Fortune's Fortress

A Primer on Wealth Preservation for Hedge Fund Professionals

Russ Alan Prince, Edward A. Renn, Arthur A. Bavelas & Mindy Rosenthal

About this Book

"Chess is life."
- *Fisher*

This book was written at the prompting of a number of our affluent clients who spend their time immersed in running money. They are hedge fund professionals. We are hired to – within the expansive confines of legality – ensure that their hard earned wealth is well protected. What they asked for was a primer on how to preserve that wealth.

When it comes to wealth preservation, we are very clear about what this means for hedge fund professionals. We are talking about ways to safeguard your net worth by defending and, sometimes, increasing it in the face of many who seek to share it with you even though you do not want to share it with them.

Among the likely participants who seek to share your wealth we include:

- Governments with their "aggressive" taxing and regulatory powers.
- Litigants such as disgruntled investors, ex-spouses and ex-business associates.
- Everyone who thinks all hedge fund professionals are fabulously wealthy and choose to target them with unjust lawsuits (see *Chapter 7: What is Asset Protection Planning?*).

Another facet of wealth preservation is protecting and efficaciously facilitating the equity transference of a management company whether it's forced or by design. Included here are strategies to freeze the future value of a management company for estate tax purposes as well as strategies to enable the management company to continue when something adverse happens to a key person, provided a replacement can be found.

Making sure your wealth is distributed to the people and charities you choose in the most tax-wise manner is yet another facet of wealth preservation. The vast majority of hedge fund professionals prefer to avoid handing monies to the tax collector when it's not "necessary" to do so. Wealth preservation in this context begins by ensuring your hard earned wealth remains in your hands or is bestowed to the people and charities you care about.

What is important to realize is that this approach to wealth preservation is not focused on finding winning investments. That's your expertise. Wealth preservation is not about becoming affluent or more affluent, although certain of the strategies we employ will increase your net worth. By our criteria, you are already affluent. In contrast, wealth preservation is about staying affluent.

The strategies for wealth preservation are predicated on our ability to navigate through the tax code and astutely maneuver through the legal and regulatory environments enabling us to capitalize on nuances in the laws and rules with sophisticated legal strategies that are sometimes supported by select financial products. Bottom line: you stay very wealthy.

The hedge fund professionals we work with are affluent. In the research we conducted with hedge fund professionals the definition of affluent was a net worth of US$30 million or more. However, many of the wealth preservation strategies we utilize can benefit less wealthy hedge fund professionals as well.

The legal strategies that underlie wealth preservation are constantly evolving in lock step with the perpetual modifications to the tax code, the regulatory environment and financial product innovations. Many of the legal strategies we bring to hedge fund professionals tend to be on the exotic side. Having said this, it's critical to recognize that, for us, there are no shades of grey. Everything we propose, every transaction we engage in is a "bright line transaction." In other words, everything we do is *perfectly legal* and *completely ethical*.

What This Primer Will *Not* Do For You

After reading this primer, you should not expect to be able to identify or develop, customize or implement wealth preservation strategies. The ability, for instance, to exploit a nuance in the tax code and consequently save a hedge fund professional millions of dollars in estate taxes or the ability to employ an offshore captive insurance company to supplement traditional disability insurance and simultaneously create a future source of income is the purview of the wealth preservation specialist.

If you are at all interested in the benefits of wealth preservation, especially when we are dealing with the more esoteric legal strategies and related financial products, then the services of an authority in the field is a necessity.

What This Primer Will Do For You

In writing this primer we wanted to:

- *Take a succinct look at the world of the hedge fund professional*. We wanted to drill down and get a snapshot of this world on a personal level. Thus we begin by addressing the four axioms that determine success for you and your peers. Additionally, we look at the way hedge fund professionals' use their wealth to benefit themselves and others.
- *Provide a brief overview of wealth preservation*. As noted, wealth preservation is not investment management. It's a way to make the most of the "regulatory and tax system" to maximize wealth retention, with periodic opportunities for wealth enhancement. And, at no time do we ever going over the line. Wealth preservation can be broadly identified as estate planning and asset protection planning.
- *Exemplify some key estate planning and asset protection planning strategies.* Our intent is to provide brief examples of strategies applicable to hedge fund professionals. Because this is a primer we do not to go into detail.

- *Explain how to find, choose and work with a high-quality wealth preservation specialist*. Most importantly, we conclude with a warning as well as detailing the guidelines and steps to selecting and working with a high-quality wealth preservation specialist.

