

A Tale of Two Capital Structures

Structural Alpha – The Key To:

(1) Better Returns, Liquidity, and Tax Efficiency for Hedge Fund Investors; and

(2) Increased AuM, Permanent Capital, and Monetization for HF Managers

Note: A couple of years ago, I gave a speech on Structural Alpha. An editor for a major publisher was in the audience and suggested that I turn the subject into a book.

Writing is not only a very painful process for me, but I also believe that a number of other people write far better than I. As such, I asked Greg Newton of “Naked Shorts” to co-author the piece and offered him any advance and all of the royalties.

After two sessions, Greg and I had completed an outline, but then, he suddenly passed away. Aside from considerable knowledge of the hedge fund industry, Greg possessed wit and irreverence in great quantities and this piece would have been far more entertaining and much more informative if Greg had written it.

As such, over the last two years, I have haphazardly and erratically added flesh to the skeleton that Greg and I began. The result is too short for a book and far too long for an article in a print publication, but Matthias Knab agreed to publish it in Opalesque.

Recently, Opalesque also produced a video on Structural Alpha - http://www.opalesque.tv/youtube/Joe_Taussig/1 . While this piece and the video overlap significantly, for those of you who are really interested in how to greatly improve the Investor Proposition or generate significant amounts of AuM and/or permanent capital, there is enough unique information in each to make it worthwhile.

Having seen myself on Opalesque TV, I plan to keep my day job and the on air talent at CNBC and Bloomberg TV have nothing to fear.

If you have any questions, please feel free to contact me.

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PROLOGUE

'Twas the best of times, 'twas the worst of times. 'Twas the age of wisdom, 'twas the age of foolishness. Charles Dickens' opening words from *'A Tale of Two Cities'* are appropriate for describing recent history. Just as Dickens compared London and Paris at the time of the French Revolution, these words are also appropriate as we compare the evolution of the capital structures of two financial services titans and the implications of their evolution for hedge funds ("HFs"), funds of hedge funds ("FoHFs"), family offices, and their investors.

Our starting points will be an analysis of one hedge-fund (sic) and another financial services partnership (often accused of being a hedge fund in disguise) about the time of their respective metamorphoses. We then examine the impact of their evolutions on their investors and managements and extrapolate lessons learned from their experiences by comparing their original capital structures (the most common structures for HFs, FoHFs, and family offices) with the two alternatives ultimately chosen by our heroes, each of which can provide any investor with: (1) significantly better returns without a proportionate increase in risk than their partnership (fund) structures; (2) equal or vastly superior liquidity; and (3) far gentler tax treatment in the UK, Canada, or the U.S. than in the traditional fund or partnership structure.

Since the managers of HFs, FoHFs, and family offices are also investors, the investor benefits alone should be compelling enough to thoroughly research these two alternatives. However, most managers who implement these structures only do so because the structures also: (1) greatly increase assets under management ("AuM") without the painful exercise of having to sell their funds to one investor at a time; (2) provide the stability of permanent capital without incurring a discount to NAV; and (3) provide a vehicle to monetize the fund manager or family office that will usually be far superior to selling some or all of the fund manager or family office to a large financial institution or taking it public through an IPO, without eliminating any of the options for selling some or all or going public.

Simply stated, this piece is about better returns, liquidity, and tax treatment for investors and asset raising, permanent capital, and monetizing the management business for managers.

A word of caution before we start. You will often feel like you are trying to quench your thirst by drinking from a fire hose. However, this piece is far from comprehensive because the variables are myriad. The purpose of the piece is to get you to think deeply about a number of issues, how they might impact you as an investor and/or your business as a HF, FoHF, or family office manager, and come to the conclusion that you would like to know a lot more about the concepts (and will contact us).

To make it more readable, I have taken some license to simplify income statements and balance sheets by eliminating extraneous information, rounding the numbers (and numbers of years), and disguising the identities of the structures at the beginning. All recent numbers are as of the end of 2010.

A number of previewers have liked our approach to using a little mystery to introduce our heroes. Some of the others did not. If you want to zero in on specific topics of interest, let the Table of Contents be your guide.

A number of very knowledgeable people previewed this piece for me and made a number of comments. I would like to particularly thank Alex Ineichen, Frank Meyer, Nicola Vestring, and Matthias Knab, not only for their considerable expertise and but also the breadth and detail of their comments.

I would also like to thank you in advance for the time you will devote to reading this piece.

CHAPTER 1 – CAPITAL STRUCTURE #1

Please examine the following financial services company capital structure that was in place in 1969:

<u>Assets</u>	<u>Liabilities</u>
\$210 million (all publicly traded securities)	\$140 million
	<u>Net worth</u>
	\$70 million

NB: The CIO had previously delivered returns of approximately 30% per year for more than 10 years.

1. Does this look like a hedge fund to you?
2. Do you think the CIO will be able to match those 30% returns over the next 40 years?

While its immediate predecessor was clearly a hedge-fund (sic) with an identical balance sheet, the CEO and CIO of Capital Structure #1 would have taken exception to being characterized as a hedge fund 40 years ago (and would be even more vehement about it today).

I would argue that this was still a hedge-fund (sic) imbedded in a new vehicle that is other than a private investment partnership, but its regulators, the SEC (for purposes of the Investment Company Act of 1940, since it was and is a public company), and the IRS agree that it was not (and is not) a hedge-fund.

As for matching the 30% returns over the next 40 years, \$70 million compounded at 30% for 40 years would be worth \$2.5 trillion today. Microsoft, GE, and Wal-Mart are each worth between \$200 billion and \$300 billion today. In light of that, does it appear to you that the CIO was able to match his previous 10 year 30% track record over the next 40 years?

Go back to 1969 and put yourself in the picture. You have \$1 million to invest. You have narrowed your choices down to three alternatives and plan to keep the investment for at least 40 years.

Your first alternative is Capital Structure #1. Despite the CIO's reputation for being very savvy, he has publicly expressed doubts about his abilities to continue to match those 30% returns in the foreseeable future much less over the next 40 years. However, you believe that he might earn 12% on his investments over the next 40 years, but that 12% is far from certain and any earnings will be subject to corporate income taxation of roughly 35% per year in addition to taxation when you sell.

Alternatively, you are offered an opportunity to continue to invest in an actively traded long/short equity partnership run by the same CIO who would be managing the assets of Capital Structure #1, just as he did in the past as a hedge-fund (sic) manager. A financial guarantor rated triple AAA is willing to guarantee annual returns of 12% (instead of his historic 30%), net of fees and expenses over the next 40 years. Furthermore, the fund will only be taxed as a partnership.

Lastly, you can invest in a new fangled S&P 500 index fund and the same AAA rated financial guarantor is willing to guarantee a return of 9.3% over the next 40 years (which was the real result).

Which would you choose if the objective is to cash out with the most after-tax dollars at the end of 40 years? Would the right answer differ if you were a Swiss living in Zürich, an American living in New York, or a British subject living in London?

Which would you choose if the objective is to have as much capital working for you for the 40 years after 2009? Would the answers differ for the aforementioned Swiss, American or Brit?

Back to more recent times. By **2002**, Capital Structure #1 had grown organically and looked like this:

<u>Assets</u>	<u>Liabilities</u>
\$210 billion	\$140 billion
	<u>Net worth</u>
	\$70 billion

While a 1,000 fold increase in each balance sheet category over 33 years is more than commendable, \$70 billion is somewhat less than the \$400 billion that 30% returns would have produced over the same 33 years, so the obvious conclusion is that the CIO failed to match the historic 30% investment target.

Failed to match his historic 30% performance? The CIO exceeded it.

In actuality, he produced ROEs of 32%, which should have compounded to \$660 billion by 2002 and \$4.6 trillion today (assuming that returns do not diminish with size - of course, they do diminish with size and have diminished with size – the CIO's earlier years far outperformed the most recent 10 years by a large margin) instead of \$400 billion in 2002 and \$2.5 trillion today that a 30% return would have generated.

Questions to ponder:

1. How can we explain this wide discrepancy (for \$4.6 trillion, \$70 billion is a rounding error)?
2. What business is Capital Structure #1 in?
3. What company is it?

Capital Structure #1 is Berkshire Hathaway. Warren Buffett insists that it is an insurance company. It is regulated by a number of state insurance commissioners in the U.S. The SEC does not consider it to be an investment company under the 40 Act (lucky for all concerned). The IRS taxes it like an insurer.

The duck theory states that if it looks like a duck, walks like a duck, and quacks like a duck, it must be a duck, regardless of what anyone else chooses to call it. As we will see in Chapter 3, under the duck theory, I would argue that Berkshire Hathaway is still a hedge-fund (sic) imbedded in an insurer.

The reason that 32% returns on equity failed to translate into \$660 billion in 2002 and \$4.6 trillion today, is that Berkshire is taxed on its annual earnings at both the federal and state levels. Asset managers only report pre-tax returns, so the CIO delivered 32% on equity (12% on assets – equity plus two increments of reserves minus 2% for Costs of Insurance for each increment of reserves). But because of taxes, Berkshire the insurer has “only” compounded at 20.3%.

Even then, its book value is only \$120 billion, while its market cap is \$153 billion (NOTE: This is ex-Burlington Northern). This difference is explained by the premium to book value of 28% (all figures for Berkshire Hathaway in this piece are for the end of 2010 but do not include the recent acquisition of Burlington). If Berkshire had been based in Bermuda, rather than Omaha, and enjoyed the same premium to book value, it would theoretically be worth nearly \$6 trillion (assuming that returns would not have deteriorated with size – which, of course, they would have and did).

Please look at the following table of profits on the \$1 million invested in 1969 for 40 years:

Investor	BRK	Hedge-Fund	S&P 500
Swiss in Zürich	\$2.2 billion	\$93 million	\$31 million
New Yorker - Hold	\$2.2 billion	\$10 million	\$31 million
New Yorker - Cash Out	\$1.65 billion	\$10 million	\$23.5 million
Londoner - Hold	\$2.2 billion	\$93 million	\$31 million
Londoner - Cash Out	\$1.8 billion	\$46.5 million	\$25.5 million

In all five cases, following Buffett into Berkshire would have been the right choice. The Swiss is indifferent to holding or selling, because there are no capital gains taxes in Switzerland. While the New Yorker and Londoner will have the same amount invested for the future as the Swiss if they hold, if each cashes out, the British capital gains rate is higher than the U.S. federal capital gains rate, but the New Yorker does not fare as well because of state and municipal taxes that do not recognize capital gains. However, if the New Yorker moves to Florida before cashing out, he would do slightly better than the Londoner who stays in London (no state or municipal taxes). On the other hand, if the Londoner expatriates to a tax friendly jurisdiction prior to cashing out, he will have as much as the Swiss.

If Berkshire did not exist and the only choices in 1969 were the hedge fund and the S&P 500, the hedge-fund trumps for the Swiss and the Londoner. For the New Yorker, the S&P makes the most sense. The New Yorker and Londoner have identical income tax rates, but Londoners are only taxed on funds when they sell. New Yorkers are taxed each year. QED - the impact of tax deferral on compounding.

Next: Chapter 2 – Capital Structure #2

CHAPTER 2 – CAPITAL STRUCTURE #2

Please examine the following financial services capital structure that was in place in 1999, just prior to converting from a partnership to a corporation:

<u>Assets</u>	<u>Liabilities</u>
\$210 million (mostly publicly traded securities)	\$203 million
	<u>Net worth</u>
	\$7 million

NB: Off balance sheet notional value of swaps and other derivatives - \$3 billion.

Notice that the magnitude and mix of balance sheet assets is identical to that of Capital Structure #1, although 30 years apart. The differences are in the liabilities and equity accounts, as well as the off balance sheet contracts. There are three questions to consider:

1. Does this look like a hedge fund to you?
2. Are you comfortable with this capital structure?
3. Is it merely leveraged 29 to 1 or is it really 458 to 1 because of the off-balance sheet notional?

Below is a recent P&L for Capital Structure #2. In the intervening 10 years, earnings and capital inflows built the net worth to \$62 million and its balance sheet leverage was “only” 13:1.

<u>Starting Equity:</u>	\$62 million
Trading profits	\$10 million
Interest, fee, and other income	\$1 million
Pre-compensation net income	\$11 million

In light of this new information, please consider the following two questions:

1. Does it still look like a hedge fund?
2. If you found out that the time frame for this P&L were only one quarter as opposed to one year, would that affect your answer to the previous question?

Most of the people who previewed this piece were quite concerned when first confronted with this capital structure. At 29 to 1, the leverage seemed excessive. If each and every item in the off balance sheet book is matched with another hedged item, counterparty by counterparty, with a right of offset, then the 29 to 1 is defensible. However, while the whole book may be perfectly hedged, it is generally done so with multiple counterparties per hedge, so rights of offset become remote. Given the Lehman Brothers and AIG experiences, it is arguable that 458 to 1 is far more realistic. How does 458 to 1 feel?

If you thought that Capital Structure #2 is a hedge fund, you would again be in the significant majority of the previewers. Some even ventured that this might be Long Term Capital (it could not possibly be Long Term Capital, which "only" had balance sheet leverage of approximately 100 to 1, versus 29 to 1 or 458 to 1, and LTCM is no longer around to play the part vis a vis the recent results).

If the time frame were a year, returns would be on the order of nearly 18% per year on an annualized basis, which would be consistent with the top tier of its industry group. Given the rising markets, this would not be out of line for hedge fund and non-hedge funds alike. If the results are for one quarter only, annualized returns are roughly 71% and it looks even more like a hedge fund to me.

Again, the leaders of Capital Structure #2 would vehemently deny being a hedge fund at any time in their history, much less 10 years ago or today and their regulators, the SEC (for purposes of the '40 Act), and the IRS agree with them. I would still argue that this is really just another hedge fund imbedded in different structure. In light of the commentary, have you changed your previous opinion?

Go back to 1999 and put yourself in the picture. You have \$1 million to invest. You have narrowed your choices down to just two alternatives and plan to keep the investment for the next 10 years.

Your first alternative is Capital Structure #2, which is about to go public and your broker can get you \$1 million worth of stock on the IPO.

Alternatively, you are offered an opportunity to invest in an actively traded long/short equity fund that has a AAA guarantee to return 12% per year, net of fees and expenses over the next 10 years.

Which would you choose if the objective is to cash out with the most after-tax dollars at the end of 10 years? Would the right answer differ if you were a Swiss living in Zürich, an American living in New York, or a British subject living in London?

Which would you choose if the objective is to have as much capital working for you for the 10 years after 2009? Would the answers differ for the aforementioned Swiss, American or Brit?

Breaking News: Taussig Makes Huge Mistake !!!!

This mistake is a real biggie.

My lame excuse is that I cannot see as well as I used to. When I read the numbers for Capital Structure #2, I read “billion” as “million” and “trillion” as “billion”. I was also lulled by the “coincidence” of having an identical amount as Berkshire Hathaway had in the asset account 30 years before.

