FROM ZERO TO SIXTY ON

HEDGE FUNDS & PRIVATE EQUITY

3.0

WHAT THEY DO, HOW THEY DO IT, AND WHY THEY DO THE MYSTERIOUS THINGS THEY DO

WRITTEN BY Jonathan Stanford Yu

From Zero To Sixty on Hedge Funds and Private Equity

Jonathan Yu

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Understanding What They Do, Why They Do It, and How It is Done

Jonathan Stanford Yu

Five Reasons Why This Book Should Start Your Hedge Fund / Private Equity Education

I remember the first day it started to make sense for me. I have been a finance-head since my early teens. Traded stocks in high school and lost a lot of pocket money. In college, I even took a class called "practical asset management". I figured myself fairly well prepared. Certainly more so than the average person.

The first day I met face to face with someone from a private equity fund I was on the investor side and they were making a pitch. They started by talking about value-add procedures, limited partner relationships, and macro-level investment selection procedures with criteria involving free cash flow and off balance sheet assets. They told us the banks were granting them leverage for their buyouts. They told us they had ground level relationships with family owned small businesses with owners looking to cash out.

What they really told me was how little I knew about the business. I had thought what I knew coming was enough but I was wrong. I did not want to be the person who asked the stupid questions. I needed to learn this and fast. Somehow I have to dig my way out of this hole I have gotten myself into.

It makes a lot of sense to start off with a book. I pulled an impressive looking textbook called "Private Equity Investing - Leveraged Buyouts" or something like that off the Barnes and Noble shelf. A Boeing sized tome that weighed more than the chair I sat on. The text size was small, the examples were ridiculously complex, and the ideas sounded utterly alien to everyone but the deeply experienced.

Okay, so maybe starting out with that one was a little too ambitious. I picked up a pamphlet on leveraged buyout modeling, thinking that it would help me understand how they did their deals and made their money. It came with a huge Excel file that I thought I could pick through. But a massive model like that makes no sense if nobody sits by you, holds your hand and walks you through that mess of numbers. That was not helpful either. I realized that I was going to have to pick it up on the fly.

So I went about it.

It was a real pain. Every day during work, I noted puzzling term after puzzling term in a small gray notebook. Every day after work I sat at my computer and Googled every term. Wrote down every definition in neat, little script. "Neat" because I had to come back to it again. "Little" because there was **a lot** of terms. Limited partner. Institutional investor. Prime brokerage. Total Return Swap. PIPE. Incentive Fee. Management Fee. RMB Denominated Fund. Junk Bond. Request for Information. Spinoff. Event Driven. Risk Arb (arbitrage). Repurchase Agreements. Futures. Global Macro.

Two steps forward, one step back. You have to immerse yourself in it and soak like beef in marinade. Right up to the point where you make jokes in the lingo. To the point where you find it crossing over into your conversations with your non-work friends. To the point where it stops feeling like a third arm coming out of your neck.

Then one day I sat with a person in the industry and she decided to challenge me with a question straight out of an interview.

"What is venture capital?"

Three answers came to mind. I took the time to count them myself. Well it could be that but then it could also be that unless when this is in effect. They rose up so fast they jammed themselves up in my head and I had no idea which one to start off with. Should I give just the most commonly known one or list all three with their individual contingent conditions?

The second those three bubbled up, I knew. That was it. That was the moment I was starting to get it together.

And it had taken way too long to get there.

Here are the places I had to work at before that day. A business brokerage catering to private equity funds. A valuation firm marking private companies. A small private equity firm. An investment advisory firm. A large hedge fund's investor relations department. An accounting firm specialized in auditing only hedge funds.

In the end, I figured there had to be something easier out there.

This work started out as a Google Doc with stuff I jotted down late at night before I went to bed. Just a letter to a friend with a passing interest in the topic. She eventually got her letter but the thing kept growing like a weed and soon I decided that I wanted to make it into something more formal. A book, perhaps.

But I did not want to go through all that trouble and spend all that time if it did not serve a purpose. Before I started on anything I sat down and found five reasons that a novice should read my work over something else. I taped the list above my iMac and so helpful they were in keeping me on track through the long and difficult birthing process that I thought that I would post them here for you to take in:

1) When I started back in the dark days, I found big long books with too much information to be helpful. I also found investing memoirs by hedge fund managers which featured great stories but were looking to entertain rather than to help me learn. I also found "trade like the pros" manuals that tried to sell me on an investing style. Those were not helpful for anyone in any way. This is a short easy read that gets you from point A to B immediately.