What you are holding in your hands is a primer. It's a brief introduction to wealth preservation for hedge fund professionals. We recognize that by being attuned to what is happening in your personal world which includes the hedge fund universe at large and having a broad-based understanding about wealth preservation as well as having an introductory conceptual understanding of selected strategies, you will be better able to make informed decisions that can result in significant wealth perpetuation.

Part I
Masters of the Universe

Chapter 1
Determining Success

"All I want to do, ever, is play chess."
- *Fisher*

This primer is geared to the hedge fund professional – more precisely the affluent hedge fund professional. As one of these select individuals, it's a truism to state that your world is vastly different than other people who have amassed a similar level of personal wealth. And, in this primer, we will be focusing exclusively on hedge fund professionals.

To begin with we need to define what we mean by a hedge fund professional. This was essential in order to be able to conduct research in this universe. We ended up with four core criteria as being integral to our definition. The four core criteria are:

- A hedge fund professional is a person who currently has an equity position in the management company of a hedge fund or fund of funds.
- The hedge fund professional is actively involved in investing monies or managing the hedge fund or fund of funds. A person, for example, who seeded a hedge fund and therefore has an equity position but is not actively involved in the management company is someone we are not considering a hedge fund professional for this research study.
- Because of our focus on wealth preservation, the hedge fund professional must be affluent. Here we define affluence as having a net worth of US$30 million or more. While we are using this number to define affluence, many of the wealth preservation strategies we will be discussing as well as the processes involved are applicable to hedge fund professionals with a considerably lower net worth.
- The hedge fund professional's net worth must be a function of his or her equity position in a hedge fund or fund of funds. So, his or her personal wealth is principally a product of being a hedge fund professional.

For this project, we conducted in-depth interviews with 294 hedge fund professionals. A detailed demographic description of the hedge fund professionals we interviewed as well as our survey methodology can be found in *Appendix A: Sample Methodology & Demographics*.

While our emphasis was on issues pertinent to wealth preservation, we also empirically examined aspects of the hedge fund professionals' world from their vantage point. In studying hedge fund professionals, we identified four axioms that prove instrumental to their success. They are:

- Axiom #1: Money Good, No Money Bad.
- Axiom #2: It's About Performance.
- Axiom #3: It's a Hard Business.
- Axiom #4: Staying Centered is Critical.

Let's now take a closer look at each of them.

Axiom #1: Money Good, No Money Bad

Among the hedge fund professionals we surveyed, it's clear that the superior path to personal wealth is having equity in a successful hedge fund or fund of funds. This is somewhat tautological because, very often, any successful venture can translate into personal wealth. The difference here is one of magnitude and speed.

Maxwell did very well as a trader at a major investment bank. On average over an eight-year career, his annual earnings were around US$2 million. About five years ago, Maxwell left the "confines" of the investment bank for the "open range" of the hedge fund world. With the compensation structure of hedge funds, and Maxwell's continued trading prowess, he got rich – really rich – and he did so pretty quickly. Within five years, Maxwell was worth a little more than US$45 million. Moreover, Maxwell is not unique in this regard.

About nine out of ten hedge fund professionals (89.8%) believe that this business is the way to become rich – really, really rich (Exhibit 1.1). Furthermore, slightly fewer hedge fund professionals (84.4%) see the business as the way to accumulate significant wealth more quickly than other endeavors.

Exhibit 1.1: The Path to Private Wealth (Column chart)

Being a hedge fund professional is the way to become wealthy	89.8%
Being a hedge fund professional is a rapid way to become wealthy	84.4%

N = 294 hedge fund professionals

Considering that the people we surveyed created their fortunes through their equity positions in their management companies, these findings are not surprising. At the same time, the hedge fund industry is recognized as one of the very best routes to amassing considerable private wealth.

In a survey of 107 investment bankers – all earning a minimum of US$3 million per year for three years running – 84.1 percent of them claimed that running a hedge fund or fund of funds was a more likely path to "big money" (Exhibit 1.2). Of the investment bankers, 80.4 percent stated that running a hedge fund or fund of funds was a way to become wealthy faster.