So that you can better assess the impact of this error, I have restated the aforementioned balance sheet and income statement for (revised) Capital Structure #2 as follows:

<u>Assets</u>	<u>Liabilities</u>
\$210 billion	\$203 billion
	<u>Net worth</u>
	\$7 billion

NB: Off balance sheet notional value of swaps and derivatives books - \$3 trillion.

The recent P&L should have read:

<u>Starting Equity:</u>	\$62 billion
Trading profits	\$10 billion
Interest, fee, and other income	\$ 1 billion
Pre-compensation income	\$11 billion

Before turning the page, there are three more sets of questions to consider:

1. Do you have any increased discomfort with the real amounts in Capital Structure #2? Why?
2. What business is this capital structure in?
3. As Robert Redford said to Paul Newman, “Who are those guys, Butch?”

Capital Structure #2 is Goldman Sachs. The performance shown is for the third quarter of 2009. Goldman’s leaders insist that it is a commercial bank. It is regulated by the Fed, the OCC, and the FDIC in the U.S. The SEC does not consider it to be an investment company. The IRS concurs and taxes it like a bank, even though interest income is miniscule as a percentage of revenues.

Keep in mind the duck theory of identification – if it looks like a duck, walks like a duck, and quacks like a duck, then it must be a hedge fund? Goldman Sachs is obviously a commercial bank and not a duck.

Theoretically, the magnitude should be irrelevant to the risk in the balance sheet and income statements. However, there is little systemic risk when the magnitude is 1/1000th as great as was originally depicted for this Capital Structure. This (revised) Capital Structure #2 appears to pose a great amount of systemic risk.

Should that matter to you as an investor? Too big to fail might cushion some downside.

Please look at the following table of **gains** on \$1 million since 1999:

Investor	Goldman Sachs	Hedge Fund
Swiss	\$1.44 million	\$2.1 million
New Yorker - Hold	\$1.44 million	\$790,000
New Yorker – Cash Out	\$1.08 million	\$790,000
Londoner - Hold	\$1.44 million	\$2.1 million
Londoner – Cash Out	\$1.18 million	\$1.05 million

The second scenario invited you to decide whether you wanted to invest for the next 10 years in Goldman Sachs or in an equity long/short fund that is certain to return 12% and do so across the same five sets of personal circumstances. Unlike the Berkshire investment, there is no clear-cut answer for all five sets of circumstances.

Since its IPO, Goldman’s shares have risen 8.6% p.a. and it has paid an annual dividend of roughly 0.8% (Berkshire does not pay dividends). Thus, the Swiss and the Londoner who continues to hold beyond 10 years are better off in the hedge fund. The New Yorker is better off in Goldman Sachs under all scenarios, while the Londoner who cashes out and stays in the UK is slightly better off in Goldman Sachs as opposed to the hedge fund. Again, the table shows the impact of tax deferral on compounding.

In a 1966 article on A.W. Jones, Carol Loomis called private investment partnerships hedge-funds (sic), which is why I have used the hyphenated term and the “sic” in describing Buffett’s structures. The Buffett Partnership was identified in the article (which is available on request) as one of these vehicles. Today, Carol Loomis edits Buffett’s annual letters, which would make it difficult for Buffett to deny he was one of the ancestors of the Gottrocks 2 and 20 crowd. Three years after the article, the Buffett Partnership morphed into ***both a reinsurer and a bank*** (as reflected in Capital Structure #1).

In a like manner, 10 years ago, Goldman Sachs metamorphosized from being a partnership into a publicly traded corporation (as a broker-dealer), and more recently it became a commercial bank. Capital Structure #2 depicts Goldman Sachs just prior to converting from its partnership structure.

Berkshire Hathaway and Goldman Sachs. Two companies run by some of the smartest people on the planet. Each was a partnership in its past, but no longer. If the partnership structure was so superior, why did they abandon it? What do they know that HF, FoHF, and family office managers who really operate exclusively in partnership or partnership-like (from a behavioral standpoint) structures do not know? More importantly, what can HFs, FoHFs, family offices, and their investors learn from Berkshire Hathaway and Goldman Sachs’ metamorphoses into a reinsurer and/or a bank and apply in the future for the benefit of their investors and themselves?

Next: Chapter 3 – Structural Alpha (The Real Secret to Buffett’s Success)

CHAPTER 3 - STRUCTURAL ALPHA (THE REAL SECRET TO BUFFETT'S SUCCESS)

Please Note

I am a huge fan of Warren Buffett. This sentiment should always be kept in mind as this paper is being read. However, no one is perfect and there is room for improvement in everyone, including Buffett. If I had used a proportionate number of words in this paper to praise what I admire as I have used to critique him, far more than 95% would be words of praise. Praise for Buffett is well-trod ground and such a piece would bore most readers.

Thus, this paper is long on critique. But critique in the context of how one of the greatest performances in the history of business (if not the greatest) was achieved, how it might have been improved, and the application of those lessons to HFs, FoHFs, family offices, and their investors.

Buffett the Hedge Fund Manager

To the extent that a hedge fund is defined as a non-traditional investment strategy that actively buys and sells negotiable instruments (as opposed to private equity or real estate), seeks to generate alpha, absolute returns, and asymmetric returns, and primarily rewards its manager with a percentage of the profits, then it is arguable that the best known and most successful person to have ever run a hedge fund for more than 10 years is Warren Buffett.

Buffett started a series of private investment partnerships in 1956 (long before the term "hedge fund" was as ubiquitous as it is today) with \$700 of his own money and less than \$100,000 from friends and family. He worked from his bedroom in his parents' house. Focusing on publicly traded securities, he always beat the benchmarks (alpha), never had a down year (absolute returns), and emphasized taking risks only when potential rewards more than justified them (asymmetric returns). He charged no management fee and a performance fee of 25% of profits in excess of 6%. God forbid, he even took short positions. The partnerships eventually merged into one called the Buffett Partnership.

13 years after starting, Buffett's fund had produced returns of approximately 30% since inception (net of fees), was roughly \$100 million in size, and Buffett's share was \$25 million. However, by 1969, roughly 50% of the fund consisted of a 70% stake in a publicly traded textile company - Berkshire Hathaway.

Had Buffett stumbled prior to 1969, he would have likely had redemptions, would have been unable to liquidate Berkshire in an orderly fashion, causing more losses and further redemptions, and might have suffered the same fate as Tiger 30 years later. Instead of becoming the "world's greatest investor", he might have become a charter candidate for Greg Newton's Hall of Shame. If today's hedge fund manager had 50% of his fund in an illiquid 70% stake in a publicly traded company, and the tidal wave of 2008 and 2009 redemptions washed over him, he would be marked for life.

By any standard, Buffett was a very, very, very successful hedge fund manager. Then he quit. Cold turkey. ***To go into insurance, reinsurance, and banking.*** From here on out, insurance and reinsurance will often be collectively referred to as (re)insurance.

To do this, he liquidated the Buffett Partnership and made a distribution in kind (which is tax free). Each partner could elect to take his proportionate share of each security or cash. Buffett took his portion of Berkshire and a significant portion of the remaining Berkshire shares when his partners elected to take other shares and/or cash instead. Thus, Buffett increased his indirect stake in Berkshire from about 17.5% at the time the partnership was dissolved to a direct stake of 41%.

Prior to the dissolution of the Buffett Partnership, Berkshire had acquired insurance, reinsurance, and banking businesses. Because of the interests in the insurer, reinsurer, and bank and because his 41% stake (and the other 29% held by his former partners) gave Buffett control of Berkshire, he was able to continue to invest in publicly traded securities without being deemed to be a closed end fund and running afoul of the Investment Company Act of 1940 (11 years later, regulators made him give up either (re)insurance or banking and he sold off Illinois National Bank).

At the time that he sold Illinois National Bank, banks in Illinois could not have branches (that is why First Chicago and Continental Illinois evolved into international powerhouses out of major high rises) and banks in general could not cross county lines in some cases and state lines in other cases. Furthermore, his personal stake would have put him at odds with the Bank Holding Company Act. As such, banking as a lone structure would have been too confining and keeping the (re)insurer was a no-brainer.

Today, banks can operate across state lines, even globally. However, if Buffett were given the choice today, I believe he would still choose (re)insurance. While its publicly traded portfolio represents roughly 60% of Berkshire's net worth, Buffett has purchased more than 80 whole companies and could not have done so if Berkshire were a bank. As such, I am relatively confident that if he had to choose (re)insurance or banking today, he would still choose (re)insurance.

Why Did He Quit?

The official story is that his investors had come to expect a level of performance that he did not feel he could continue to match in the future. As such, he felt that he would be letting them down if he tried to continue as in the past and hated the pressure of having to meet their expectations and perform at a level that he no longer thought was achievable. Furthermore, as they grew in number and the fund grew in size, the investors increasingly impacted his time.

There is little doubt in our mind that performance pressure was a major factor in his decision and quite possibly the only factor. However, the decision had several other salutary benefits and it is difficult to imagine that a man as savvy as Buffett was unaware of any (or even all) of these other benefits.

The first benefit was that it removed him from having to deal with his investors as regularly as he had to do as the GP of an investment partnership. In fact, because Berkshire was a public company, for legal reasons, he could no longer communicate as the partnership investors had come to expect in the past.

As I pointed out earlier, at the time of the transition, the Buffett Partnership had roughly 50% of its assets in one stock – Berkshire Hathaway. This position represented roughly 70% of Berkshire's shares. As long as the fund kept growing through a combination of performance and new AuM, this was a manageable situation.

But what if 1969 were 2008? Buffett suffered losses as did most everyone else in 2008 and if his performance in 1969 had also suffered in the same manner as it did in 2008, he would likely have had

net redemptions as did most of the hedge fund industry. With 50% of assets owning a 70% position in a single stock, it could have been very ugly.

Thus, by morphing into the (re)insurance and banking businesses, Buffett solved his redemption risk and simultaneously achieved “permanent capital”. It is difficult to imagine that he was unaware of this outcome, but I have never seen it mentioned. Then again, drawing attention to this possibility might have triggered a sequence of events (redemptions) that he feared or should have feared.

On the surface, the transition from the hedge fund to Berkshire Hathaway was a transition from a partnership to a holding company. At the time, one of the seminal business theories was espoused by Bruce Henderson, the founder of the Boston Consulting Group. Essentially, Henderson’s concept was to milk the cash cow as it declined in order to fund new, ascendant business initiatives. Whether or not this influenced a voracious reader like Buffett is uncertain, but he redirected the cash flows of a declining textile business into other, unrelated lines of business, particularly (re)insurance and banking.

When one thinks of “growth”, (re)insurance and banking do not normally come to mind (although Buffett’s versions of (re)insurance and banking were truly ascendant). As such, there may have been other considerations at play in Buffett’s thinking. Thus, aside from the logical economic benefit of redeploying capital from a declining business to businesses that were ascendant, the selection of (re)insurance and/or banking had three additional significant, but very subtle, benefits.

First of all, reinsurers and banks are exempt from the Investment Company Act of 1940. If Berkshire were not primarily engaged in (re)insurance and/or banking, its own public status and its portfolio of publicly traded securities would likely have required it to be regulated as a mutual fund.

Had it been a mutual fund, Buffett would not have been able to intervene in GEICO or Salomon as he did, nor could Berkshire have acquired the more than 80 whole companies that it has over the last 40 years. Buffett also had several legal and regulatory problems early in the Berkshire saga (an anti-trust suit against Blue Chip Stamps, reorganization problems in consolidating his partnerships, and the acquisition of a savings and loan in California). It also appears to me that the acquisitions of GEICO and Gen Re may have insulated him from “inadvertently” becoming an investment company later on.

Again, I have never seen the exemption from the ’40 Act mentioned and while it is possible that Buffett was unaware of this benefit, if he were aware of it, it would not have served him to have this subtlety in the spotlight in view of the other legal and regulatory issues he had to deal with and a ’40 Act sword of Damocles would likely have hurt the market value of the company.

The second subtlety was the “float”, Buffett’s euphemism for leverage. Leverage is generally in disrepute at this time and Buffett has publicly eschewed the use of leverage over the years. However, there is leverage and then, there is leverage. As we will see later on, a form of specialized leverage without the drawbacks of traditional leverage is **the** major factor in the success of Berkshire Hathaway.

The real problem with traditional leverage (short-term borrowing) is the combination of its costs and availability. Asset values tend to move inversely with the risk free rate of return, which is the basis for the pricing of most leverage. Thus when costs of leverage go up, the asset values supporting it usually decline. This often has an effect on its availability in that loan to value ratios often require more equity when equity is unavailable, causing a liquidation of assets at a most inopportune time.

However, the availability of leverage is also tied to the inclination and ability of the leverage provider to continue to provide leverage. If the leverage provider is having difficulties on its own, it may have to

withdraw its funding for reasons unrelated to the performance of the borrower. This has clearly been the case in the last two years and has tipped many performing borrowers into liquidation.

(Re)insurers and banks are leveraged by their very nature. However their costs of leverage are significantly lower than the costs of most loans (roughly 3% each and every year in (re)insurance, and variable in banking – currently less than 2%). Furthermore, the availability of their leverage is relatively independent of asset values (tied to insurable events in (re)insurance and depositor confidence – often backed by government guarantees - in the case of banking). Thus, reserves and deposits are less costly and far more stable than margin type loans.

The third subtlety is that (re)insurers and banks with believable balance sheets (a rarity these days) generally tend to trade at a premium to book value (1.25x to 3x). The implications of this, coupled with far higher ROEs due to leverage, cannot be overstated. Had the shareholders of Berkshire Hathaway sold all of their holdings in 1969 and reinvested the proceeds in the S&P 500, their \$70 million would have compounded at 9.3% for 40 years and be worth only \$2.5 billion today.

But what of Warren Buffett, the “world’s greatest investor”? I have reverse engineered his investment record within Berkshire Hathaway. 12% per year. In investment parlance, his investment “alpha” is 2.7% per year. This is pretty good, but does it qualify him for the reputation he has as the “world’s greatest investor”? Had the same investors liquidated their holdings in Berkshire Hathaway and had Buffett the asset manager manage the proceeds in the Buffett Partnership, the \$70 million would have grown to \$4.4 billion in 40 years. This is a far cry from the \$153 billion of market cap that BRK enjoyed before the Burlington transaction.

This Difference Between \$153 Billion and \$4.4 Billion is what I Call “Structural Alpha”.

In the (re)insurance businesses, the industry standard is that underwriting profits (or losses) equal premiums, minus claims, minus operating expenses. These generate an average underwriting loss of 3% per year (also known as the cost of insurance or “COI”) for each dollar of reserves. The industry generally invests these reserves in long only fixed income securities (“because that is how we have always done it”). Assume that the fixed income generates 5% per year. Thus, for every dollar of reserves in a traditional (re)insurer, returns are 2% per year (5% for investments minus 3% for COI).