2) The thoughts, observations, and discussions in this book come right out of the workplace. I pulled subjects from lunchtime conversations, midday rants, and late night talk in the office. It is not stuffy academic material written by a professor in the ivory tower. It is not a bland accounting analysis by a billionaire hedge fund manager. I wanted to make this writing earthy and topical. This is the kind of stuff that people in the industry think about, stress out on, and ponder over everyday.

3) The “Starting Off” section, which comprises of this book’s first four chapters, is the only thing you should read first. After that, anything you do not care for you can skip. You can read the private equity section first if you wish. Or the hedge fund section if that is your cat’s fancy. Everything is cut into smaller sections with informative titles and “let’s get to the point” writing. It is for you. Drop and pick up whenever it is convenient for you.

4) This book is not going to cost you an arm and a leg. You put down a good $80 for a textbook and even $16 for a journalistic expose on the hedge fund industry. The up front cost for this one is nowhere near that amount.

5) A personal message at the very end, with the best career advice I ever gave to anyone and a simple moral lesson that I wish I knew from the first day of my career. Especially important for those who want to actually make a living in the industry. Most people I meet seem to want to. I hope one inspires you and the other actually helps you.

Five reasons I gave myself to write this book. I hope these same five can move you to read it.

The book starts off with the recommended preamble on hedge funds and private equity. There we talk about portfolio theory, limited partners, and fees. Then I talk about some select hedge fund strategies like high frequency trading and event-driven. Following that is a bit on bonds and derivatives. I walk you through it to make it as easy to understand and I think it is important for a full understanding of the markets. Next comes private equity featuring a comprehensive example of a leveraged buyout. At the end is my conclusion; a short moral message and some work commandments.

Feel free to skip around to whatever is your fancy. Not like these words are going to disappear from the page anytime soon.

As you read, if you come across anything that may seem puzzling to you or for some reason does not jive with what you already know or have read in the news, step back for a second and think about why that might be the case. Perhaps special circumstances dictated an exception. If that is the case then you can make an excellent educational opportunity out of comparing what you know and what is in here. Or perhaps I am just wrong. If that is the case then and you feel like helping a friend out, feel free to reach out to me via email and let me know. I would love to hear from you.

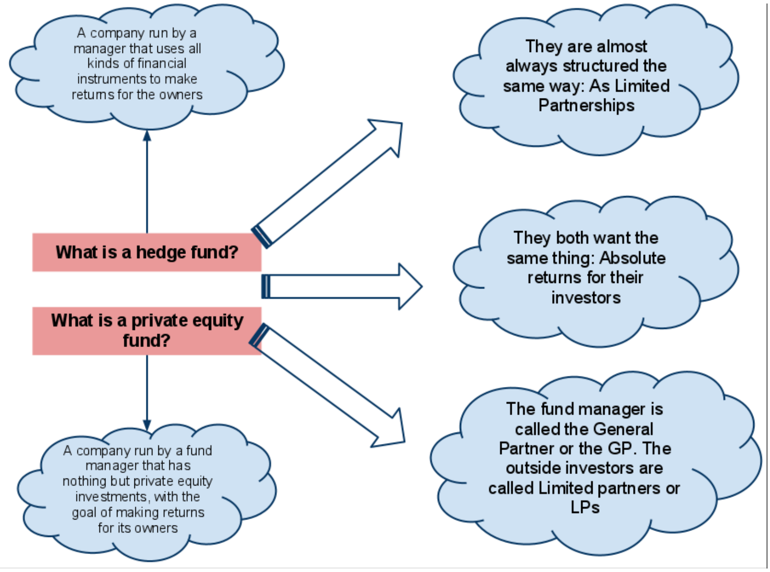
Now enough chatter from me. Let's go!

What are Hedge Funds and Private Equity Funds?

The Basics

This probably is the toughest part of the book because it is the point where you make that first leap into the alternative asset management world. It is kind of like making a cannonball dive into a freezing cold lake - some things are definitely going to make your teeth chatter. And since I start building on these terms real fast in the next few chapters I thought I should pause you here for a second and tell you what you can expect in this chapter. **My learning philosophy is that the more times you see a phrase and its definitions repeated, the faster you start to get it**. For most documents I know, that means reading some long droning passage over and over again. I hate that, so I am going to do my best to have you avoid that.

