Memo

Some thoughts on becoming an independent fund manager

Robert Vinall, Kilchberg, 3 February 2014

My fund, Business Owner, had its fifth anniversary in September last year. The more historically minded of you will note this was also the fifth anniversary of the Lehman crisis. And to think nobody believed me when I said I would one day be bigger than Lehman….

The anniversary got me thinking about how RV Capital, my firm, has evolved. As it happens, I think I have done quite a few things right. I can say this free from any sense of immodesty as it was mostly due to luck and acting out of necessity, rather than following a master strategic plan. By putting down in writing what I have learnt, I hope that some of you can get by design to where I got by chance.

It may seem a little strange for a comparatively early stage manager to be passing on valuable (I hope!) advice to potential competitors. Why am I doing it? As I survey the fund management industry, I am more often than not disgusted by what I see. Fees are overblown, performance is mediocre, a minority of undeserving people gets very rich, and a majority of deserving people find a gap between what they have saved and what they need to meet their financial goals.

I would love to make a difference, but the capital I manage directly will never amount to more than a drop in the ocean (my fund will close at around EUR 300 m). By encouraging and helping a new generation of managers to fulfill their dream of gaining independence and doing things the right way, I hope to extend my influence beyond the capital I manage directly.

The following 10 points are addressed to would-be independent fund managers who have a long track record of managing their own money successfully and want to start their own business by offering their capital allocation skills to investors who cannot or will not manage their capital themselves. It is not addressed to promoters who are indifferent to managing money but see starting a fund as an easy path to riches. In any case, I doubt they will find anything in the following which is of any practical use.

1. **Get the initial structure right**. The right structure will almost force you into great capital allocation whereas the wrong one will make it impossible no matter how talented you are. I really want to emphasize this point as when most young managers start out, their main concern is probably raising capital. The fund structure may simply come about as a default of what the most promising route to capital appears. The structure though is pretty much set in stone at Day One and is very difficult to change later. Nearly all the following points relate either directly or indirectly to structure.

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2. **Do not follow the siren call of promoters** offering a dollop of cash to manage in return for a share of the economics. David Swensen writes compellingly in "Pioneering Portfolio Management" why funds that do this are pretty much doomed at the outset. One reason is the conflict of interest between the promoter (whose focus on raising assets) and the manager (whose focus is performance), but there are many more.

3. **Keep costs ultra low**. When I started out, I worked from my bedroom, had no Bloomberg and slept on friends' sofas when I was visiting companies in foreign places. I did this out of necessity (I warned you not to expect a strategic master plan) because I did not want to have to abandon the project a few years in because the big cheques had not arrived and my current account was running low. I now choose to work from home as I have found being in a stable environment helps me to stay balanced when the markets go haywire; I would not put a Bloomberg on my desk even if paid to do so as it would be an enormous distraction; and I still enjoy visiting friends where possible. Keeping costs low is the ultimate no brainer for any business, especially a young one, and yet I see almost every start-up fund go the opposite way. Most young funds go for swanky offices in the West End or 5th avenue, a team of traders and analysts, and a hot receptionist thrown in for good measure. How this is going to improve anyone's capital allocation is a mystery to me. It may lend credibility with a certain class of investor but these are probably not the ones you want in any case (see point 6).

4. **Do not bother marketing**. I could point out that you are paid to get your investors rich, through finding great investments, and not yourself, through drumming up capital, but instead I will speak more directly to self-interest. First, marketing is a complete waste of time. Nobody, other than the most loyal friends, family and business associates are going to invest in the early years in a young manager with no track record and no funds under management. Second, success in the long run will be determined solely by performance. Time is far better invested in identifying great companies and building a first class track record than futile marketing pitches. Third and finally, there is no shortage of capital looking for fund managers with a credible methodology and the ability to turn 50 cent coins into dollar bills. In fact, the bottleneck is <u>always</u> the managers' capacity and not the availability of capital. It is far better to spend their capacity wisely by building the investor base patiently rather than taking everyone and anyone.