In terms of ROEs, the key is the ratio of reserves to equity (leverage), which runs around 5x in the P&C industry. With its equity invested in the fixed income portfolio at 5% plus 5x of reserves earning 2% per increment of reserves, pre-tax ROEs tend to be 15% and after-tax ROEs are roughly 10%.

Consider the following excerpts from page 6 of Berkshire’s 2009 annual report:

“Our property-casualty (P/C) insurance business has been the engine behind Berkshire’s growth and will continue to be. It has worked wonders for us. We carry our P/C companies on our books at \$15.5 billion more than their net tangible assets, an amount lodged in our “Goodwill” account. These companies, however, are worth far more than their carrying value – and the following look at the economic model of the P/C industry will tell you why.

Insurers receive premiums upfront and pay claims later. In extreme cases, such as those arising from certain workers’ compensation accidents, payments can stretch over decades. This collect-now, pay-later model leaves us holding large sums – money we call “float” – that will eventually go to others. Meanwhile, we get to invest this float for Berkshire’s benefit. Though individual

policies and claims come and go, the amount of float we hold remains remarkably stable in relation to premium volume. Consequently, as our business grows, so does our float.

If premiums exceed the total of expenses and eventual losses, we register an underwriting profit that adds to the investment income produced from the float. This combination allows us to enjoy the use of free money – and, better yet, get *paid* for holding it. Alas, the hope of this happy result attracts intense competition, so vigorous in most years as to cause the P/C industry as a whole to operate at a significant underwriting *loss*. This loss, in effect, is what the industry pays to hold its float. Usually this cost is fairly low, but in some catastrophe-ridden years the cost from underwriting losses more than eats up the income derived from use of float.

In my perhaps biased view, Berkshire has the best large insurance operation in the world. And I will absolutely state that we have the best managers. Our float has grown from \$16 million in 1967, when we entered the business, to \$62 billion at the end of 2009. Moreover, we have now operated at an underwriting profit for seven consecutive years. I believe it likely that we will continue to underwrite profitably in most – though certainly not all – future years.

If we do so, our float will be cost-free, much as if someone deposited \$62 billion with us that we could invest for our own benefit without the payment of interest. Let me emphasize again that cost-free float is *not* a result to be expected for the P/C industry as a whole: In most years, premiums have been inadequate to cover claims plus expenses. Consequently, the industry's overall return on tangible equity has for many decades fallen far short of that achieved by the S&P 500. Outstanding economics exist at Berkshire only because we have some outstanding managers running some unusual businesses. Our insurance CEOs deserve your thanks, having added many billions of dollars to Berkshire's value."

Under Buffet's leadership, Berkshire never had a cumulative underwriting profit until 2006 (after which time his cumulative cost of "float" or COI became less than 0.0%). Up until that time, Berkshire's underwriting losses were still better than the industry norm (his COI was 1% to 2% p.a.). Furthermore, at 2x, his level of leverage was far less than the industry standard of 5x.

Nonetheless, while Buffett publicly eschews leverage, he puts lipstick on the pig and freely admits that the "float" (avoiding the term "leverage") is the real driver of Berkshire's success.

Investing the equity at 12% and adding 10% for each increment of reserves (investment returns of 12% minus the 2% COI), the total was a pre-tax 32% (12% + 2x10%). Taxes reduced it to an after-tax 20.3%. 20.3% compounding for 40 years turns \$70 million into \$120 billion. A price to book of 1.29x brings it to \$153 billion. Thus the structure generated \$149 billion of alpha (\$114 billion in better ROEs and \$35 billion in a premium to book value).

Stated another way, if Buffett had been run over by a truck 40 years ago but Berkshire had done all of the same things that it did in the meantime, except that it invested in the S&P 500, Berkshire would still be worth \$26 billion (versus \$2.5 billion in the S&P or \$4.4 billion with a manager who could consistently generate returns of 12%). Substitute the HFRI index (a random selection of hedge funds) for the S&P 500 and the amount is \$101 billion. While \$153 billion seems like a lot more, Buffett's share of the difference is far greater than any major hedge fund manager's performance fees, save Steve Cohen.

However, had Berkshire invested in the S&P 500 and been in Bermuda, it would have been worth \$323 billion or twice what it is today (the most valuable company in the world – without Buffett). Again, substitute the HFRI index, and Bermuda based Berkshire would top \$1 trillion.

Berkshire with Buffett in Bermuda would have theoretically been worth the previously mentioned \$6 trillion. If that were the case, it is arguable that Buffett's decision to become the Sage of Omaha rather than the Sage of Bermuda has cost Berkshire shareholders more than \$5 trillion. NOTE: Buffett has taken advantage of the Bermuda tax regime in the past by investing in White Mountains, which reorganized itself from the U.S. to Bermuda, before inversions were deemed to be taxable.

There are lies, damn lies, and statistics. The lie in the statistics? To borrow from Lord Acton, "Size kills and absolute size kills absolutely". BRK with Buffett in Bermuda would hardly have become worth \$6 trillion. Buffett has had serious difficulty deploying assets in liquid securities for more than a decade. Instead, he has bought whole companies for cash on cash returns that are not unattractive, but far short of his historical numbers. In more than 40 years, he has failed to beat the S&P 500 only seven times. Three of them were in the last 9 years when Berkshire had become too big to get out of its own way.

Is Buffett Still a Hedge Fund Manager?

If a hedge fund were defined as a non-traditional investment strategy that actively buys and sells negotiable instruments (as opposed to private equity or real estate), seeks to generate alpha, absolute returns, and asymmetric returns, and primarily rewards its manager with a percentage of the profits, it is arguable that there is still a lot of hedge-fund (sic) manager in Warren Buffett.

Consider the following hedge fund-like attributes:

Non-traditional investments?

Currency trading? Sounds like global macro to me. See's Candies, NetJets, Nebraska Furniture Mart? To borrow from Robert Duvall's character in *Apocalypse Now*, "don't you just love the smell of synergies in the morning"? Insurance and reinsurance risks? For the first 41 years, Berkshire had never had a cumulative underwriting profit. However, as Buffett has often pointed out, his "cost of float" was generally less than 1% to 2% per year and was not correlated to asset values as normal leverage is (meaning it cannot be pulled if asset values are down or if the provider has problems as margin loans often can).

Negotiable instruments?

A \$70 billion portfolio with \$50 billion of unrealized gains (he also enjoys the additional benefit of investing \$20 billion of deferred taxes - BRK's total net worth is roughly \$120 billion). 2006 was one of the greatest underwriting years in the history of the insurance and reinsurance industries (no major disasters or shocks in the tort system) and Berkshire's cumulative underwriting results turned profitable for the first time (finally giving him a negative cost of "float" over the history of the company). In the best underwriting year in history, Berkshire's underwriting profits neared \$7 billion, but the unrealized gains in the publicly traded stocks were \$50 billion. So, what business is he in? No wonder he is called the "world's greatest investor" rather than the world's greatest insurance man.

Alpha?

The first page of Buffett's annual letter shows each year's performance against the S&P 500 (which he has beaten 32 out of 42 years) and the relative compounded values since inception (by which he has soundly trounced the index).

Absolute Returns?

Buffett's first rule of investment is to never lose money. His second rule is to never forget Rule #1. In fact, Berkshire Hathaway has only had two years where its book value per share decreased (when the dot.com bubble burst, it took everything down, even the old economy fuddy duddies like Buffett and Julian Robertson. The other was 2008's *annus horribilis*).

Asymmetric Returns?

Buffett says, "When Charlie (Munger) and I do not see anything we like, our default position is Treasuries. We hate taking risks and only do so when the rewards are compelling and relatively sure. Our idea of real risk is eating cottage cheese one day past its expiration date".

Performance fees?

41% is pretty good. He certainly never got rich on the \$100,000 per year management fee.

Summary

As a pure hedge fund manager, Buffett was successful by any standard. However, because he quit the hedge fund business as we know it, he has been able to achieve a legendary level of success that is unlikely to be attained by any of today's HF, FoHF, or family office managers who exclusively use the traditional hedge fund structure.

It is our firm belief that more than one star quality hedge fund manager who creates and/or acquires insurers, reinsurers, or banks and manage all of the investable assets for them will ultimately enjoy the same levels of wealth, reputation, and status in the future that Buffett enjoys today.

Next: Chapter 4 – AIG, Tiger, "The Snowball", and the Hedge Fund Industry

CHAPTER 4 – AIG, TIGER, “THE SNOWBALL”, AND THE HF INDUSTRY

It is useful to compare Berkshire Hathaway with AIG and Tiger Management (when Tiger went out of business). In comparing them, it is very important to note that I am also a huge fan of Hank Greenberg and Julian Robertson. This sentiment should always be kept in mind as this paper is being read. Again, no one is perfect and there is room for improvement in everyone, including Greenberg and Robertson (as well as Buffett). If I used a proportionate number of words in this paper to praise what I admire in Greenberg and Robertson as I have used to critique them, as with Buffett, far more than 95% would be words of praise. Again, praise for Greenberg and Robertson is well-trod ground and would bore most readers. Lastly, it is also useful to comment on Alice Schroeder’s book on Buffett – The Snowball and some general comments on the hedge fund industry. So, back to critique and commentary.

AIG

In a major irony, AIRCO (American International Reinsurance Company), the centerpiece of CV Starr’s empire, moved from Bermuda to New York and became AIG in 1978 in order to better access the U.S. capital markets. In doing so, its income tax rate on non-U.S. business (most of AIG’s business) went from 0.0% to roughly 25%. Many of the old hands at AIG considered this move to be the worst mistake in the company’s history and over the years, AIG supposedly spent more than \$100 million trying to figure out how to get the toothpaste back in the tube.

At its peak, AIG’s net worth reached \$100 billion. Had it stayed in Bermuda and been able to access the U.S. capital markets as all of the major Bermuda insurers and reinsurers have over the last 20 years, I estimate that AIG would have been worth \$360 billion in 2006. The additional \$260 billion would have been more than the TARP funds given to AIG and AIG would probably have weathered the crisis.

Tiger

Buffett and Robertson are value investors who were derided and criticized by pundits and investors alike for failing to “get” the new economy of the 1990s and for failing to jump on the technology band wagon. They were both heavily invested in U.S. Air.

Even though they never went over to technology’s dark side, they both suffered significant portfolio losses when the dotcom bubble burst. In the case of Tiger, investors redeemed \$2 for every \$1 in losses. Liquidating into falling markets to meet redemptions exacerbated the losses, causing a spiral of more losses, redemptions and liquidations. More than \$20 billion turned into \$6 billion on roughly 20% losses (similar to 2008’s hedge fund industry performance).

The hedge fund industry’s seeds of destruction (the high water mark) began to germinate. At \$22 billion, Tiger’s compensation probably topped \$1 billion a year. While Robertson is certainly wealthy, that is a lot of overhead to carry for a couple of years until the high water mark is reached. Thus, the best and brightest of Tiger left, because they could be paid performance fees at a new fund but not so for the same performance at Tiger. Many left and no one would replace them. Despite \$6 billion in AuM, and a 20% since inception track record (the combination of which would make most funds more than viable), Tiger was no longer viable – nobody would be home to service the business.

In contrast to Tiger, unhappy Berkshire investors could not redeem, but could only sell their shares on the NYSE. While Berkshire’s price suffered, Buffett did not have to pour gasoline on the fire by having to liquidate assets as Tiger did. Buffett could also continue to invest as he had historically.

Those investors who stayed with Buffett were rewarded for their patience. Those who would have wanted to stay with Robertson were not only unable to do so, but were trampled in the stampede if they tried to.

The Snowball

Alice Schroder's recent book on Buffett is called "The Snowball". The snowball is a metaphor for the power of compounding (Einstein called it the eighth wonder of the world). Buffett has always emphasized that the objective was to compound book value per share each and every year (sounds like a duck, er hedge fund).

While he is a very good investor, his investment skills without the structure were only worth \$2.5 billion more than the S&P 500 over 40 years. Within the structure, they have been worth about \$150 billion more than the S&P (if the structure remained in Omaha), but less than worthless if Berkshire had invested in the S&P and been in Bermuda. While Buffett may not be the "world's greatest investor" after all, he would certainly earn our vote as the "world's greatest structurer".

The Hedge Fund Industry

The total equity capital of the North American life and annuity, property and casualty, and reinsurance industries was on the order of \$1.5 trillion at the end of 2010. The total equity capital of the U.S. banking system was less than \$1 trillion at the end of 2010. Thus, the combined equity capital of the life and annuity, property and casualty, reinsurance, and banking industries was roughly \$2.5 trillion.

The total fee generating equity capital in hedge funds and funds of hedge funds was more than \$2.5 trillion at the end of 2010. Every HF or FoHF investor could have invested in publicly traded (re)insurers or banks but did not. However, many investors in publicly traded (re)insurers and banks could not invest in hedge funds (mutual funds are not allowed to, many pensions have restrictive guidelines, tax-exempts can lose their tax exemptions or cause ERISA contamination, and individuals do not qualify).

It is arguable that those with unrestricted choice will make better decisions than those with restricted choice. As such, we should expect the hedge fund industry to consistently outperform the banking and (re)insurance industries (and it has).

In the second half of 2010, the 10 most profitable hedge fund managers (ESL, Farallon, Brevan Howard, Moore, Caxton, Appaloosa, Baupost, Bridgewater, Paulson, and Soros) were shown to have generated more profits for their investors than the six most profitable banks combined (Goldman Sachs, Morgan Stanley, JP Morgan, Barclays, HSBC, and Citi). Yet, it is estimated that the hedge fund managers achieved their results with fewer than 5,000 employees, while the banks had more than 1.2 million (arguably less operational risk). In addition, banks tend to pay 50% of revenues in compensation, which makes 2% and 20% look positively cheap in comparison.

The economic model of the (re)insurance and banking industries consists of two components: (1) investment returns on equity capital (generally long only fixed income); plus (2) operating profits. Since the returns of hedge funds tend to be greater than the combination of the two components and the two components are independent of one another, then it would seem to be a no brainer to substitute hedge fund strategies for long only fixed income at the equity level, even if nothing else changes. Managing a small increment of liabilities and taking advantage of offshore tax regimes, pushes these returns to even higher levels. This is the theme of the rest of this piece.

Next: Chapter 5 – Replicating the Goldman Sachs and Berkshire Hathaway Models

CHAPTER 5 - REPLICATING THE GOLDMAN AND BERKSHIRE MODELS

Overview

Goldman Sachs and Berkshire Hathaway have benefitted significantly by abandoning their partnership structures and becoming a bank in Goldman's case and a (re)insurer and bank in Berkshire's case.

In each case, their investors have been able to obtain returns that were superior to those they would have achieved as a partnership and do so without a proportionate increase in risk. This is largely due to their access to leverage that is far cheaper and far more stable than available to a partnership structure (or publicly traded broker dealer in the case of Goldman) and a premium to book value their stock prices command. As public companies, their investors also enjoy the legal right to resell their investments to the public that was unavailable when they operated as partnerships.

