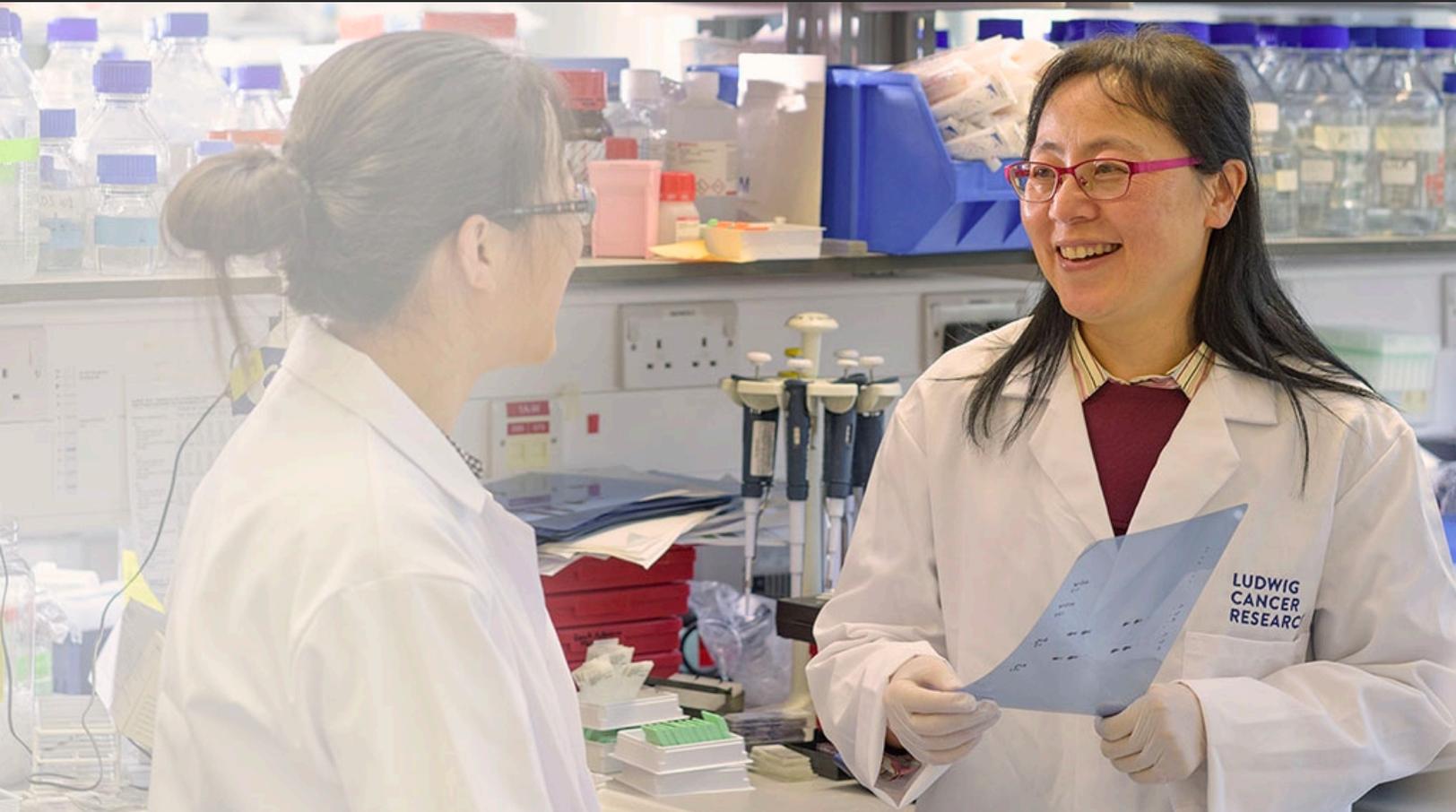




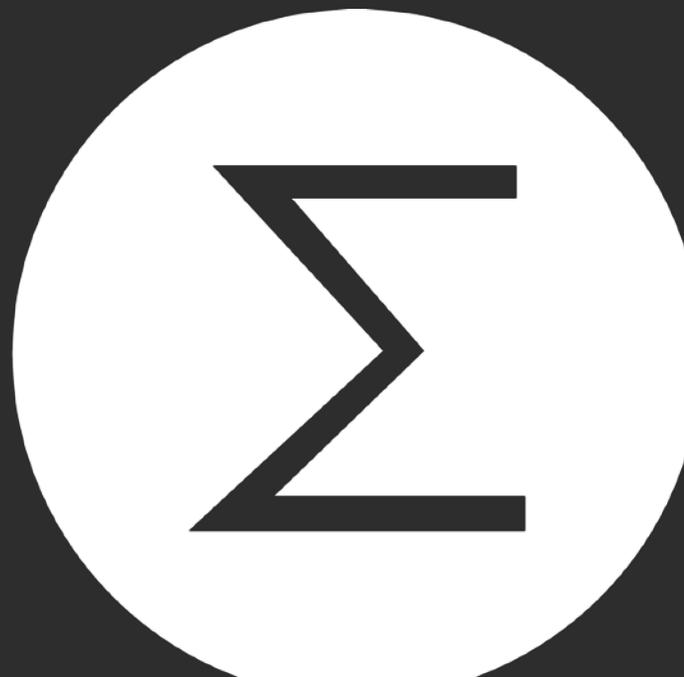
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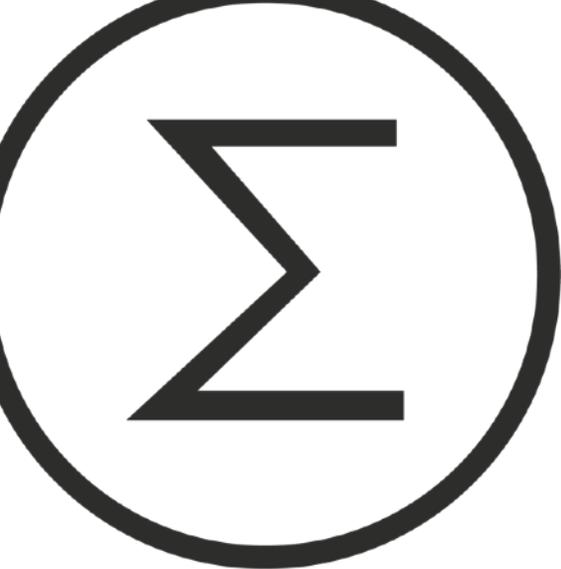
ALLOCATOR INTERVIEW



PICK YOUR POISON:
LEVERAGE,
CONCENTRATION, OR
MARKET RISK

JANUARY 2019





ABOUT THE INTERVIEW



This is the fourth installment of the SumZero Allocator interviews, a series of discussions with respected leaders in the institutional investment space. My