You can expect this chapter to go in this sort of direction:



The above graphic tells you everything you know about this whole chapter. This is what you need to know and keep in mind because we build on this. If all of it is already familiar to you then feel free to skip ahead to the next chapter, which discusses the fees that hedge and private equity funds charge their clients. That chapter immediately starts using some of the terminology I introduce here. However, any of this looks alien to you then keep on reading and know that **you already are starting to get it**.

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What are hedge funds? **They are largely unregulated business partnerships investing money in hope of obtaining absolute returns**. They are companies like just like any other you might imagine, founded and operated by a fund manager (sometimes also called a portfolio manager), but their entire business is to take in money from outside investors for investing.

I understand that that is a very broad definition. **Such a broad definition and a general lack of understanding as to what these**

things really are has led to the term being thrown around willy nilly. In my opinion the original definition has been long made useless. The first hedge funds were called as such because they differentiated themselves from mutual funds by having the power to hedge some of their investments by shorting stocks.[1] Today, there are mutual funds that can short stocks too and there are hedge funds that do not short at all. Therefore the definition has been diluted to such that the term "hedge fund" is just kind of a catch-all phrase for investment companies seeking absolute returns. What "absolute return" means I will get to in a second.

Next, a private equity fund. This is easier to understand. Private equity refers to a type of transaction, a classification. **A private equity fund is just a fund (again, a business set up by a manager to take in money) entirely made up of private equity investments**. So what makes a transaction a private equity transaction? It is a diagnosis of exclusion. **A private equity transaction can be called as such if it involves the purchase or sale of securities that are not publicly traded on the market**.

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Achieving absolute returns is a very specific thing. Every year the market (usually defined as the S&P500 or the Russell 3000, just every possible investable stock out there) goes up or goes down, returning a number. Some years it is positive. Some years it is negative.

These market returns matter for people seeking "relative returns", where you just want to beat the market. **Mutual funds seek to achieve relative returns.** They are a much larger industry with more regulation. Their threshold is the market, so it is okay with them if they end the year with a negative return if the market did a bigger negative that year.

[1]To remind you, they are people skeptic about the stock's ability to continue collecting price gains in the future. They borrow the stock through their brokers and sell it. They keep the money but know that eventually they have to return the borrowed item, the stock, to close the trade. If the price goes down then they get to keep the difference between the cost of repurchasing the stock back to close the trade and the money they got from the first sale.

Hedge and private equity funds do not care about the market and are not judged by the market. Their clients have very high expectations; they want their investments to grow in value every year without fail. A mutual fund with a negative return can point to the market and tell their investors that it was a bad year for everyone. They can do that and their investors can understand because for a mutual fund seeking relative returns, how the market does matters.

Hedge funds do not really have that excuse. If the market is negative, their clients want to be positive. If the market is positive, their clients want an even higher positive. It seems like an ambitious goal and certainly nobody should ever think that it is an easy job to hit those goals year in and year out.[2] Yet managers have done it before and are motivated to do so with very fat fees. In addition, funds are authorized to use every sort of financial instrument available to do their business. What some of those instruments might be I will expand upon in the coming chapters.

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I find it very helpful to imagine these funds not as "funds" but as "companies". Like any other type of business they have income statements and balance sheets. They take money from their investors to buy things which they hope can make them profits. The amount of profit that the company makes at the end of the year gets charged certain fees (the details of which are in the next chapter) and is then reported to the investors as the fund's year end return. These profits can either be funneled back into the company or returned to the investors. *Funds, hedge and private equity alike, are companies* and if you keep this metaphor in mind then it makes the

[2]There is a phrase I hear that describes this and it is called "Alpha". Alpha is defined as the return someone can get you above and beyond the normal market return. You can calculate it too and make a number out of it, which excites the statheads. Perhaps it is just my own personal experience but I have never heard this phrase used by the hedge fund professionals that I have worked with unless it is in a marketing context.

next concept I look to explain, that involving limited partnerships, much easier to take in.

Companies can choose to be structured in many different ways. Such structures affect how the company's owners are taxed by the government and can also protect those owners from becoming liable for the misdeeds and damages that the business might have caused (the latter concept's idea of limiting what is liable is why it is often called "limited liability"). In fact, the way we classify every type of business structure by their differences regarding the tax and limited liability implications. **Hedge funds and private equity funds frequently set themselves up in a specific way**: **As a limited partnership**. Let me break that down for you.

A partnership is defined as a business with many owners, the partners. A limited partnership is a special type of partnership, a sub-classification. The very distinct thing about it is its two types of partners: Limited and general partners.