However, because they are based in the U.S., their earnings became subject to double taxation, whereas if either had started offshore, only their U.S. operations would be subject to double taxation. In addition, the new level of taxation is applied annually, which has major ramifications for compounding returns over long periods of time. As we will see, the benefits are compelling irrespective of tax, but mitigating tax cushions downside risk and permits more powerful compounding on the upside.

From their perspective as managers, Goldman and Berkshire are accessing assets they would otherwise be unable to access in a partnership structure, have permanent capital, and have been able to imbed the management in the structure, thus monetizing their management roles in a far superior manner than selling out to a larger institution or floating the management function on a standalone basis.

Any HF, FoHF, or family office manager that can consistently outperform long-only fixed income returns on a multi-year basis can replicate the best parts of either or both of Goldman's or Berkshire's successes. In doing so, their investors (including themselves as investors) should enjoy a combination of: (1) significantly better returns than offered by the partnership structure, without a proportionate increase in risk; (2) daily liquidity (if publicly traded); and (3) gentler taxation in the UK and U.S. As managers, they can: (1) greatly increase AuM that would not otherwise be available; (2) secure permanent capital; and (3) gain an additional option with respect to monetizing the manager's business.

It is important to remember that while Goldman's net worth is \$62 billion and Berkshire's net worth is \$120 billion, they had \$7 billion and \$70 million respectively when they metamorphosized. There are many hedge funds, FoHFs, and family offices with bigger balance sheets than Goldman and Berkshire had when they took the plunge and could replicate Goldman's and Berkshire's successes if they have the will to do so.

The idea is to simply follow Goldman's and Berkshire's leads in creating and/or acquiring one or more insurers, reinsurers, or banks and leverage off their investment skills and existing fund management infrastructure to benefit both investors and themselves in ways that are far superior to their existing fund structures.

HF managers, FoHF managers, or family offices do not need to take such a drastic step as quitting the HF, FoHF, or family office business cold turkey as Buffett did. Instead, he or she can simply start or acquire a (re)insurer or bank (whereby he or she would manage all of its investable assets) and treat the foray as he or she would treat the launch (or acquisition) of a new fund.

In order to do this, it is more than helpful (but not absolutely necessary) if the new business becomes publicly traded as soon as possible (even as a startup), because the HF manager's, FoHF manager's, or family office's clients and (unaffiliated) Strategic Investors will be far more willing to make larger commitments if those commitments can be conditioned on the success of an IPO.

If the commitment from the manager, his clients, and his funds is only \$10 million, the concept still makes sense (the significantly better returns and gentler tax treatment are more than justification), although as a private company (it would be too small to be publicly traded). In this case, operations will still produce \$20 million to \$100 million in AuM for him, depending on the investment strategy.

However, the manager who cannot commit enough for an IPO or the manager who wishes to remain private will have difficulty in getting clients to come along unless he commits to use the earnings to fund a Dutch auction in order to return capital to investors that want liquidity at capital gains rates for taxable investors.

The greater the cumulative levels of commitment from the manager, his clients, and/or his funds, the more Strategic investors and the public are likely to invest and the greater the cumulative equity, and the larger the magnitude of reserves or deposits that might be deployed in the investment strategy.

If some combination of the manager, his investors, or his funds commits less than \$50 million, it is unlikely that any Strategic Investor of note will join. However, at \$50 million in personal, client, and fund commitments, it is possible that a strategic investor may join and it is likely that that investment banks can still raise a like amount in an IPO even if there are no strategic investors. This should still create a total of \$250 million to \$1.25 billion in new AuM, depending upon the investment strategy.

If the HF or FoHF manager and his investors are willing to commit \$150 million or more, then Strategic Investors might invest \$100 million or more. Because Strategic Investors validate the business strategy, the investment strategy, or both, investment banks may raise a far greater proportion of capital from the public (maybe as much as three times the committed capital, if the committed capital exceeds \$250 million). This would generate another \$2 billion to \$10 billion of AuM from (re)insurance or banking operations, depending upon his investment strategy.

It is not beyond the realm of possibility that a \$50 million commitment by the HF or FoHF manager could result in \$100 million from his or her clients, \$100 million from Strategic investors and \$750 million from the public, resulting in \$1 billion of equity capital. Even greater levels of commitment by some combination of the manager, his or her investors, and Strategic Investors, could magnify those amounts even more.

To place these greater amounts in perspective, a larger fund manager could arguably commit significantly more than \$50 million, convince a larger number of its clients and Strategic Investors to commit billions, and a \$5 billion, or even \$10 billion IPO is not out of the question.

If an HF or FoHF manager could pull off a \$10 billion IPO, the equity capital would be virtually equal to the 5th largest (re)insurer or 6th largest bank in the U.S. With \$5 billion, the company would be equal to the 10th largest (re)insurer and 15th largest bank. With only \$1 billion, it would be virtually equal in size to the 35th largest (re)insurer or 50th largest bank.

The best way for the HF or FoHF manager to convince investors of these benefits is to make the largest possible personal financial commitment to the new company (because the HF manager, FoHF manager, or family office believes it will achieve better returns than investing the same amount in its own funds).

Based on the HF or FoHF manager's levels of personal commitment (could be conditioned on success of an IPO), many of the HF or FoHF manager's clients will be more likely to commit, conditioned on a successful IPO, because they will get several significant benefits (relative to directly investing in the same HF or FoHF strategy): (1) higher returns, without a proportionate increase in risk; (2) daily liquidity (if publicly held) instead of lockups, periodic liquidity, notice periods, and gating; and (3) tax deferral on annual returns for U.S. taxable investors and capital gains rates for U.S. and UK taxable investors. The merits of these will be covered in the next Chapter "Significantly Improving the Investor Proposition".

An IPO of a startup or early stage company runs counter to conventional wisdom, but in (re)insurance and banking, there are significant precedents. In the insurance and reinsurance business, I have had direct involvement with three companies that raised their startup capital in an IPO: (1) PartnerRe (\$980 million in 1994); (2) Annuity and Life Re (\$360 million in 1998); and (3) Scottish Annuity (\$250 million in 1998). In 2005, Merrill Lynch raised \$1 billion for Lancashire Holdings for a startup IPO in London.

Virtually every bank in the U.S. was initially financed through an IPO. In fact, U.S. banks are exempt from registration under the Securities Act of 1933, because public policy in the depression encouraged bank formations but was against concentrated power in banking. Government could diffuse power by making it easier for anyone to become a shareholder in any new bank (hence the exemption).

There are several reasons that a startup or early stage insurer, reinsurer, or bank can finance itself through an IPO. Most new businesses only try to raise enough capital to get to cash flow breakeven, without diluting the founders more than is necessary. Because overheads in new insurers, reinsurers, and banks are relatively low as a percentage of equity capital, these businesses are usually cash flow positive at the very beginning due to investment returns.

Furthermore, founders of new insurers, reinsurers, or banks rarely get cheap stock (they usually participate in the upside through options and warrants, which have notional values proportionate to the size of the financing – that is an incentive for them to make the startup or early stage company as large as possible), so dilution is rarely an issue for the founders.

Another reason that a startup or early stage insurer, reinsurer, or bank can raise its initial or early stage capital through an IPO (and allocate all of its investable assets to a HF or FoHF strategy) is that there are no diseconomies of scale. Most startups raise an amount of capital to target a specific return on that new capital. However, raising twice as much capital is unlikely to double the magnitude of the return, because the second increment of capital cannot be deployed as profitably as the original amount and the extra capital dilutes the founders.

If an insurer, reinsurer, or bank invests the IPO proceeds in a HF or FoHF strategy, then twice as much capital should generate at least twice the returns and four times should generate four times etc. Up to a point (passed by Berkshire long ago), size is also an advantage in insurance, reinsurance, and banking. First of all, size improves ratings so each entity can charge more for the same product or get the flight to quality nod when pricing is the same. Furthermore, size makes it easier to attract better talent. Lastly, after-market liquidity is better and more institutions will be able to own the stock.

If an investment bank likes the story enough, it can sell air conditioning in the Arctic and hangar heaters in the Amazon. Investment bankers are paid on the number of zeros separated by commas, so size matters for them. Since most startups and early stage companies limit the size of their initial financings due to diseconomies of scale and dilution issues, and because the investment has significant downside risk, they are not attractive enough to get the attention of major investment banks.

However, IPOs of startup insurers, reinsurers, or banks raising hundreds of millions (or billions) of dollars at book value, with significant commitments from the manager, his existing clients, and/or Strategic Investors has limited downside risk, is a story an investment bank can sell, and the payday is attractive.

Based upon the HF or FoHF manager's demonstrated preference for investing in the startup (motivated by the prospect of significantly better returns than he would get in his funds not to mention the prospect of fees on permanent capital that could exceed 60 to 260 times his personal investment), he can craft a business plan and forecasts for the (re)insurer or bank and try to convince as many of his investors to follow him as is possible, but strictly subject to an IPO (no IPO, no obligation to invest).

Every investor who follows the manager converts his investment from something that can be redeemed to permanent capital. Based upon the HF or FoHF manager's personal commitment and the commitments made by investors who know him or her well, he or she can recruit management and a board, and try to convince Strategic Investors with recognized expertise in alternative assets and/or insurance, reinsurance, or banking to invest as part of the IPO (again, no IPO, no obligation to invest).

Private Equity and Real Estate Funds

It is not nearly as easy to apply these principles to private equity and real estate funds, but we believe that with some variations, it could work. While we have not completed any transactions with managers of either of these types of funds, we have held numerous exploratory meetings with managers in each of these areas and are hopeful of completing at least one in 2012 or 2013.

The primary motivation is permanent capital so that the manager isn't faced with having to raise another fund once all capital in the preceding fund has been deployed. A secondary motivation is to use bank financing in a variety of ways that do not breach large exposure restrictions, yet facilitate transactions. The third motivation is to use the structural tax advantages to buy and sell businesses and properties.

Should any private equity or real estate funds be interested in exploring this avenue, please feel free to contact me.

Next: Chapter 6 – Significantly Improving the Investor Proposition

CHAPTER 6 - SIGNIFICANTLY IMPROVING THE INVESTOR PROPOSITION

Overview

While it is possible to obtain a number of benefits of (re)insurance or banking relative to a partnership structure without the involvement of his investors, there are significantly greater benefits for the manager if his investors come along for the ride. However, his investors will only join the party if it clearly improves their investor proposition, relative to investing in his fund structure. The purpose of this chapter is to conclusively demonstrate that investing in a (re)insurer or bank that allocates all of its investable assets to a given strategy will significantly improve the investor proposition, relative to investing the same amount in a fund managed by the same manager in the same strategy.

When any investor makes an investment, he or she surveys the landscape and commits to the one investment whose prospective returns exceed all others of a similar degree of perceived risk and/or legal and regulatory constraints at that moment in time. As such, it is assumed that each investor in a given HF, FoHF, or family office portfolio has already come to this conclusion about that fund when he or she initially invests and then continues to hold the fund only if there is nothing better to invest the after-tax proceeds of the fund investment into something more promising.

For purposes of this section, we will assume that the prospective investor has decided on a fund strategy and has narrowed his or her choice to either investing in (or holding, if already an investor) a given fund relative to everything else. Or ... should he or she invest in an insurer, reinsurer, or bank that allocates all of its investable assets to that same strategy managed in the same fashion by the same manager.

To make this choice, the investor needs to examine the sources of return, terms, and conditions for an investment in a fund (could be a FoHF) or an insurer, reinsurer or bank, and the risks of the fund relative to those for an insurer, reinsurer, or bank that allocates its investable assets to that given strategy.

As such, I plan to demonstrate that all investors in insurers, reinsurers, or banks that allocate all of their investable assets to a given strategy should enjoy: (1) significantly better returns than funds using the same strategy, without a proportionate increase in risk; (2) equal or better liquidity (daily if there is an IPO); and (3) gentler tax treatment in the UK, the U.S., and many other jurisdictions.

Operational Profits in Insurance, Reinsurance, and Banking

The essence of insurance or reinsurance is taking in a premium for a specific coverage and investing it until claims have to be paid and expenses are incurred. Funds set aside to pay claims and expenses are known as reserves. Industry wide, premiums minus claims minus expenses generally works out to be minus 3% per year in the property and casualty business and minus 4% per year in life insurance. However, most insurers and reinsurers invest both their equity and their reserves in a long only fixed income strategy that tends to earn about 5% per year. Thus for each \$1 in reserves, the typical property and casualty insurer or reinsurer nets 2% per year per increment of reserves (usually 5x equity capital) from operations and the life insurer nets 1% per year per increment of reserves (usually 10x equity capital) from operations.

The essence of banking is to take in deposits and lend them to borrowers, earning an interest rate spread and some fees. Thus, operating profits are the sum of interest income plus fees minus the cost of deposits minus expenses. The typical bank earns operational profits of roughly 1% for each \$1 in deposits.

Suppose that I were able to start an insurer, reinsurer, or bank with only \$100 of capital and nothing ever goes wrong. Furthermore, suppose that policyholders ignore the level of capital and bought so much coverage at standard prices that the \$100 insurer or reinsurer had \$10 billion in reserves (and nothing ever goes wrong). By the same token, suppose that depositors ignored the paucity of capital in the \$100 bank and made \$10 billion in deposits (again, nothing ever goes wrong).

Theoretically, the low level of capital has no bearing on the operating profits of either business. Thus, ROEs are more or less infinite in these examples. Because nothing ever goes perfectly, regulators (and market discipline) require minimum levels of equity capital to support given amounts of reserves and deposits. While this minimum amount of capital is invested, the returns on this investment are independent of the operating profits (or losses).

So how does this turn out? In property and casualty insurance and reinsurance, a typical company carries \$5 in reserves for each \$1 in equity. In life insurance and banking, they carry \$10 in reserves or deposits for each \$1 in equity respectively. At 2% for each increment of reserves in property and casualty insurance and reinsurance, operating profits translate to ROEs of 10% per year. At 1% for each increment of reserves in the life insurance business and each \$1 of deposits in banking, operating profits also tend to equate to ROEs of 10%.

When added to the 5% earned from investing the equity in long only fixed income securities that are held to maturity (which is the core strategy for insurers, reinsurers and banks for tax and accounting reasons), these companies tend to earn 15%, pre-tax and 8% to 10% after-tax. Later on, we will see how this model changes when an investment strategy that can consistently generate better returns than long only fixed income over long periods of time is introduced into the equation, but for the time being, let's examine the economics of the HF, FoHF, and family office investment strategies and structures.

Investing in HFs, FoHFs, or through Family Offices

When an investor buys into a fund at NAV, he or she may be subject to a combination of lock ups, longer than one month redemption periods, lengthy notification periods, gating and, in extraordinary circumstances, suspension of redemptions altogether. In many cases recently, funds have suspended redemptions. When he or she can exit, it is also at NAV.