Exhibit 1.2: Of Hedge Funds and Investment Bankers (Column chart)

Hedge fund professionals are more likely to get significantly rich	84.1%
Hedge fund professionals are more likely to get rich quicker	80.4%

N = 107 investment bankers

Anecdotally, we see the allure of managing hedge funds and fund of funds by Wall Street professionals from analysts to traders, and from brokers to portfolio managers who leave a certain level of career security for less career security that is offset by the perceived rewards of the hedge fund business. Without question, being a hedge fund professional is about making money and being "appropriately" compensated for doing so.

What is more telling is that these hedge fund professionals universally agree that money is good. We are not talking about the Gordon Gekko "greed is good" attitude. It's just that, at the core of the hedge fund professional, accumulating wealth for investors and consequently for themselves is something of – as one hedge fund professional put it – "***a moral imperative***." There's no way around it. Making money is what hedge fund investing is all about.

The strongly held belief among the hedge fund professionals is that without a very intense desire to become exceptionally wealthy you will not excel in this business. As we will see in the next chapter, most hedge fund professionals personally enjoy the rewards of their labor as well as use their largess for the benefit of others.

Axiom #2: It's About Performance

In studies of high-net-worth, family office, pension and eleemosynary hedge fund and fund of funds investors, those hedge fund professionals who adroitly manage the expectations and investing experiences of these clients are able to mitigate the adverse impact of poor investment performance for a period of time – sometimes an extended period of time. This "window of opportunity" permits them to rectify their less then stellar investment performance by subsequently putting up superior numbers.

While we know that hedge fund professionals can and – from a business point-of-view – should manage client expectations and experiences, in the final analysis, this is only a stopgap measure. While doing so might be crucial to the success of the fund because it buys time, there is absolutely no question that, in the final accounting, hedge fund investing is about investment performance. What's telling is that hedge fund professional recognize the role of performance at an almost elemental level.

Based on our analysis of the hedge fund professionals, we found that all of them strongly identify with their funds – and that means they identify with their funds' performances. In effect, their personal identities are strongly tied in with their careers. While this finding is not novel as many business owners identify with their careers and their companies, hedge fund professionals prove to be way out on the curve in this regard. The psychological identities of about eight out of ten hedge fund professionals (81.6%) are nearly inseparable with the success of their funds (Exhibit 1.3).

Exhibit 1.3: Hedge Fund Professionals Psychologically Identify with Their Funds
(Pie chart)
Psychologically tied 81.6%
N = 294 hedge fund professionals

What is even more telling is that for hedge fund professionals making the investment decisions (see *Appendix A: Sample Methodology & Demographics*), in many ways their portfolios are them personified. This was the case with 97.3 percent of these hedge fund professionals (Exhibit 1.4). Just as the self-identity of many lawyers and other service professionals is a function of their clientele, for these hedge fund professionals their self-identities are a function of their funds and the performance of those funds.

Exhibit 1.4: Investment Professionals are their Portfolios (Pie chart)
Are their portfolios 97.3%
N = 256 hedge fund professionals

Comments like: "I eat and breath my numbers" and "I go to sleep thinking about the fund. I dream about the fund and every waking hour I think about the fund" are more the norm than the exception. As one hedge fund professional poetically noted: "I am Excalibur Prime and Excalibur Prime is me." Excalibur Prime is the name if the fund he manages.

For their investors, the fact that there is a psychological melding between hedge fund professionals and their funds is a good thing. The highly permeable psychic boundary between themselves and their funds more likely translates into pecuniary success for all.

Axiom #3: It's a Hard Business

While many people have entered the hedge fund business, not everyone succeeds. Fewer yet reach the financial pinnacle we used to screen our sample of hedge fund professionals (i.e., a minimum net worth of US$30 million).

It takes a special type of person to excel in the hedge fund business. The following five characteristics were identified by 75 percent or more of the hedge fund professionals we surveyed as being essential to success:

- Entrepreneurial.
- Obsessive.
- Highly competitive in the extreme.
- Smart, sometimes bordering on brilliant.
- Confident.

While the upside can be very high, it's not as if success as a hedge fund professional is "a can't lose bet" even if a person possess these characteristics. Nor is success as a hedge fund professional all wine and roses. There are tremendous pressures and it's because of their ability to excel in spite (and in some cases because) of these pressures that hedge fund professionals reach the financial peak.

More than half (54.1%) of our hedge fund professionals report regularly suffering from the Icarus Syndrome (Exhibit 1.5). This is the concern that in running the hedge fund or fund of funds, the professionals fly so high only to come crashing down to Earth.