name is Nicholas Kapur and I am SumZero's COO and head of the firm's internal fund manager program called Cap Intro.

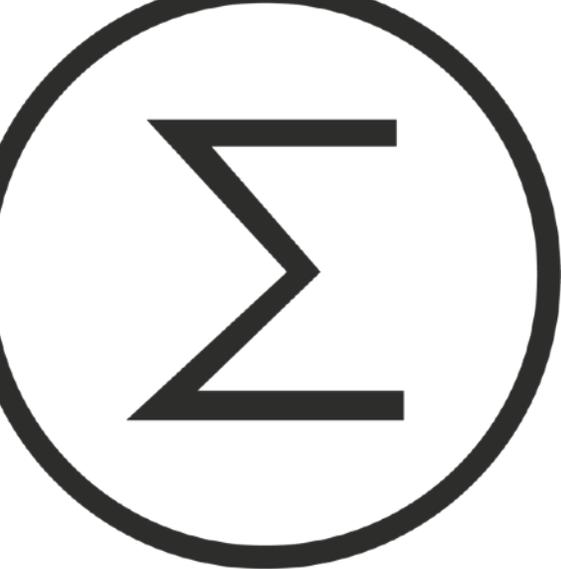
I am honored to be joined by Mr. Bill Louis of the New York City and Zurich-based foundation, the *Ludwig Institute for Cancer Research*. Through the dedicated LICR Fund, Bill helps oversee nearly \$1.5B in assets designed to fund a major scientific research operation and fuel its future endeavors.