In addition, in the UK and many other jurisdictions, taxable investors in funds are only taxed on their gains when they exit the investment, but at far higher rates than their capital gains rates on stock investments. In the U.S., taxable investors are taxed each year on any dividend or interest income and any realized gains in the portfolio (if the fund actively trades, these gains are also usually subject to ordinary income rates).

Summarizing - a \$1 million investment in a fund comes in at NAV, has limits on its liquidity, compounds at whatever rate of performance, exits at NAV, and may be subject to taxation on annual gains or taxation on exit at very high rates.

For example, assume that \$1 million is invested in a fund yielding 12% per annum, net of all fees and expenses. Aside from liquidity constraints and taxation issues, the \$1 million would grow to \$3.11 million in 10 years, for a gross return (net to an offshore or tax-exempt investor) of \$2.11 million.

However, if the investor is taxable in the UK, he is subject to a 50% tax on his returns leaving a 10 year net gain of \$1.05 million. If he or she were based in Florida (whose 35% rate is 15% lower than the UK rate), he or she would have only \$1.00 million in a 10 year net gain (a lower return despite a lower tax rate illustrates the power of tax deferral). If he or she were a New Yorker, the 10 year net gain would only be \$690 thousand (this hardly seems worth the effort relative to New York municipal bonds).

Investing in Insurers, Reinsurers, and Banks

When that same \$1 million is invested in a startup insurer, reinsurer, or bank that allocates all of its investable assets to a HF, FoHF, or family office strategy, ***the capital works twice***. First of all, if the equity capital is invested in the strategy and if the (re)insurer or bank breaks even operationally, it should earn the same return as the fund. (Since the (re)insurer or bank can take advantage of less liquid opportunities without fear of redemptions – Buffett has bought more than 80 whole companies - it is arguable that the equity capital of the (re)insurer or bank should outperform the fund).

However, the equity capital not only yields the same (or greater) returns as the fund strategy, it also provides the statutory capital to support the insurance, reinsurance, or banking businesses (and their attendant operating profits). Assuming that we simply substitute an investment strategy that yields 10% (instead of 5% in long only fixed income) and everything else stays normal in the insurer, reinsurer, or bank, then pre-tax ROEs grow to 20%. However, the insurer, reinsurer, or bank can be structured in such a manner to minimize corporate income taxes, so the 20% is roughly the same after-tax (compounding at Berkshire's rate rather than the S&P 500's).

If the insurance, reinsurance, or banking business breaks even, then the insurer, reinsurer, or bank would earn the same (or greater) return that the fund does. If the insurer, reinsurer, or bank loses on its operational activities, then its ROEs would be less than the returns on the identical fund strategy (although the tax system is still likely to take more out of the fund returns than the losses from insurance, reinsurance, or banking so the investment would still be worthwhile for taxable investors in the UK or U.S.). To the extent that the insurer, reinsurer, or bank profits from its operational activities, then the ROEs of the insurer, reinsurer, or bank should significantly exceed those of the funds.

As it will be shown, it is relatively easy to make a profit from insurance, reinsurance, or banking operations and very difficult to either consistently lose money in them or lose money over multiple time periods. Assuming that this is true, then each startup insurer, reinsurer, and bank that allocates its investable assets to a given fund strategy should reasonably be expected to have higher ROEs than a fund with an identical investment strategy, without incurring a proportionate increase in risk.

These ROE enhancements can be significant. An insurer or reinsurer with a core investment strategy yielding 10% could readily have ROEs in excess of 24% and a bank with a core strategy yielding 10% could readily have ROEs in excess of 30%.

While these may seem out of line with reality, it must be remembered that a conventional insurer, reinsurer, or bank generally uses long only fixed income instruments that are held to maturity as its core investment strategy (Buffett has done it with 12% returns while being taxable).

Higher ROEs mean the book value of an insurer, reinsurer or bank will be far higher (proportionately) in the future (when compared to the NAV of a fund with an identical strategy) than the relative proportion of ROE differential, due to Einstein's eighth wonder of the world (compounding). In other words, twice the rate of return means far more than twice the returns over long periods of time.

However, higher ROEs are only part of the story. Assuming that the book value of an insurer or reinsurer is believable (unlikely today), insurers and reinsurers tend to trade at 1.25 to 2.5 times book value. Assuming that a bank's balance sheet were believable (also unlikely today), banks tend to trade at 1.5 to 3 times book value (Swiss banks other than UBS and Credit Suisse have believable balance sheets and still trade in this range). Hedge funds and funds of hedge funds redeem at NAV.

Using a figure closer to the lower of the multiple of book value range (1.25 x for insurers or reinsurers and 1.5x for banks), the gross value of the investment in an insurer or reinsurer increases by another 25% and another 50% for a bank, setting even a greater multiple of distance relative to a like investment in the fund (still no proportionate increase in risk).

Combining the higher ROEs with market multiples, a \$1 million investment in an insurer or reinsurer with a core investment strategy yielding 10% should be up \$9.7 million in 10 years versus only \$1.61 million in a fund with an identical strategy, which is nearly a six-fold improvement. As noted earlier, we call this difference "Structural Alpha", since the difference is largely created by the structure rather than by investment decisions.

A \$1 million investment in a bank should be up more than \$19.7 million or more than 12 times the return of the fund in 10 years. This gross difference would be the benefit for an offshore investor or a tax-exempt investor and should be more than enough to attract offshore and tax-exempt investors.

If this were not enough, there are additional benefits beyond significantly better returns relative to directly investing in the HF or FoHF for some or all of the investors. Assuming the insurers, reinsurers, and banks are publicly traded, the investor also has daily liquidity (instead of lock ups, periodic liquidity, notice periods, gaiting or suspensions that most hedge funds and funds of hedge funds impose or can elect to impose).

In addition, there are no annual taxes on earnings at the corporate level for insurers and reinsurers (and minimal for banks) nor are there annual taxes on the investor's share of the earnings for U.S. taxable investors. When U.S. and UK taxable investors (who have held their shares for a proscribed period of time) sell their shares, their gains will be taxed at far lower rates than they would have been if the same amount had been invested in the HF or FoHF with an identical investment strategy.

Thus, taxable investors will see a far greater percentage of the gross return after taxes than they would in the fund, so the difference between the insurer, reinsurer, or bank is even greater when compared to after-tax returns of the fund. When these insurers, reinsurers and banks are profitable from operations and market multiples kick in, the tax benefit is icing on the cake, but is only 10% to 20% of the performance differential between the insurers, reinsurers, and banks and the funds. Nonetheless, the tax benefits for UK and U.S. taxable investors are a significant hedge against operating losses.

Tax-exempt investors in the U.S. usually avoid investing in onshore funds, because they often use leverage, take short positions, and use derivatives, each of which can cause the tax-exempt to become taxable due to Unrelated Business Taxable Income ("UBTI"). Consequently, they invest in offshore

funds, if at all, and even then, those tax-exempts that are covered by ERISA can cause anguish for offshore funds in terms of making the offshore fund subject to ERISA. Tax-exempt investors in offshore insurers, reinsurers, and banks are also exempt from UBIT taxation issues and the ERISA issues go away, regardless of the size of their investment relative to the total capital of the company.

While no one should ever invest in a company solely for tax reasons, tax benefits can be a competitive advantage (as the Bermuda insurance industry repeatedly demonstrates) and tax efficiency can also turn average returns for the fundamentals of a business into great returns and great returns for the fundamentals of a business into spectacular returns.

In order of importance, higher ROEs are the primary driver of these superior returns for insurers, reinsurers, and banks that allocate their investable assets in fund strategies, followed by market multiples, and tax benefits (only when applicable) as a distant (but not unimportant) third.

Operational Profits without a Proportionate Increase in Risk

All of this sounds good provided that operating profits occur in the insurance, reinsurance, and banking businesses. While there can be no guarantees, these types of businesses can generally be operated to virtually assure an operating profit.

Anecdotally, insurers, reinsurers, and banks have to compete with the rest of the world for equity capital, so they must post ROEs comparable to other companies to do so. They can usually do this in one of three ways - invest their assets to achieve equity like returns, be more operationally efficient than the competition (thus increasing operating margins), or price their products higher (without chasing business away).

Since they generally invest their assets in long only fixed income securities, they start in the hole with respect to equity like returns and they must rely on a combination of operating efficiencies or pricing superiority (underwriting in the case of insurers or reinsurers) to make up the difference.

Regulatory regimes often restrict operational efficiencies and pricing opportunities. Because there are few operating efficiencies to be had unless total change is made to the fundamental business (think of Berkshire's GEICO selling direct), and because regulations and commoditization of the products tend to harmonize pricing, and because most insurance is high frequency, low severity in nature and all actuaries have identical data, there are very few edges to be had. In the high severity, low frequency arena, it is arguable that luck plays a huge factor in the results at the event level, although a highly diversified portfolio of uncorrelated low frequency, high severity risks should mitigate this.

Thus, the conclusion is that the industry's operational efficiency and pricing as a whole is enough to overcome the investment deficiency that takes place due to long-only fixed income investing and if one can simply match the operational efficiencies and pricing of the insurance, reinsurance, or banking industries as a whole, it should make fairly substantial operating profits (after all, the competition must do so to remain competitive for equity capital, given the lag in investment returns on their equity).

One of the keys to profitability in insurance, reinsurance, or banking is avoiding one of Taleb's Black Swans. In insurance or reinsurance this means contractually limiting tail risk or laying it off on a secured basis (merely converting reinsurance risk to credit risk is not enough). In banking, the key is to avoid significant loan losses and/or a bank run.

This is the defensive viewpoint. Let's examine a more optimistic outlook. There are significant opportunities in insurance, reinsurance, and banking (without proportionate increases in risk) waiting to be grabbed by those with vision.

Most hedge fund strategies depend on finding and exploiting inefficiencies in the capital markets, whereby the pricing tradeoff between risk and return is out of kilter with the natural laws of supply and demand. Systemic inefficiencies are far broader versions of the same idea. They may occur due to regulatory, accounting, taxation, ratings or mass purchasing behaviors that are so out of kilter with the natural laws of supply and demand that they beg to be exploited.

Opportunities in Insurance and Reinsurance

The insurance and reinsurance industries offer a treasure trove of these systemic inefficiencies, beginning with the granddaddy of them all – an investment strategy that is predominant in the portfolios of most of the insurers and reinsurers in the world: Buy and hold, long-only, high-grade, fixed income securities. In the U.S. and in many other jurisdictions, this investment practice is the vestige of a balkanized regulatory environment that has existed for more than 100 years when fixed income investing meant hold to maturity rather than its evolutionary changes over the last 35 years.

In many cases, this cultural DNA has been passed on to successive regulatory offspring who are the result of a Darwinian selection process: those who would be inclined to think differently would never become insurance regulators (or join the insurance or reinsurance industries) and are better suited to the more interesting and higher paying worlds of investment banking, commercial banking, asset management, and (shudder) hedge funds.

Those who are inclined to accept this old way of thinking are not competitive enough for the more lucrative world (including entry into the higher paying insurance and reinsurance industries) and become insurance regulators by default. This situation is further abetted by the lack of talent in the insurance, reinsurance, and ratings industries, ratings agency practices (just look at the monoline situation), accounting treatments, and tax regimes.

While financial services are higher up the economic food chain than working as a regulator, employment in the insurance or reinsurance industries or with ratings agencies is still a far cry from the rest of the financial services industry in terms of an interesting environment and compensation, so there are far fewer of the best and brightest in their midst.

By way of anecdotal illustration, a former professor at a top tier business school, who had also served as high level federal regulator and later in a very senior position with a major Wall Street firm, was asked how many of his former students worked for investment banks, large consultancies, commercial banks, asset managers, and hedge funds. In each of those categories, he could think of many. When asked if any of his former students had joined the insurance or reinsurance industries, he could not think of one.

To the extent that the Lehman Bond Index is a proxy for a high grade, long-only fixed income strategy, there are numerous studies that show that a diversified portfolio of hedge funds consistently yields better returns with less volatility than the Lehman Bond Index. The same could be said for many single manager strategies.

Thus, a truly conservative regulator or ratings agency should applaud any insurer that turned its back on long-only fixed income investing for better risk adjusted returns in a diversified portfolio of hedge funds. Ain't gonna happen.

Regulators confuse risk of default with investment risk and regard volatile assets (that are not likely to default) as less risky than "risky" hedge funds (which also tend not to go to zero unless there is fraud). This is further exacerbated by regulatory ignorance that equates hedge funds with leverage, while ignoring the fact that a hedge fund leveraged 2 to 1 is far less leveraged than the larger banks they regulated with leverage between 60 and 100 to 1 before the crisis.

It is no mere coincidence that the two greatest companies in the history of the insurance business, Berkshire Hathaway and AIG (ex-credit default swaps), have never followed the conventional wisdom when it came to investment strategy. Buffett is known as the "world's greatest investor", not the "world's greatest insurance guy", but the results of his insurance and reinsurance businesses have been spectacular. No one else in the insurance or reinsurance industries fills any of the next places on any one's list of great investors. In the land of the blind, the one-eyed man is king.

Accounting and tax treatments also perpetuate systemic inefficiencies in the insurance and reinsurance industries. Insurers and reinsurers in the U.S. can avoid any mark to market impact on their balance sheets or income statements, when they designate fixed income securities as "held to maturity".

Under U.S. GAAP, if they sell any defaulted securities so designated, they must mark to market the whole "held to maturity" portfolio on the balance sheet. If they designate securities "available for sale" in order to take advantage of interest rate changes, they must mark them to market for balance sheet purposes, but not for income statement purposes.

Fixed income securities available for trading and all other securities (such as equities) must be marked to market for both balance sheet and income statement purposes and any fixed income securities designated as "held to maturity" or "available for sale" that are found to be subject to trading run the risk of having the entire portfolio run through both the income statement and balance sheet. So, what do they do? Fixed income held to maturity. Safe. No mark to market. But, underperforming.

For the insurer or reinsurer who worries about smooth earnings growth, trading fixed income securities or holding equities, hedge funds, funds of hedge funds, or private equity funds make the task nearly impossible. Powerful incentive to buy and hold fixed income securities. On the other hand, if one is more focused on compounding since inception (as is Buffett and most alternative asset investors) in spite of the volatility of earnings, equities (whether traded or held for the long term), trading fixed income securities, and alternative asset strategies should win out in the end.

As Buffett says, "We would rather have a lumpy 15% than a smooth 12%"

Another accounting treatment that alters the natural laws of supply and demand in the insurance and reinsurance industries is that U.S. GAAP does not permit property and casualty insurers or reinsurers to discount their reserves for reporting purposes (but the IRS requires them to do so for tax purposes).