5. **Communicate in an open and transparent fashion**. I think it is incredibly important to communicate openly about how you invest and then lay out the rationale behind the main investment decisions over time. If you do not, I fail to see how an investor can verify that your track record has been generated through a plausible methodology which was strictly adhered to as opposed to a streak of lucky coin flips. I think it can be argued that secrecy is necessary to protect good investment ideas, but I suspect the true motivation for secrecy is more often than not the desire to create an air of mystique designed to camouflage mediocrity. There is also a second argument for openness. The purpose of a business is to deliver a benefit to the customer. In fund management the main benefit is a first class financial return, but there is a second one: peace of mind. Most people find it unnerving to entrust their hard earned savings to a 3rd party (especially those who in the past have fallen into the clutches of a private bank). By explaining in

simple terms where the money is and why it is there, they receive a positive emotional return which may be as important as the financial one.

6. **Get your target investors to self select**. When I started the fund, I initially tried my hand at marketing, but soon gave up when I realized I was wasting my time. Nothing much happened for a few years and then suddenly something strange started to happen. Every now and again a potential investor would drop by, usually by way of a referral. Not only would they nearly always invest but they were quite euphoric to have found me. I was not too displeased myself as they were exactly the type of partners I was looking for. At first, I thought this was a wonderful coincidence. Then it dawned on me that by being open about how I invest and having the patience to wait for investors to find me, my investors were effectively self selecting. Only investors who liked my approach and saw the benefit of my independence were coming to me. The ones looking for swanky offices and an army of analysts were not, but these were not the ones I was looking for in any case.

7. **Say no to the wrong type of investor**. Any investor who pulls their capital out when the markets get rocky, places a substantial burden on the manager's time, attempts to influence the capital allocation process, and so on, is likely to do more harm than good. Politely decline their business. I loved the book "Different" by Youngme Moon. She argues that great businesses are different and you only achieve difference by declining to be all things to all people. I could not agree more. A manager can only allocate capital well with investors who "get" the strategy. The rest have no place in the fund.

8. **Seek responsibility**. I love it when a friend or a referral from a friend entrusts a large part of their net worth in me as I know I can make a difference to that person's life. It is humbling. I imagine a doctor feels something similar when a friend brings their child to her to be checked over (whereby I by no means intend to equate the importance of the job of a doctor with that of a fund manager). I see some people who are filled with horror at the thought of so direct and tangible a responsibility. They seek to absolve themselves of it through teams of co-managers, analysts and compliance officers. If this is you, you may be a talented analyst, but you are not a fund manager. Leave the capital allocation to the grown-ups.

9. **Dig a moat around your business**. All value investors seek companies which have a competitive advantage or "moat". Demand it of your own business. Michael Porter argues that there are two main sources of competitive advantage: low cost and differentiation. He also argues that the two are mutually incompatible. This is true for many businesses – it is difficult to imagine a discounter being successful if it tried to compete with Procter & Gamble on marketing spend, but it is not for ours. A fund management operation can have ultra low costs <u>and</u> loyal customers. My only major operating expense is my travel and largest capex was my Jura coffee machine. There are no analysts, no traders and no rent. I cannot see how costs could be any lower and yet despite this, or I would argue because of this, I have exceptionally loyal investors. There is no staff between me and them. In fact, I have had only one redemption in the last five years despite having no lock-up and this was by a friend who wanted to buy a

house (I take a dim view of redemptions, but make the occasional exception when the capital is needed for food or shelter). Every business should aim for the lowest possible costs and the highest possible customer loyalty.

10. **Seek great partners**. I have been incredibly fortunate in having great partners. I would highlight Norman Rentrop who provided me with my start-up capital at no financial gain to himself other than the hoped for returns from my capital allocation, Jens Grosse-Allermann, who in addition to being a great investor himself, takes care of all the operational and regulatory side of things, together with his colleagues at Fiducia, Georg Stolberg who encouraged me to go my own way right from our first encounter, and several others who would prefer not to be named. As you will have noticed, I like to write in the first person singular ("I") form and not the first person plural ("we") which is far more prevalent in the financial services industry. This is because I find "we" is used to diffuse and ultimately hide responsibility. The "I" reflects my desire to assume responsibility should a capital allocation decision not work out, but when things go right, the "we" is definitely the more appropriate form.

So there you have it. It is not a roadmap to riches for the hedge fund impresario with dollar signs in his eyes. It is though an almost guaranteed route to independence for the talented fund manager. That is in any case the only type who should be entering this industry.