LICR and Bill Louis are long-standing members of SumZero's Cap Intro program, an internal platform designed to direct high-quality exposure toward participating funds for the purposes of capital raising. We reached out to Bill because we wanted to better understand the process of hedge fund allocations from the viewpoint of a major philanthropic foundation.

ABOUT BILL LOUIS



Bill Louis is Director of Investments at LICR Fund, Inc., a 501(c)3 organization that manages the assets of the Ludwig Institute for Cancer Research. Prior to joining LICR, he was a member of the investment team at Seven Bridges Advisors, a New York-based investment office serving institutions and high net worth investors. Bill began his career as an Investment Analyst at Carnegie Corporation of New York, a not-for-profit foundation founded by Andrew Carnegie in 1911 to support education and international peace. Bill received his A.B. with a double concentration in Slavic Studies and Mathematical Economics from Brown University.



NICHOLAS KAPUR, SUMZERO: *Bill, I am excited to get the perspective of someone from the foundation world. I think folks in your position come at the problem from a different angle. So, thank you for joining me.*

You have worked with a number of prominent institutions that fit the broader definition of 'hedge fund investor', not least of which is your current position at LICR. What drew you into this world?

BILL LOUIS, LICR FUND: Thanks, Nick. I appreciate the opportunity to be here. I started my investment career at *Carnegie Corporation of New York*. It's funny, because when I was in college, I didn't even know that capital allocator roles existed. I knew about hedge funds and private equity, but I never really gave a lot of thought to where all that capital was coming from. When I was introduced to Carnegie, I found the approach of their investment office fascinating. I was also attracted to Carnegie's philanthropic mission.

Like Carnegie, the Ludwig Institute for Cancer Research (LICR) is a mission-driven organization. LICR supports hundreds of scientists around the world, providing resources to advance lifesaving science. Since its founding, LICR has provided over \$1.8 billion to fund cancer

research. It's an honor to be a part of the organization and very motivating to know that the work I do supports the cutting edge work of preeminent cancer research scientists. I really enjoy the intellectual challenges that come with a career in investing, but Ludwig's mission truly gives my job meaning. Are my millennial stripes showing?

NK: *Hah. Perhaps. Please do not let that stop you--the mission is critical, obviously. You mention the intellectual challenges of the job. You and I recently had an interesting chat about the Yale Endowment Model being broadly misinterpreted. Let's dig in there to start. How are others missing the mark with Swensen's big idea?*

BL: David Swensen outlined what became known as the 'Yale Model' or 'Endowment Model' in his seminal book *Pioneering Portfolio Management*. This book is basically the endowment & foundation capital allocator bible. I would highly, highly recommend that anyone who wants to raise capital from E&F investors read this if they haven't already. It will go a long way in helping aspiring GPs understand what E&F investors are looking for.

In the book, Swensen outlined a strategy for investing that involved heavy allocations to alternative strategies including hedge funds and private equity. The goal was to take advantage of market inefficiencies and leverage the long term time horizon that many endowment investors have the privilege to enjoy.

Swensen, like all of us, has certain preferences for the types of funds he chooses to invest in. When he wrote the book, he seemed to prefer discretionary equity-oriented strategies for various reasons that made a lot of sense for him

and for Yale at the time. The book was brilliant and is something I've read and reread a number of times. However, problems emerged when some other institutions tried to emulate his asset allocation choices rather focusing on exploiting market inefficiencies and leveraging their own institutional advantages.

NK: *How so?*

BL: Here's an example: Adherents of the Yale model often eschew quant and other trading-oriented strategies because Swensen didn't particularly have an affinity for them. But if you think you have a competitive advantage selecting these types of strategies, it may make sense to pursue them, especially for tax exempt investors. I think this is very much in line with the spirit of Swensen's Endowment Model.