When interest rates are very low, as they have been recently, there is very little impact on behavior. However, at higher levels, many insurers and reinsurers will take a pass on certain liability business because they will have to take an earnings hit and will have to pay taxes on the non-cash underwriting "profits" that they cannot report at the same time.

Under IFRS, all investments are marked to market for income statement and balance sheet purposes and reserves are discounted for reporting purposes, bringing cash flows and earnings into line with each other (as each year passes, the company earns income on its portfolio to offset the reserve creep that occurs as the discount applies to one year less).

The combination of the investment, regulatory, and tax systems also encourages a significant number of insurers and reinsurers to invest in municipal bonds. In addition, avoiding U.S. taxes has been a major driver in attracting more capital to Bermuda than exists in insurance or reinsurance industries of any other country other than the U.S.

The insurance industry also offers systemic inefficiencies in terms of policyholder behavior. In many forms of insurance, the actuarially fair price for the risk assumed is conveyed to the buyer (usually via an agent) by means of comparison between competing vendors or dictated by regulators. In many others, insurance is ancillary to another transaction (often dictated by a third party), the cost of insurance is small compared to the cost of the transaction, and the buyer is unable to easily compare prices.

Examples of this might include being required to buy title insurance when buying a home or credit life or disability insurance when financing any large purchase. Other examples entail point of sale insurance sales such as warranties, rental car insurance, and extra insurance for shipping packages (UPS built a \$2.5 billion business in Bermuda, tax-free, off of this). While insurers compete heavily for this business, the key to success is in sharing the profits with the point of sale or transaction providers.

Given all of these systemic inefficiencies, how does one exploit them? Simply set up an offshore reinsurance company.

I favor reinsurance over insurance by a wide margin. Insurers tend to be very transaction and operationally intensive. Lots of salesmen, lots of monthly premiums, lots of administration, lots of claims. Reinsurers do not need a lot of people, but they do need persons who are a cross between actuaries and investment bankers to structure contracts.

Thus, our reinsurers tend to take one of several forms, each of which is designed to take advantage of the fact that competitors structure products using buy and hold fixed income returns in their pricing, while our reinsurers assume that the assets will earn superior risk adjusted returns, especially if the assets can be held for more than five years on average, and they can structure the contract and price competitively to get the business.

Recurring themes include:

- (1) general reinsurers who provide capital capacity to 4,000 captives and 4,000 small and medium sized insurers in the U.S. virtually all of which are profitable.
- (2) specialty (re)insurers that can hedge their tail risks in the reinsurance or capital markets;
- (3) insurers and reinsurers whereby there is an underwriting and/or investment profit participation with the producers of the business or point of sale gatekeepers

In each case, the objective is to gain long-term assets that earn higher risk adjusted returns for the benefit of both the hedge fund manager (who does not have to make any sales calls to significantly increase AuM) and the shareholders.

When an insurer goes offshore for its reinsurance, the assets become less regulated (investable in alternative assets) and because they now belong to the reinsurer, their returns are untaxed (the onshore insurer's investment returns would be taxed as Buffett's have been and are and AIG's have been in the past). Furthermore, if the reinsurer mirrors the onshore insurer's investment strategy the reinsurer gains no investment edge in assuming risks and needs to have a likelihood of losing less and/or making more on an underwriting risks than the insurer would.

However, when the reinsurer is confident that he will realize superior risk adjusted returns in his investment portfolio relative to a diversified portfolio of fixed income securities or the 10 year Treasury (particularly over longer periods of time), he can leave some of the expected underwriting profit to the insurer in order to attract the business, so he can invest the assets and more than offset the reduced profitability from underwriting (provided that tail risk is capped).

The profitable insurer often reinsures to create capacity to write even more business (earning additional profits) without having to increase its capital (and investing the proceeds the old fashioned way, which hurts ROEs) or to reduce the capital tied up in the business (most captives). For the profitable insurer, most reinsurance is analogous to a bank securitizing a loan portfolio and collecting fees for servicing it.

Scottish Annuity and Max Re

One of the major objections that we face with prospective clients is tied to the histories of Scottish Annuity (later Scottish Re) and Max Re (now Alterra). In the late 1990s, two hedge fund managers sponsored the formation of two startup reinsurers that eventually became publicly traded. Maverick Capital (Lee Ainslie) sponsored Scottish Annuity and Moore Capital (Louis Bacon) sponsored Max Re. The original intention of each was to have the respective managers manage all of the investable assets.

Neither was a smashing success. The traditional investment establishment (mutual funds, long-only managers, Wall Street analysts) remembers that they were hedge fund sponsored and cites their lack of success as evidence that an investment driven insurer or reinsurer simply doesn't work (even with hindsight, they might still say the same thing about Berkshire). But is this correct?

As the two companies evolved, a combination of insurance executives, Wall Street bankers and analysts, and traditional insurance investors (the "traditionalists") watered down the originally intended investment strategies.

In the case of Scottish, Lee Ainslie never managed any of the assets. In the case of Max Re, the strategy quickly evolved to 50% alternatives and 50% long-only fixed income and then the 50% alternatives morphed into 10% to Louis Bacon and 40% to a fund of funds run by his brother Zach (who had no previous FoHF experience of significance and was never able to make a great success of his own FoHF business). Max Capital's alternative investment portfolio was eventually reduced to less than 5%.

I have reviewed the results of Scottish and Max over the years and reconstructed each of them as if Ainslie and Bacon had managed all of the assets as originally conceived. In each case, the companies raised roughly \$800 million of equity capital over the last 10 years. In the case of Scottish, the maximum amount of cumulative earnings was on the order of \$400 million (net worth of approximately \$1.2 billion) and in the case of Max, the cumulative earnings were roughly \$500 million (net worth of roughly \$1.3 billion).

Superimposing Lee Ainslie's returns on Scottish's assets over its history would have added more than \$2 billion to the maximum net worth. Scottish eventually shot itself in the foot with an imbedded derivative in its reinsurance contracts and did not survive in its original form. However, it is arguable that if a talent like Lee Ainslie had managed the Scottish portfolio and held a major equity stake (as originally intended and as David Einhorn does with Greenlight Capital Re), Ainslie would have taken an active interest in the company and it would have avoided the calamity of the imbedded derivatives (I have every confidence that David Einhorn will avoid this type of irresponsibility at Greenlight Capital Re) and even if Scottish still suffered from the imbedded derivatives, the extra \$2 billion cushion would have probably ensured its survival. Missing out on Ainslie's magic was an exceptionally costly mistake.

In 2010, Max merged with Harbour Point (formerly Chubb's reinsurance business) to form Alterra and since it did not kill itself in the reinsurance business, the comparison of what could have been and what has happened is far more instructive.

Over its life, Max's cumulative investment returns were approximately \$1.25 billion and have averaged 5.5% per year. Since its cumulative earnings were roughly \$500 million, it means that underwriting losses were approximately \$750 million or 3% per year (consistent with industry economics). By comparison, Buffett's cumulative underwriting losses were 1% to 2% for more than 40 years, but he invested the "float" – 2x equity capital at far higher returns than 1% to 2% and earned leveraged profits (the leverage was not only cheap, but its availability was tied to insurance events, rather than asset values or lender stress).

During the same time, Bacon earned 10.1%. Superimposing those returns on Max's assets over the life of the company, the net worth would have been roughly \$1.9 billion greater (\$3.2 billion vs. \$1.3 billion). Alterra currently trades well below book value and would likely trade at a significant premium to book if Bacon had managed its assets (IRRs significantly greater than 20%). Which version of Max would you want to own? Put another way, would you want to own Berkshire if Buffett only ran 10% of the assets?

If Ainslie and Bacon had run the assets of Scottish and Max, would the earnings have been lumpy? Of course they would have been. But their fund earnings were lumpy anyway, and their (far more) sophisticated investors have stayed. In the interest of pleasing insurance executives who do not have the ability to reorganize their thinking, Wall Street bankers and analysts who have always done it their way, and traditional investors, a combined \$1.6 billion of investor capital was unnecessarily dumbed down and earned roughly \$900 million over 10 years, leaving nearly \$4 billion on the table. QED.

Opportunities in Banking

Banking also offers significant systemic inefficiencies. These also include regulatory, accounting, taxation, ratings, supplier, or mass purchasing behaviors that are out of kilter with the natural laws of supply and demand.

Think of how inefficient the processes of gathering deposits and making loans are. Ordinarily, they are people intensive and expensive. Depositors are either too small or have liquidity needs that prevent them from being paid a fair rate for the weighted average duration for their collective deposits. Lenders need to balance spread opportunities against liquidity requirements.

Thus, a bank that can lower the cost of, but pay more, to attract deposits (think ING Direct or the inter-bank wholesale markets) or can pay less (think Swiss private banking) and still attract deposits would have a significant advantage as would a lender that can lower costs without a proportionate decrease in

interest income or increased liquidity issues (think margin lending at Merrill Lynch, prime brokerage to hedge funds, and the inter-bank wholesale markets). Invest the bank's assets in a better risk adjusted portfolio and/or outsource its proprietary trading activity to the hedge fund industry and move it offshore so that it is barely taxable and the expected returns become very, very attractive.

Another market inefficiency that can be exploited by banks is the *raison d'être* for most Asset Based Lending ("ABL") funds. ABL funds suffer from two mismatches: (1) Assets and Liabilities; and (2) Opportunities and Funding. Lending long with shorter redemption periods has been a recipe for disaster. Even when things work, the manager throws many hooks on the water and if too many are ripe, he or she has to scramble for funding or miss an opportunity. If he or she takes in funds before opportunities present themselves, he or she impacts returns.

If the skills of an ABL fund manager could be directed to the loan portfolio of a bank that he or she controlled, then it is arguable that his or her investors would be better off as shareholders in the bank than as investors in a credit fund run by the same lending guru.

Anecdotally, I know of a credit fund whose loan participations were 100% performing. Unfortunately, the fund was levered six to one (very conservative for a bank) and when the subprime crisis hit, they suffered redemptions. The prime broker was nowhere to be found to bridge the need, so each \$1 of redemptions required \$6 of loans to be sold. There were no buyers. As loans were sold at steep discounts, losses were reported and more redemptions occurred. The spiral was on.

Had those same loan participations been on the books of a bank and if they were still performing, there would have been no redemptions or write downs. There is no reason that we can see for an ABL fund manager to operate through a fund, instead of a bank.

As asked in the Michael Caine movie, "So ... What's it all about, Alfie"?

Just prior to going public, Goldman Sachs had something on the order of \$210 billion of assets, \$203 billion of liabilities, only \$7 billion of equity, and an off balance sheet swap and derivatives book with a notional value of roughly \$3 trillion. Some might argue that the notional value should have been added to both sides of the balance sheet.

Regardless, the assets are the assets are the assets. It is brain power that makes those assets perform. What is amazing about Goldman Sachs is that the duration of its liabilities could have been measured in nanoseconds. The duration of liabilities in the life insurance industry is often 30-50 years, so it is arguable that a life insurer that had the brain power to run the assets like Goldman Sachs would be far better suited to handle Goldman Sachs balance sheet (and even more profitable). The same could be said for a property and casualty insurer, a reinsurer, or a commercial or private bank. The instability of traditional funding sources for broker dealers sunk Bear Stearns, Lehman, and Merrill Lynch and Goldman and Morgan Stanley became commercial banks to access more stable funding (deposits).

While a life insurer (or reinsurer) or bank is unlikely to attract that brain power, it can rent it from alternative assets managers. For all of the structural reasons previously outlined, that is very unlikely to happen. What is more likely to happen is that alternative assets managers will most likely start (or take over – but legacy liabilities and the premium to book value entry fee makes this less likely) insurers, reinsurers, or banks and impose those risk adjusted economics from without.

The total equity capital of the North American life insurance, property and casualty insurance, and reinsurance industries was on the order of \$1.5 trillion at the end of 2010. The total equity capital of the U.S. banking system was less than \$1 trillion at the end of 2010. The total fee generating equity capital in hedge funds and funds of hedge funds was more than \$2.5 trillion at the end of 2010. Thus, the takeover or infiltration of the insurance, reinsurance, and banking industries by the HF and FoHF industries may not be so far-fetched an idea.

On June 5th, 2007, James Altucher wrote in the Financial Times, “My prediction is that the next big investment move we see will come from Mr. Lampert (Edward Lampert of ESL, which controls both Sears and K-Mart). He will end up doing what Mr Buffett did: getting into insurance. I would not be surprised to see him start his own insurance company or buy one of the more interesting players out there such as Endurance Specialty Insurance or Markel”. <http://www.ft.com/cms/s/d98445a0-1302-11dc-a475-000b5df10621.html>.

Going into the insurance or reinsurance business is a great idea for Mr. Lampert. Buying either Markel or Endurance would have been a terrible idea, because Mr. Lampert would have been ill-served in trying to acquire either of these companies at that time. To be sure, Markel is a fine company, one of the best in the industry. In fact, Markel comes closer to our model than any company other than Berkshire that was not sponsored by a hedge fund, FoHF, or family office manager (Markel invests its equity in equities, but invests its float in long only fixed income – thus, an operating profit enhanced equity mutual fund).

However, acquiring Markel or Endurance risks taking on unforeseen legacy liabilities (asbestos, pollution, tobacco, subprime-related D&O and E&O etc.) that rarely turn out to be pleasant surprises later on and can result in frightening financial restatements with alarming frequency.

Assuming that legacy liabilities were not a factor, in 2007, Markel traded at 1.8 x of book value (a \$1.3 billion premium – it now trades at 1.3x), so if Mr. Lampert acquired Markel, his capital would only work half as hard as it would if he started a new insurer or reinsurer offshore. A lot less than the nearly \$1.3 billion premium to book value of Markel could pay signing bonuses for all of the talent (whose last names are not Markel) that Markel has and have a lot left over for investment in Lampert’s strategy. Furthermore, his capital would be trapped in the inefficiencies of the U.S. regulatory, ratings agency, accounting, and tax regimes. Lastly, Markel’s earnings are taxed, whereas an offshore startup that replicated the best parts of Markel’s business would not be taxed.

In the case of Endurance, Lampert could have avoided the premium to book value (since Endurance traded at 1x of book value – it now trades at a 30% discount to book value) and avoid having his capital trapped in the inefficiencies of the U.S. system, since Endurance is in Bermuda. However, there is a reason that Endurance trades well below the market multiples accorded the industry (such multiples generally apply when the market suspects that liabilities are under-reserved), and complex U.S. tax laws makes it very difficult for a U.S. person or U.S. based business to take over an offshore reinsurer.

As such, I feel Mr. Lampert would have been far better off starting his own insurer or reinsurer offshore, so that he could have avoided the legacy liabilities, used a small portion of the premium to book value that he would dodge to lure the best talent, and avoided the regulatory, ratings agency, accounting, and tax traps of the U.S. system. It would also have allowed him to structure the mix of shareholders and voting rights from the outset to avoid unnecessary taxation. Given his performance and the expiration of his five year lockups in the interim, it is arguable that Mr. Lampert may have missed an opportunity and that miss could someday prove to be fatal.

