I have, mostly with interactions with people that trigger emotional responses. Just have more of an ability to see it for what it is an emotional response, and then not react. And so that's been the tangible thing. I think that's come from it.

Patrick 01:14:22 **There's a book that perfectly encapsulates that, which you may have read, which is Dan Harris' 10 Percent Happier, which was basically his experiment. He went through a whole thing, you know, he went and met with Deepak Chopra. He did the whole gamut, was very skeptical, and ultimately says basically that's it. That, "I feel 10 percent happier," that there is a noticeable—not massive, but a noticeable—improvement and that it is cumulative. That it seems, maybe, that 10 percent… this book is a couple of years old, maybe that's 20 percent now or 30 percent. That seems to be the common experience that it helps you recognize in yourself trigger reactions that don't make any sense if you're looking back through the lens of a year. You know, if you're asked a question, "Okay, a year from now looking back on this, does my reaction make sense?" And it helps you identify those and get rid of them too. Great. Two great ideas.**

Then the last question is, what's next for you? So you know, you mentioned obviously a sort of transitional period, have kind of seemingly met everyone and done it all and the hedge fund world. What has your interest right now? Maybe it's several things.

Ted 01:15:30 I've had some friends suggest that my next book should be about career phases and transitions. I think I have enough material. I don't know if I'll have the time to do it right now.

I've spent the last year trying to figure out how to plug in, and where, and that particular skill set I have is very specific, right? It's, you know, I know how to take out a certain type of trash at a certain time of day and there's a degree to which that's been a little bit devalued financially in the marketplace.

So what I've done, I, I have a three or four board relationships with… they're mostly relatively early stage asset management business run by a close friend of mine who used to manage some money for Protégé, and outsourced operations business things in and around the asset

		management space. And I'm still kind of looking for the right fit, which may be a different allocator position really, with a pool of capital that, that feels stable, where I can try to help drive the boat. It may be joining an investment organization in a more of a business capacity and however I can help. But it's really trying to find something that I have conviction in. What the underlying product is, with great people.
Patrick	01:16:40	**Well, this has been really a blast. I really appreciate your time. Thanks for doing this!**
Ted	01:16:45	Thanks for having me, Patrick.
Ted Seides	*01:16:48*	*Thanks for listening to this episode. I hope you found a nugget or two to take away and apply in your investing, and your life. If you've liked what you've heard, please rate and review on iTunes or Google Play to help others find out about the show. Have a good one and see you next time.*