Conversely, if an institution lacks the ability to partner with exceptionally high quality alternative asset managers but puts capital to work in alternatives anyway in order to have an asset allocation that superficially looks like Yale's, I think they are making a big mistake.

NK: *This is a powerful distinction--playing to one's unique strengths versus adhering to a prescriptive allocation model. One size does not fit all clearly.*

To run with the idea a bit, what are some of LICR's competitive advantages in terms of allocating to the hedge fund industry? How have you come to understand what you're good at?

BL: LICR has a number of institutional advantages that my colleagues and I

attempt to leverage. One example is Ludwig's size, at \$1.5 billion. It means we can invest checks that are meaningful to our GPs, but at the same time allow us leeway getting into oversubscribed or otherwise capacity-constrained situations. These may be check sizes that may be small-ish relative to the overall capital raise, but that are nevertheless meaningful to us. This has allowed us to get exposure to more than a few attractive strategies whose lack of scalability would have been a nonstarter if we had to put a lot more capital to work.

“We can invest checks that are meaningful to our GPs, but at the same time allow us leeway getting into oversubscribed or otherwise capacity-constrained situations...”

NK: *You notably said to me that hedge funds broadly do not take enough risk. And yet, unlike many foundations, LICR directly oversees a large, capital-intensive research organization.*

Help me reconcile the prior statement with what seems like a structural need to avoid big volatility due to the reality of the latter.

BL: The Ludwig Institute employs over 500 cancer research scientists. It's

important that we have ample liquidity to meet these funding needs. However, like many other endowment and foundation investors, we need to balance our current liquidity with our future funding needs. Long-term absolute returns are very important to us. We have cash and lower risk fixed income assets in our portfolio to provide ballast. We need our hedge fund portfolio to generate attractive absolute returns.

I run into a lot of hedge fund managers who are averse to leverage, but are also allergic to concentration and market exposure. You have to pick your poison. If you run a moderately diversified long/short portfolio without material leverage, say 95% long and 55% short, you have to make some really heroic alpha generation assumptions to get to an attractive absolute return. Not so much with higher exposure levels, say 150% long and 110% short. With those exposures, you can get to healthy net returns much more easily, assuming reasonably productive stock picking.

“Leverage is not the answer for everyone or every strategy, but you have to take some risk – some combination of leverage, concentration, and market risk. There is no free lunch.”

Of course, leverage brings risk. Part of my job is to underwrite the risk management process of every manager we invest with,

especially for leveraged strategies. Leverage is not the answer for everyone or every strategy, but you have to take some risk – some combination of leverage, concentration, and market risk. There is no free lunch.

NK: Pressing a bit deeper, you mentioned that you seek funds that are truly differentiated. But some investing strategies are fundamentally advantaged and totally unoriginal in concept. Do you dismiss these opportunities on principle even if they're doing precisely what they are designed to do?

BL: Definitely not. My colleagues and I are looking for portfolio managers running repeatable strategies taking advantage of some sort of market inefficiency. Structurally advantaged, unoriginal strategies are pretty rare, but I love them when I can find them. Micro-cap, long/short equity would be one example, but it's obviously highly capacity constrained. It's not as if no one has ever thought about buying and selling micro-cap stocks. The issue is that most managers who meet with success in that segment of the market eventually move upmarket in order to take in more capital to generate more fees.

If you know of any managers who are happy running small amounts of capital and just want to focus on crushing returns, please let me know.

NK: Hah. Well, you may well be hearing from a few shortly. Speaking of these types of funds, foundations like LICR do not fit the traditional profile of firms that allocate to small/emerging fund managers. Under what circumstances do you actually consider it?

BL: We definitely are open to considering allocations to emerging managers, but the bar is high for us to allocate very early in a manager's lifecycle. We don't do seed investments in exchange for revenue shares or GP stakes, but we do consider participating in founders' share classes in exchange for fee concessions.

I would say the fee concessions offered in founders' share classes that I've seen generally are not material enough to mitigate early stage risk, but every once in a while, we come across structures that are interesting.