There must always be a general partner. He runs the partnership and without him there is no partnership. **The fund dissolves if the general partner for some reason disappears**. This entity runs the company and because of that shoulders *"unlimited liability"*. The limited partners do not get involved in the operation of the business - they only bring in the money and get out of the way. Their limited participation in the operation of the business means that limited partners cannot lose any more than what they brought in. The business term for that is "limited liability". If partnership for some reason (like some sort of court decision that goes against their way) owes an amount that is greater than the Limited Partners' investment, then the difference is made up by the general partner.

In applying these concepts to a hedge or private equity fund, the general partner is the fund manager and the limited partners are the outside investors. People in the industry commonly use the phrases GP and LP for short. I will do the same.

So right now where are we? In this section we found that hedge funds and private equity funds are nothing more than companies seeking to achieve absolute returns for their LPs. They take on a special business structure authorized by the government, the limited partnership. The limited partnership is defined by two types of owners. These two types are called the general partner and the limited partner. The general partner is the fund manager and is the fearless leader guiding the fund forward. The limited partners bring in the money and watch with a paternal eye.

Like I said, this is the first step. If you still feel wobbly about anything, go back to the graphic and look at it again. Or go do something else and come back. Let it stew in your head for a while. I did not write this book to make it a chore, so do not let it be one for you.

Up next: I am going to talk about how the fund managers (or the general partners or the GPs) of the funds get paid.

How Do People In Asset Management Get Paid?

Hint: They are not paid goats from Kazakhstan.

Here I am going to talk about fees, the charges the GP collect. These are the payments made by the LPs (the outside investors) to the fund manager so that the investor can see his total investment grow. So why did I make this the topic that comes right after the introduction? I want to have you get immediately familiar with some more language. Fee language and concepts are universal to all funds. You can drop the term “incentive fee” in a finance-oriented conversation without sounding like an idiot.

One other reason I wanted to put this here is because most everyone knows about the godly rich hedge fund manager. They have become a common character in Hollywood movies and romance novels. People have started to associate the role with just plain “riches”. How such riches are obtained is glossed over. Here, you are going to learn where all that money comes from. Wealthy hedge fund or private equity fund managers, their fortunes start to made through these fees from big outside investors. Later on though, I am going to tell you that the dynamic reverses. Soon the fund managers become their own biggest investors, making themselves wealthy by investing their own huge sums.

Some of the other things you can expect to figure out here are:

> \~ **What are incentive and management fees and what are they paying for?**
>
> \~ **What is with those billion dollar paydays anyway?**
>
> \~ **When is a 100% return not enough to earn an incentive fee?**
>
> \~ **How can a big fund screw its investors over with its management fees?**
>
> \~ **Why do investors stick with big funds then?**

Much more as well but that is soon to come. Right now, let us walk through the kind of money you as a fund investor can expect to pay the person running your fortunes.

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Funds are paid through two types of fees, *a management fee* and *an incentive fee*. The management fee is the money paid by the limited partners (the investors) to the general partner (the fund manager) for the trouble of managing their money. It is calculated by taking a certain percentage of the total assets at the beginning of the year, the most common number seems to be 2%.

Incentive fees are taken out of a fund's profit for the year. Profit? Remember that a hedge fund, private equity fund, or venture capital fund is a business. They have money brought in by their partners and they invest it so to make more money. **The extra money that**

is brought in by their investing activities is profit and becomes subject to the incentive fee. This fee tends to be pegged at 20% but varies depending on the quality of the GP. Top hedge funds with high performance ability get to charge more because of their proven record, sometimes up to 40%.

What does all this money pay for? Asset management firms are not expensive to set up in a practical sense. You rent an office, pay a prime brokerage a certain amount, and you are pretty much ready to go. No factories or heavy equipment to bring in. Probably the most expensive piece of equipment is the Bloomberg terminal, a desktop computer that brings financial types a wealth of up-to-date facts and figures. People swear by it and thanks to their cost (thousands of dollars a month!) they make great status symbols. **These hang-the-slate expenses as well as the year end bonus pool for the regular employees (operations managers who make trades happen smoothly, accountants, and more) are paid from the management fee**.

Incentive fees go to the owners of the asset management firm. This is in part because incentive fees are very volatile from year to year and regular employees would be very unappreciative if they found their bonus pool vaporizing with a down market. It also aligns the incentives of the managers with the LPs. The partners of the fund management company get paid the most when their fund is successful. This means that no one gets cheated out if the fund returns suck.