Exhibit 1.5: The Icarus Syndrome (Pie chart)

Affected	54.1%

N = 294 hedge fund professionals

David started with less than zero and now his net worth has eight zeros. His fund is highly leveraged and he says he wakes up sweating that his whole world can come crashing down at any moment. He likes the very good life he created for himself and his family and worries religiously about keeping it intact.

In a related vein, more than seven out of ten hedge fund professionals (72.8%) are very or extremely concerned about the Third Standard Deviation Effect (Exhibit 1.6). This is when extremely rare to occur market forces destroy a hedge fund. One hedge fund professional described the Third Standard Deviation Effect as the "obscene gestures of the invisible hand." Another noted, "Sometimes God *does* play dice with the universe." And a third said: "The really big risk is the one you don't even know is out there. Not knowing what to worry about is scarier than knowing."

Exhibit 1.6: The Third Standard Deviation Effect (Pie chart)

Concerned	72.8%

N = 294 hedge fund professionals

Aside from these two maladies, the day-to-day need to produce results can place enormous strains on hedge fund professionals. In many respects, the hedge fund business can be equated to living in a pressure cooker. As one hedge fund professional put it: "The business is like living in a fish tank populated by human piranhas and one day you might be a goldfish…. Not everyone gets out alive."

Axiom #4: Staying Centered is Critical

As just noted, the hedge fund business requires a lot of hard work to be successful. At the same time, it can be replete with stress (Exhibit 1.7). About four out of five hedge fund professionals (79.3%) find their job to be periodically very stressful. Somewhat fewer (67.3%) admit that sometimes they can be a little overwhelmed. Moreover, 88.1 percent reported that they knew a very successful hedge fund professional who "burnt out."

Exhibit 1.7: A Stressful Business (Column chart)

The job can be very stressful	79.3%
Sometimes the stress can be a little overwhelming	67.3%
Personally know hedge fund professionals who "burnt out"	88.1%

N = 294 hedge fund professionals

There is no debate that some hedge fund professionals do a poor job of coping with the stress. The three "Ds" are known to plague the industry – drink, drugs and divorce. Ryan, a self-professed hedge fund burnout, said that the first hint that his life was going downhill was when his golf handicap started to sour. The rest of his life soon followed.

More productive approaches to handling the stress are evident among the hedge fund professionals we studied. Some of them employ “angst buffers.” These are people who understand what they are confronting and provide the appropriate level and kind of support. Sometimes, other hedge fund professionals are good “angst buffers” including partners so long as they do not create a vicious cycle that only makes matters worse by exacerbating the anxieties.

For some hedge fund professionals, business coaches are the answer to productively mitigating the stresses of the business. They are also being employed to ensure that a lifestyle boutique, for instance, does not abrogate the need for astute practice management. The key is for the business coaches to not be generic but to be truly attuned to the world of the hedge fund professional.

This is best exemplified in research which clearly shows the need for hedge fund professionals to “stay centered.” One hedge fund professional explained that when he was focused on doing what he did well, his fund did very well. However, when he deviated from his expertise and tried to do “other things,” his investment performance suffered setting off a downward spiral.

We have found that the demise of many hedge funds – and the accompanying private wealth of the hedge fund professionals involved – is often a function of them deviating from exercising their unique abilities. What had enabled them to achieve extreme personal wealth was to capitalize on their often-exceptional talents. When hedge fund professionals are no longer centered on capitalizing on their unique abilities, they tend to make poor investment and business choices.

In working with exceptionally successful hedge fund professionals we hear a plethora of reasons for them to deviate from exercising their unique abilities. Martha, for example, got all wrapped up in the politics of her three-person hedge fund. Instead, of concentrating on trading energy futures, her mind kept coming back to her conflicts with her partners. For over a year this went on and the performance of the hedge fund suffered significantly. With the resolution of these conflicts, the hedge fund was once again able to put up exceedingly good returns. It’s sadly quite common for partners in management companies to have issues that end up badly hurting their success primarily because it causes the partners to deviate from exercising their unique abilities. The more expeditiously such matters are rectified, the quicker the hedge fund can get back on track.

What is clear is that when hedge fund professionals are deviating from their unique abilities the results are regularly disastrous. On the other hand, by staying centered, hedge fund professionals are able to ride out uncooperative markets, mercurial investors as well as their own often-passing insecurities. Moreover, based on the research, those hedge fund professionals centered on their unique abilities prove to be at the top ten percent of hedge fund professionals based on their net worth.