My favorite was from a fund that was launching back in 2012. The manager offered low-ish fees, something like 1.5% management and 15% incentive for the first \$200 million that came into the fund, but then the fees dropped to zero in perpetuity after the manager's AUM went above something like \$500 million. It was similar to a seed deal but it worked better for everyone involved. Structures like that are interesting.

Another situation where we would be inclined to move early is where the strategy is highly capacity constrained, and I don't think I'm going to get another look later if I don't get involved close to day 1.

NK: *Well, I think any rational person would prefer to pay less for something if they could (0, of course, sets a pretty impossible standard for "low").*

Assuming it is not "0", what do you think is the most attractive fee structure for a new manager in this day and age?

BL: I'm not anti-fees per se. I want to see that LP and GP interests are aligned, and I want to pay for alpha generation rather than beta. For long-only and heavily long-biased strategies that charge

performance fees, I feel that a market-based hurdle rate is appropriate. I often suggest this when meeting with managers running long-biased strategies.

Some GPs have pushed back and straight up told me that a market hurdle is not something they'd be interested in implementing because it's hard to outperform the market. They don't think they'd be able to generate much income from incentive fees with a market hurdle. That's not a great answer.

My job is not to pay you fees. My job is to generate attractive investment returns to support cutting edge cancer research. If you don't believe you can add material value above exposure that I can get cheaply from a passive ETF, then why should I?

“My job is not to pay you fees. My job is to generate attractive investment returns to support cutting edge cancer research. If you don't believe you can add material value over exposure that I can get cheaply from a passive ETF, then why should I?”

Another thing I think people ought to keep in mind is that management fees

should be intended to keep the lights on and pay basic expenses, not enrich the manager. That's what performance fees are for. I like the idea of capping management fees or reducing management fees along with AUM growth.

“We try not to be overly dogmatic about putting managers in specific buckets, but if a manager moves outside of what we believe is her/his core competency, it's going to slow us down.”

NK: Let's say you have a manager that has made it to your watchlist. You're tracking him/her, monitoring performance, doing your ODD, etc. Aside from the obvious performance-related calamities that can occur in this stage, where do managers most frequently go wrong in this phase of the process?

BL: There are so many ways a manager can go off the rails aside from poor performance. In fact, performance alone would rarely be the issue for us. If we continue to be sold on a manager's strategy and process, a drawdown would only really be a problem if it was of a magnitude that was inconsistent with our view of the risk/return profile of a

strategy, and we have pretty wide tolerances around this. Strategy drift is the most common problem. A small cap manager buying FANG stocks is a red flag. We try not to be overly dogmatic about putting managers in specific buckets, but if a manager moves outside of what we believe is her/his core competency, it's going to slow us down.

NK: Apart from having a sound strategy/process and good investing acumen, what are some traits that you look for in managers?

BL: Some of the other people you've interviewed have mentioned things like intellectual curiosity and grit. I agree, but another trait that I think is really important that may be a bit surprising to some is pessimism.

While it's great to be able to identify companies on the verge of positive inflection points, it's also very important that portfolio managers be able to identify how things might completely fall apart.

I love it when I meet managers who are passionate about short selling. That is the secret ingredient to success of the long/short equity framework. I have no interest in paying hedge fund fees to long-only funds.

Please tell your readership to reach out to me if their goal is to make money shorting stocks.

NK: Between the micro cap managers and the short-sellers, I am pretty curious what your inbox will look like after this.

Apropos of exactly that, you mentioned that you take a lot of calls/meetings with managers and 'kiss a lot of frogs' to coin

your phrase. What is the most common way in which prospective managers fail to prep for that beginning phase of the process with you?

BL: The “kiss a lot of frogs” phrase was something that one of my former bosses at Carnegie Corporation used to say and she was so, so, right.

If you’re looking for managers focusing on niche-y or capacity constrained areas, there’s no easy way to quantitatively screen for what you’re looking for. You just have to speak with a lot of people. In these conversations, I am definitely not looking for slick marketing, but I do need a coherent description of the manager’s strategy. If you can’t explain to me why you’re unique or have some sort of edge relative to other market participants, I’m not going to rush to fund you.