CHAPTER 7 - INCREASING AuM AND PERMANENT CAPITAL

Background

The HF or FoHF structure is inherently unstable and many HF or FoHF funds have “blown up” when they suffer losses, which trigger redemptions, requiring untimely liquidations and a spiral of additional losses, further redemptions, and more liquidations may repeat itself (often more than once). Leverage further exacerbates this spiral because its availability is often tied to asset values or amount of equity and thus, it may be pulled and require multiple liquidations (per dollar of redemption) into falling markets, which further depress prices and may start another round of redemptions, liquidations, and losses.

Furthermore, the “high water mark” causes many HF and FoHF employees to leave during these cycles of loss, redemption, and liquidation, because they are unlikely to see any incentive fees for several years no matter how well they perform if they stay. On the other hand, if they join another firm, even a startup, they can immediately be rewarded for identical performance. By the same token, no one is likely to join a firm undergoing one of these cycles, since performance and compensation are disconnected until the high water mark is reached.

“Blowing up” rarely means that investors lose all of their investment, unless fraud is involved. However, investors often realize additional if not meaningful losses when a fund “blows up”, and a “blow up” usually means that significant redemptions have reduced the organization and/or the fund to a level that it is no longer able to realize the returns envisioned or the fund manager is unable or unwilling to continue to operate it.

This is what happened when XL Capital funded Front Point for two of the most senior members of Tiger Management. A number of the Tiger staff followed them out the door, and no one was available to replace them. As such, the largest hedge fund in the world went out of business, not because its investors lost everything, but because there were too few people left to service the remaining assets and investors continued to redeem until Tiger finally decided to return all remaining funds.

Using Tiger as a metric, for every 1% of loss, approximately 2% of the remainder of the fund was redeemed. When Tiger disbanded, it had delivered returns since inception in excess of 20% and had \$6 billion in AuM, which would still have made it one of the largest hedge funds at that time and more than viable in terms of size and performance. It just couldn’t service those assets. Nobody was home.

Ironically, while Tiger investors endured losses relative to the high water mark, many of them were long time investors who had actually prospered mightily from the time of their original investment in Tiger until their funds were returned. This is analogous to finding a stock early, riding it upwards, and then watching it back off 20%. At any time, these investors can choose to take a healthy profit or stick with the stock (as they have done with Berkshire Hathaway). In Tiger’s case, the early investors had still done exceedingly well; they just never had the opportunity to stick with the manager.

It is worth noting, that while Julian Robertson was no longer a manager, he has successfully seeded a number of new funds, which are known as the Tiger Cubs (and exempt from high watermark compensation implications as they would face if they were still part of Tiger).

Lock Ups and Closed End Funds

In the hedge fund industry, the traditional remedies for this instability are lock-ups (including variations, such as longer redemption and notice periods and/or gating) or closed end funds.

Lock-ups and their variations have historically met with investor resistance. Part of this stems from the fact that lockups sometimes exceed the real amount of time that a manager needs for an orderly liquidation. Even when successfully negotiated, lock ups are often too short to take advantage of some of the opportunities for superior performance that require a longer term view.

In 2008 and 2009, many managers have had to liquidate some of their most promising assets in order to meet redemptions and have done so at the expense of those who remain (including investors who might be loyal for the longer term). This is the equivalent of being in a theatre when someone yells "Fire", correctly deciding that it is a false alarm, but being trampled in the stampede anyway. As such, lockups, which were difficult to sell in the past, may be even harder to sell in the future.

Closed end funds are also problematic, because history argues that they are virtually certain to trade at a discount to net asset value. As long as investors can obtain a virtually identical investment strategy in an open ended fund at NAV, there is no reason to buy a closed ended fund with an identical investment strategy at a premium to NAV, nor does it make sense to even buy at NAV if its upside relative to NAV is capped and the likelihood is a discount when an open ended equivalent can always redeem at NAV.

Thus, knowledgeable investors usually avoid closed end funds on the offering (the investment banking, legal, and accounting fees put it at an immediate discount), preferring to take advantage of the sure discount in the aftermarket and purchase later on (advantageously vis a vis the open ended equivalent), if at all. If no one buys the offering, will there be an after-market discount to take advantage of?

To a large extent, closed end funds often depend on "dumb money". There have been a modest number of closed end hedge funds and closed end funds of hedge funds launched in the UK because two types of investors were willing to suffer a discount to NAV, provided that it was not too great: (1) taxable investors in the UK used to get far better tax treatment in closed end funds (in comparison to open ended funds), although newer UK tax rules have both eliminated and re-established some of this benefit (taper relief went from 10% to 18%, but ordinary rates have gone from 40% to 50%); and (2) certain regulated entities can only access the returns of hedge funds or FoHFs through closed end funds.

However, in order to succeed, most of these closed end funds have had to promise to buy back shares in the open market if the discount becomes too steep, so it is questionable whether or not this is really permanent capital (which is nonetheless far better for a manager than the normal HF or FoHF structure, although it is questionable that the complaint factor for an otherwise successful manager is worth it).

Furthermore, in one case, a large FoHF manager, FRM, was replaced as the manager of a closed end fund by Permal. Because the discounts have tended to be greater than tolerable (and became even less tolerable when the new tax rates were instituted in the UK) and because the universe demanding these benefits is somewhat limited in the first place, I feel that closed end HFs and FoHFs will likely become nearly impossible to launch in the future.

(Re)insurance and Banking

There is little doubt that Goldman gave up its partnership structure in order to obtain permanent capital and while it is uncertain whether permanent capital was part of Buffett's thinking in converting his partnership into an insurer, reinsurer, and bank, Berkshire has benefitted mightily from it.

The only permanent capital in the HF, FoHF, or family office businesses is partner capital. All other investors have redemption rights of some kind. As such, every investor that converts his partnership interest into shares of a (re)insurer or bank that allocates all of its equity capital to the HF, FoHF, or family office manager, is now providing permanent capital to that manager. Thus, if there are no other shareholders in the (re)insurer or bank than the manager and existing clients, this takes a lot of pressure off the manager and is of substantial value in and of itself.

However, begetting begets begetting. If there is enough of a commitment on the part of the manager and existing investors, it can instill confidence in strategic or public investors to join, and this capital is not only permanent too, but it also represents fee generating assets AuM that the manager would not otherwise have under management.

Equity capital, raised in an IPO, is only part of the permanent capital story. The equity should always be managed by the HF or FoHF manager and can never go away unless the company fires him (for complicated reasons, this is almost impossible to do, whereas in a closed end fund it is far easier).

However, insurers and reinsurers generate permanent capital in addition to their equity by issuing policies and contracts for premiums and investing those premiums (net of operating expenses) until claims are paid. Again, these are fee generating AuM that the manager could not otherwise have under management.

Banks can also generate permanent capital in addition to their equity by taking deposits and using them to make loans (in the case of credit strategies), provide portfolio financing for the HF or FoHF manager's investors, or directly invest in the hedge fund strategy (a prop book).

While premiums and deposits are not as quite as permanent as the equity capital, they are far more permanent than most lock ups and far more permanent than margin financing, without having their availability being correlated to asset values or the willingness or ability of the lender to continue to make margin loans.

To the extent that a (re)insurer continues to operate, new premiums replace reserves as claims are paid. To the extent that the net worth is growing, it can support ever increasing reserves if the underwriting opportunities are available. However, the availability is tied to (re)insurance events, rather than asset values or lender issues. This is the secret to Buffett's success. If he were a manager, instead of fee generating assets growing at 12% p.a., they would have grown at 32% p.a.

In banking, one key is to never have a run. This can be handled in a combination of several ways. First of all, a bank run is all about confidence. Simply never give depositors a cause for concern vis a vis confidence. One key ingredient is government backed deposit insurance. Another is to maintain a very liquid balance sheet and/or focus on deposits of a savings nature, particularly term deposits.

Most hedge fund managers gather assets the old fashioned way. They take out their knee pads and tin cups and go begging – one investor at a time. This is a tough road. It generally requires an appearance by the founder and/or portfolio manager and disrupts their ability to maximize returns. Premiums (for insurers and reinsurers) and deposits (for banks) are wonderful alternatives that do not take anywhere near the same effort to generate and do not tie up the founder or portfolio manager's time.

When a policyholder buys insurance, the insurer gets to hold the assets (less operating expenses) until a claim has to be paid. When an insurer buys reinsurance, the reinsurer gets to hold the assets (less the operating expenses) until the claims are paid. When an HF or FoHF manager sponsors an IPO for an insurer or reinsurer, he or she gets to manage the assets created by the premiums, without having to make a typical hedge fund type of sales call. (Re)insurance underwriters generate the assets and do so without requiring the founder or portfolio manager to make an appearance (which frees them up to concentrate on maximizing returns).

In some forms of insurance or reinsurance, the interval of time between collecting premiums and paying claims is very short (property insurance). In other forms, the interval of time between collecting premiums and paying claims is much longer or very long (life, medical malpractice, warranties). Some forms of insurance and reinsurance can be quite volatile (hurricanes in the Southeastern U.S.), while others are less volatile (structured reinsurance contracts – even if the underlying risks are volatile).

In order to avoid one of Taleb's Black Swans, the competitive advantage of the investment strategy allows the hedge fund sponsored reinsurer to contractually limit the magnitude of the worst possible scenario in exchange for leaving more of the underwriting profit with the ceding insurer (this is very attractive to very profitable insurers with capital constrained capacity limits).

Insurers and reinsurers can usually support premiums that create reserves of one dollar to three dollars for each dollar of equity, although higher and lower numbers might exist for differing lines of business. This means that insurers and reinsurers generate additional permanent capital reserves of 1 to 3 dollars for each 1 dollar of equity.

We generally use 1 to 1 through 2 to 1 (Berkshire's level of leverage) for forecasting purposes. Even if policyholders quit buying coverage, these funds remain for a long time and if policyholders continue to buy, new premiums usually replace claims that are paid, so the level of permanent capital is maintained (or continues to grow), arguably forever, which, in effect, makes it more or less permanent.

When a bank gathers deposits, the manager does not have to participate in the asset gathering side of the business as he does in the fund business. Depending upon his strategy, its liquidity metrics, and the deposit gathering strategy, a manager should be able to manage and generate fees on 10% to 100% of the deposit generated assets of the bank.

Banks can provide permanent capital for the manager in two ways: (1) by lending to and providing HF and FoHF linked structured products (rated and unrated principal protected notes, rated and unrated fund linked notes, total return swaps, barrier options, letters of credit for captive insurers and reinsurers) to investors in the manager's HF or FoHF strategies; and (2) by directly investing some of the deposits in the strategy itself (some credit strategies might be able to utilize most, if not all of the deposits this way).

For most hedge fund and funds of hedge fund strategies, the bank can take in up to 12 dollars of deposits for each 1 dollar of equity and use 10 to 11 dollars of the 12 dollars for lending purposes and 1 to 2 dollars of the 12 dollars as a “prop book”. For some credit strategies, all deposits can become fee generating AuM.

A word of caution - unlike insurance or reinsurance liabilities, which can last for years, if not decades, deposits can leave rather quickly and as a source of “permanent capital” might not be so permanent if the bank is not careful, although we have developed some methods to significantly mitigate this for most banks.

Summary

At the end of the day, the successful launch of an insurer, reinsurer, or bank can reasonably result in permanent capital of anywhere from 60 to 260 times the investment that the HF or FoHF manager may personally make (talk about an outsized return). Aside from the 10 to 20 times the return (22 to 45 times, if taxable) that the HF or FoHF manager can make as an investor over 10 years (as opposed to investing in his own funds), he or she also stands to earn incremental management and incentive fees each and every year that may be far in excess of the amount of his personal investment.

Because of their permanent capital, insurers, reinsurers, and banks with large amounts of capital have gravitas. Think about it. Do publicly traded HF and FoHF managers such as Och-Ziff, GLG, or Gottex have the market clout that a reinsurer or bank with equity capital identical to their AuM would have?

With their transitory capital, hedge fund managers are always at risk of becoming dinosaurs (Tiger showed that even the largest hedge fund manager can go out of business) and those that hemorrhage assets but eventually survive are unlikely to ever gain the respect or clout that an insurer, reinsurer, or bank can have.

Next: Chapter 8 – Monetizing HF Managers, FoHF Managers, and Family Offices

CHAPTER 8 - MONETIZING HF MANAGERS, FoHF MANAGERS, AND FAMILY OFFICES

Overview

Any HF or FoHF manager or family office that enters the insurance, reinsurance, or banking industries usually does so in order to:

- (1) raise a significant amount of new AuM;
- (2) obtain permanent capital;
- (3) take advantage of systemic inefficiencies available in reinsurance or banking;
- (4) significantly improve returns without a proportionate increase in risk; and/or
- (5) provide superior liquidity, income tax, UBTI, and ERISA solutions to investors

In doing so, the HF or FoHF manager or family office should also gain a very valuable option with respect to monetizing some or all of his or her firm.

The hedge fund industry has experienced a combination of growth and profitability unprecedented in the history of business. If a widget industry had the same growth and profitability metrics that the hedge fund industry enjoys, 99% of the profitable ones could easily monetize a portion of their business by selling out and/or monetize all of their business by selling out or going public.

On the other hand, I believe that fewer than 5% of all HF and FoHF managers will ever get one penny for any part of their business, because the hedge fund industry does not lend itself to being bought out or to becoming a public company, which are the two traditional means of monetization.

The IPO of a HF Manager, FoHF Manager, or Family Office

For most companies, an IPO not only monetizes the business, it also raises capital that can be deployed to increase profits. In addition, it provides currency to make acquisitions, decouples its shareholders from the lock step timing of a collective monetization when individual financial needs and ambitions vary considerably, and provides a more meaningful equity incentive for up and coming talent in the firm.

HF and FoHF managers do not require very much capital and, even if the proceeds were deployed in the investment strategy of the manager, it is unlikely that their portion of the balance sheet would command a premium to book value and might even cause the company to trade at a discount to book (although book value could rise significantly as returns and fees compound).

As such, the proceeds of most IPOs in this space have gone to selling shareholders rather than the company and the firms intend to pay out most, if not all, of their earnings (because they cannot put them to work effectively and for tax reasons in the U.S.).

Another negative aspect of an IPO for a HF or FoHF manager is the level of disclosure required. In an IPO, the company must bare its innermost secrets, even though the IPO may not be successful. Even if the success of the IPO were guaranteed, baring the innermost secrets of a HF or FoHF manager is antithetical to the hedge fund culture. After the IPO, Sarbanes-Oxley would likely be a cultural

nightmare for any publicly traded HF or FoHF manager that chose to list in the U.S. and flotation in other markets might not make as much sense if there is no natural connection to that market.