In sum, the hedge fund business is all about the money – and everyone is aware of it. What is evident is that success in the business is predicated on long hours and considerable effort. Additionally, it requires that hedge fund professionals stay centered on their unique abilities. While some people looking in see mansions and private jets, Patek Philippe watches and free flowing champagne, these rewards are predominantly a function of talent and a lot of hard work. It also requires a mindset that enables them to persevere, as the path is not always easy.

The Future's So Bright, I Have to Wear Shades

Now and again, we here a lot of doom and gloom talk in the hedge fund industry. When the performance among hedge funds as measured by a variety of indices is down we often here the death knell of the industry. Some complain that the really good investment opportunities are fewer in number. Competition is more pervasive and intense a contributing factor to mitigated investment opportunities and "disruptive noise" among potential investors. Clients are more demanding and difficult. And, on and on it goes.

The hedge fund professionals we studied, tended to have a different point of view. While the future of the hedge fund industry will not be a direct line extension of the past, for them the halcyon days of the hedge fund business are still to come. Moreover, 79.3 percent believe that the opportunity to personally become Croesus-like wealthy by running a hedge fund or fund of funds is unabated (Exhibit 1.8).

Exhibit 1.8: The Hedge Fund Business Will Continue to Be the Way to Get Very Wealthy (Pie chart)

The part to significant private wealth	79.3%

N = 294 hedge fund professionals

There are many reasons for this, some of them having to do with the mess the world is in. The reasons for a bright future include likely worldwide economic turmoil and looming geopolitical crises. In effect, instability can play well for the adroit professional investor. "As long as the world's a mess, we get volatility and that's good for us," stated a hedge fund professional.

Another structural factor cited was the exploding pace of entrepreneurial activity. Specifically, new business-derived wealth is being created at ever-quicker rates – though nothing to match that of hedge fund generated personal wealth. Again, this factor can play well for the adroit professional investor.

On another point, the pool of investors in hedge funds and fund of funds is both expanding and becoming wealthier. For example, a substantial number of institutional investors needing to meet projected distribution needs require better returns and are therefore looking to hedge funds.

Private wealth in the world is increasingly bifurcating between the "haves" and "have-nots" with the "haves" growing in number and, more importantly, in absolute wealth.

The very wealthy – those with a net worth of US$10 million or more – are multiplying faster and the size of their fortunes are growing almost at an even greater pace.

The best estimate available today is that there are 1,104,000 families in the world with a net worth of US$10 million or more. They control in excess of US$91.7 trillion. Most of them are indeed candidates to invest in hedge fund or fund of funds.

This means that the demand for high-quality investment talent will only burgeon. Consequently, those hedge fund professionals who can deliver will continue to have the choice of who to take on as clients since there will be many more potential clients to choose from. As one hedge fund professional put it: "Money will chase returns." Another said: "The future belongs to the top managers. They are the new and eternal Masters of the Universe."

One more factor to consider: the very nature of the hedge fund universe is in flux. This can be readily seen in the changing investment landscape. While new investment strategies are being validated and commercialized some of them are moving off the beaten path. From the addition of private equity to hard-money lending to financing family offices engaged in esoteric tax-arbitrage strategies and from providing the funds for premium life insurance financing to getting involved with it's first cousin, life settlements, the variety of investments that hedge funds are involving themselves in is dramatically expanding. This situation, therefore, provides more investment avenues for talented hedge fund professionals and these investment avenues are of considerable interest to affluent and institutional investors.

From a number of different perspectives, no matter which way things shake out, there are always opportunities for talented money managers. It's just that many of those money managers have equity positions in hedge funds and fund of funds. For these talented professionals, the future is indeed bright.

Conclusions

The business world of the hedge fund professional is unlike any other. It's populated by hardworking, laser focused, extremely talented individuals – individuals with truly unique abilities. Furthermore, the world of hedge funds "seduces" these individuals through many means such as the intellectual and competitive challenge of the business. Still, the principal seduction is the enormous private wealth a capable hedge fund professional can amass.

The four axioms of determining success provide evidence as to the trials hedge fund professionals constantly confront. Nevertheless, the hedge fund professionals we surveyed see the future of the hedge fund business to be bright, if not blindingly so. There are some really nice benefits to being a highly successful hedge fund professional which is where we now turn.