NK: *I have enjoyed ending all of these interviews with the same question: What advice would you give someone considering the launch of a new fund? And what single thing can a manager do to make him or herself a more viable candidate for a firm like yours?*

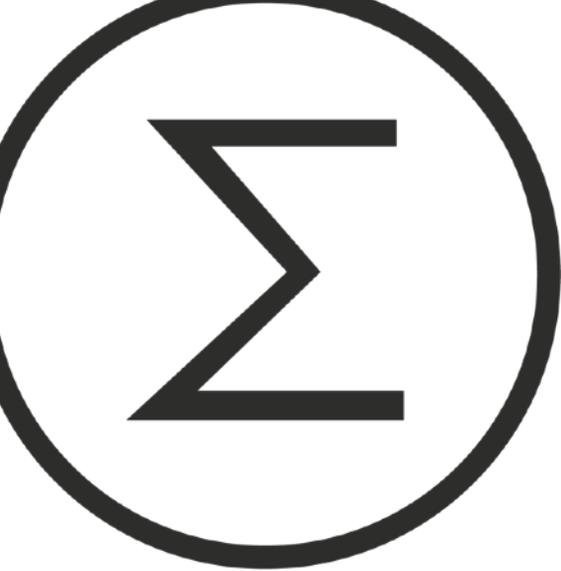
BL: The hedge fund market is already pretty saturated and the failure rate for small funds is quite high. Unless you’re somehow able to launch with real scale, your chances of economic success are far from assured, so launch a fund only if you’re really passionate about running a fund for its own sake.

If you have the passion, the skills, and a little bit of luck, investors may eventually follow, but you have to recognize that it can take years before you’re able to replicate the income that would be available to you as an analyst at a larger, more established fund.

If you do decide to proceed, focus on performance, process, and continual improvement. There will always be investor demand for alpha. Create an alpha generation machine and investors like LICR will come knocking on your door.

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ABOUT SUMZERO

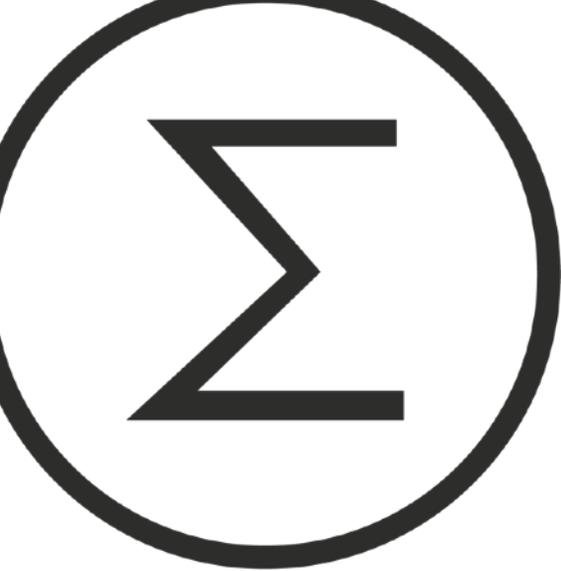
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The research on SumZero cuts through the noise that pervades the industry and provides its community with in-depth, actionable investment research and data. SumZero offers several ancillary services in support of our research platform. These services include capital introduction, buy-side career placement, media placement and more.

ABOUT CAP INTRO

SumZero Cap Intro is a passive, reverse-solicitation platform that connects eligible funds with pre-qualified institutional LPs for the mutual purpose of capital allocation. Cap Intro is available on an opt-in basis to all hedge funds, private equity funds, and other asset managers that are actively fundraising.

Using Cap Intro, fund managers leverage direct exposure to a community of more than 700 pre-vetted institutions by presenting their strategy and performance via a self-curated fund profile. In turn, allocators use these profiles to discover, screen, and initiate direct conversations with funds. Since 2014, Cap Intro has catalyzed hundreds of inbound inquiries to funds from accredited institutional investors.



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