Investors in publicly traded companies like to see smooth upward growth in earnings. This is a problem for a publicly traded HF or FoHF manager, because EBITBA (Earnings before interest, taxes, bonuses, and amortization) will be somewhat dependent on performance and AuM.

When performance suffers as it did for most of the industry in 2008, fees decline (profits decline even more). Thus, earnings could fluctuate violently unless assets grow at a tremendous rate in the face of performance problems, which is unlikely. As mentioned earlier, when Tiger left the business it had suffered roughly 2% in redemptions for each 1% of loss.

Thus, redemptions are likely to exacerbate the problem and if and when the performance and redemption spiral ends, the fund manager is unlikely to ever recover to his former glory. As such, most publicly traded alternative asset managers have massively underperformed in the public markets and several have been unmitigated disasters (we believe that this will also affect their fund investors in terms of confidence in the manager with an attendant impact on AuM) .

Even if performance is steady, public markets expect growth and growth can only come from increasing AuM. The problem of accelerating AuM is the law of diminishing returns. In the hedge fund business, size kills and absolute size kills absolutely. If returns fall, and redemptions accelerate, it could have a disastrous effect on the stock price.

Lastly, the above negatives apply in today's tax environment but would be magnified and/or pale by comparison if proposed legislation altered the current U.S. tax laws. At this time, U.S. based hedge fund managers benefit from tax treatments of their funds. These benefits have been preserved to some degree by using REIT-like tax rules for the publicly traded managers.

However, legislation has been proposed to close these down for publicly traded HF or FoHF managers (it may ultimately fail to pass, grandfather those already public, or could ultimately extend to privately held hedge fund managers as well). If the ultimate scenario applies only to publicly traded firms, there will be even less reason go public than there is now.

A Total or Partial Sale of a HF or FoHF Manager

The history of acquiring all of a HF or FoHF management firm has not been great. The acquirer's "assets" go down the elevator every night. HF and FoHF managers are a very entrepreneurial class by definition, while almost all potential acquirers are large financial institutions, run by bureaucrats and technocrats (Sarbanes-Oxley anyone?) and cultural clashes are inevitable. In almost all cases, the principals in the HF or FoHF management firm that has been totally acquired leave at the first opportunity.

Partial sales seem to work better, although the lesser the amount acquired, the more likely that both parties will be satisfied. When a majority stake or large minority stake is acquired, the two parties end up in a deadly embrace, particularly if the acquirer has provided institutional credibility that has allowed the HF or FoHF manager to grow rapidly. For the buyer, acquiring the balance could be very costly and could ultimately drive the principals (who have stayed to protect their remaining stake) away. For the principals, purchasing the institutional piece could put them in debt for the rest of their lives.

Anecdotally, I know of a situation where the institution acquired a majority stake, but the hedge fund manager has consistently posted better results than the institution's proprietary trading desk. He has repeatedly asked for the opportunity to run the prop desk, only to be rebuffed by the politics of the institution. The founder of this firm is the most unhappy, seriously rich, person that I know.

Smaller minority stakes (10% to 20%) seem to work far better, particularly if the acquirer has distribution capabilities that could help the HF or FoHF manager grow by a percentage greater than that acquired. If a manager sold 15%, but the acquirer helped it grow by 15% or more per year than it would have otherwise grown, then the seller has a smaller piece of a much bigger pie (and it has not really lost anything) and has pocketed the sales price in the process. Assuming the buyer has not paid too much, there are often synergies that result from the new relationship that further enhance the buyer's ROI beyond cash on cash returns.

These transactions can occur in many forms from a purchase of percentage of equity to a purchase of a percentage of revenues. They can also target management fees only, performance fees only, domestic fees, only, offshore fees only, or any combination of these in equal or differing proportions. Depending upon the jurisdictions of the buyers and sellers, the tax and regulatory regimes can make all the difference as to whether or not a transaction can or should consummate and in which form.

Reverse Mergers

A variation of both selling out and an IPO is the reverse merger, whereby some or all of the HF or FoHF manager merges into a company that is already publicly traded. In 2007, GLG, a British hedge fund manager merged into Freedom Acquisition Corp, a Special Purpose Acquisition Company (or "SPAC") and began to trade on the New York Stock Exchange. GLG was not a success and recently merged with Man Group plc. Also in 2007, Carl Icahn merged his investment management company into an REIT that he already controlled. Ramius merged into Cowen and lastly, KKR reverse merged into one of their publicly traded funds.

Relative to selling out, the manager may take advantage of a reverse merger without losing control. Relative to an IPO, proxy disclosure is less onerous than IPO disclosure and success is far more likely at the time of disclosure than in an IPO. A reverse merger can have significant positive or negative tax ramifications that are too complicated to cover in this piece and if merged into a SPAC, there can be a substantial frictional cost (estimated at \$500 million in the case of GLG) for the HF or FoHF manager.

Reverse Merging into an Insurer, Reinsurer, or Bank Sponsored by the Manager

Should a HF or FoHF manager sponsor a startup insurer, reinsurer, or bank, that entity could ultimately acquire some or all of the manager (as in the Icahn case). The manager could then enjoy the benefits of monetization on a basis that is advantageous to both the manager and the acquiring institution in ways that would be unlikely for a less connected combination and the manager can further consolidate his control of the public company. Under this scenario, the HF or FoHF manager begins to look a lot more like Buffett.

One of the benefits of monetization through a reverse merger into an insurer, reinsurer, or a bank that was sponsored by the HF or FoHF manager (as opposed to an IPO or a reverse merger into a SPAC or another public shell) is that the earnings of the far larger institution are less dependent on the earnings of the HF or FoHF management business to meet growth targets. Thus, the HF or FoHF manager can get full value for his or her business without the long term risk imposed by the pressures to grow AuM. In

addition, the HF or FoHF manager controls something that has far more gravitas or clout, while after-market liquidity and attractiveness for institutional investors becomes far more likely.

Lastly, the bailout bill in 2008 eliminated fee deferral for offshore funds for tax purposes. The impact on the economics of managing hedge funds and funds of hedge funds will be significant. Each incremental dollar of AuM in an offshore fund was worth 2 to 16 times the future after-tax value of the same dollar in an onshore fund. Because of this and because the domestic fund paid most of the expenses of the fund management business, many hedge fund and fund of hedge fund managers have far more of their personal wealth untaxed in offshore fund deferral accounts.

If a U.S. based fund manager properly structures his relationship with the insurer, reinsurer, or bank that he or she creates, and later merges the fund management business into the insurer, reinsurer, or bank, much of the value of the previously allowed offshore fee deferral can be recaptured.

Because Goldman Sachs is so new to banking, it is difficult to draw a portrait similar to the one I did with Berkshire Hathaway. Instead, I can apply the principals of Berkshire to a traditional bank that takes deposits and makes loans.

In a traditional bank, each dollar of deposits generates about 1 cent worth of fees or interest rate spreads, net of operating costs. Again, the impact on banking ROEs is largely dependent on the number of increments of deposits for each increment of equity. In its simplest form, a bank that lends out its entire deposit base to corporations would be limited to \$10 of deposits for \$1 in equity. In mortgages, it could lend \$20 of deposits for \$1 of equity.

So how and why did banks such as Citi, B of A, and HSBC end up with balance sheets leveraged 60, 80, or even 100 to 1? They were able to do it by a combination of proprietary trading of instruments (i.e. governments, money markets, and derivatives) that have virtually no or very low capital charges. In doing so, the banks experienced escalating staffing levels and complexity, both of which translated into executive compensation at the highest levels in the most opaque of manners.

The average return on equity for the five largest banks in their best five years was 22%. A simpler bank with \$10 of deposits for each \$1 of equity would generate ROEs of 10% to 15% pre-tax from operations that would translate to 15% to 20% pre-tax when added to a 5% return on a long only fixed income portfolio for the equity capital or 10% to 13.3% after-tax. Since this is somewhat better than the (re)insurance industries, banks tend to trade at higher multiples.

But what if we changed two parameters? Instead of long only fixed income, we substitute either the S&P 500 returns for the last 40 years or the HFRI index over the last 10 years. We add roughly 4% and 6% respectively. What if we could also cut corporate taxes by 90%, the after-tax ROEs become 18% to 25% respectively. With very minimal complications. Add one more dimension, using some of the deposits to fund a prop book or directly lend in a credit strategy, and the numbers explode.

You may recall that Buffett quit the hedge fund business to go into reinsurance and banking. Where is the bank? 12 years later, the U.S. government made him give up one or the other. At the time, banks could not cross state lines, so he gave up the bank. Even though state lines are no longer an obstacle, he would likely have given up the bank if given the same choice again today. Banks cannot buy whole companies, whereas reinsurers can. More than 80 acquisitions later, this would surely have cramped Buffett's style.

Next: Chapter 9 – Family Offices, a Special Case

CHAPTER 9 – FAMILY OFFICES, A SPECIAL CASE

Family Offices generally come in two types: (1) Single family; or (2) Multi-family. A family office that has made a decision to leverage its asset management capabilities and manage assets for non-family members will also be considered a multi-family office for purposes of this paper.

In many ways, Family Offices are very similar to private banks without the regulatory constraints of a banking license (or major benefits thereof). Private Banks try to combine wealth administration with asset management, call it wealth management, and charge accordingly.

As a Swiss, it pains me that our private banks are superior wealth administrators, but that most are short on world class asset management capabilities. Instead, many private banks outsource asset management to external managers (as do many Family Offices) but rely on retrocessions (commissions on management and performance fees) from the managers they “select” to generate a significant amount of their private banking profits (which Family Offices are generally disinclined or unable to do).

To the extent that Family Offices and private banks allocate assets to external managers, they are very similar to FoHFs. Thus, a Multi-Family Office or a Single Family Office that would be willing to manage non-family assets could readily substitute itself for any reference to a FoHF throughout this paper.

Multi-Family Offices that allocate some or all of their assets to a portfolio of hedge funds should start one or more banks that allocate an equal amount of assets to that same portfolio of hedge funds. Single Family Offices willing to manage non-family assets should do likewise. Even Single Family Offices unwilling to manage non-family assets, but willing to control a publicly traded private bank would also benefit from doing so.

The two primary reasons for doing so are: (1) significantly better returns for family members and non-family members alike, without a proportionate increase in risk; and (2) gentler tax treatment for investors in the UK and U.S.

While a case can be made that a Family Office that is so inclined should consider a lending oriented banking strategy, the likelihood is that most Family Offices that follow this prescription will limit their activities to private banking. In addition to delivering significantly better returns and tax treatment (if taxable in the UK or U.S.), banking also provides better liquidity (if the bank is publicly traded) and an additional wealth management platform if a Swiss bank is the focus or part of the banking group.

For the Multi-Family Office or Single Family Office that wants to manage external money, the additional benefits are: (1) a significant increase in AuM that would not otherwise be available; (2) permanent capital that can never be redeemed; and (3) a vehicle to monetize the business value of the family office without selling out and losing control or having to take a standalone family office public.

Let’s start with significantly increased returns without a proportionate increase in risk, which are available to the main family and non-family members alike. By way of reminder, the operational profit and loss statement of a bank is interest income plus fees minus deposit costs minus expenses. Accordingly, the average lending bank earns 1 cent for each \$1 of deposits.

Thus, a bank with \$100 million of deposits should earn \$1 million from operations and a bank with \$1 billion in deposits should earn \$10 million from operations. These operational profits are not very difficult to achieve. Two million Americans of average abilities show up to work in banks every day and generate these operational results.

However, these operational profits are independent of the amount of the equity capital in the bank. Thus, if the bank had \$1 billion of equity capital, the impact of operational profits on \$100 million or \$1 billion in deposits would be negligible and minimal (respectively) in comparison to the returns generated by investing the equity capital. On the other hand, if the bank had only \$100 of equity capital, the impact of the earnings on \$100 million or \$1 billion in deposits would be infinite in terms of ROE.

In terms of the P&L, there is no connection between the operational earnings of a bank and its level of capital as long as everything goes right. However, regulators and market discipline prevent banks with only \$100 in equity capital from ever attracting \$1 billion in deposits. As such, regulators (and the market) generally like to see at least \$1 in equity capital for every \$10 of deposits to cover problems.

Furthermore, the equity capital is usually invested in a portfolio of long only fixed income securities. For argument's sake, let's assume that the equity capital returns 5% and that there are \$10 of deposits (earning 1%) for each \$1 of equity capital. The bank would then have a pre-tax ROE of 15% (5% + 10 x 1%) and an after-tax ROE of 10% if it were in the UK, the U.S.

Let's look at a diversified portfolio of hedge funds earning 10%. On the surface, the investments in the hypothetical bank and portfolio are equal. For the offshore or tax exempt investor, the two hypothetical investments would have the same future value whether he holds or cashes out. While the Londoner also compounds at 10% as long as he remains invested in the each vehicle, if he cashes out, he will be taxed on the funds at 50%, but at only 18% in the bank.

In the case of a New Yorker, the fund returns are subject to annual taxes of roughly 50%, while his investment in the bank is not subject to annual taxation and is taxable at roughly 25% only when he sells. To illustrate this, look at the following table, which shows the gains on a \$1 million investment in funds or a bank for each type of investor under two scenarios (hold or cash out) after ten years.

<u>Scenario</u>	<u>Offshore or Tax - Exempt</u>	<u>Londoner</u>	<u>New Yorker</u>
Funds Hold	\$1.594 million	\$1.594 million	\$0.629 million
Funds Cash Out	\$1.594 million	\$0.797 million	\$0.629 million
Bank Hold	\$1.594 million	\$1.594 million	\$1.594 million
Bank Cash Out	\$1.594 million	\$1.307 million	\$1.195 million

Quite an eye-opener. All things being equal, the offshore or tax-exempt investor is indifferent with regard to funds or the bank and whether to hold or cash out. On the other hand, the Londoner is indifferent if he holds, but is far better off investing in the bank if he plans to cash out some day. The American is far better off in the bank whether or not he holds or cashes out.

There are no changes to the funds that would yield different outcomes. However, there are two changes that can improve the bank. Change the investment strategy for the bank's equity capital from long only fixed income to the fund strategy. This would raise pre-tax ROE to 20%. Then move the bank offshore, where the corporate tax rate drops from 33% to 5%. Now look at the gains.

<u>Scenario</u>	<u>Offshore or Tax - Exempt</u>	<u>Londoner</u>	<u>New Yorker</u>
Funds Hold	\$1.594 million	\$1.594 million	\$0.629 million
Funds Cash Out	\$1.594 million	\$0.797 million	\$0.629 million
Bank Hold	\$4.695 million	\$4.695 million	\$4.695 million
Bank Cash Out	\$4.695 million	\$3.850 million	\$3.521 million

Gets better. For all of three types of investor, the bank outperforms the funds, whether one holds or cashes out. As such, it is difficult for us to imagine why anyone would refrain from pursuing a bank if they have the wherewithal to do so.

But this is a privately held bank that is only valued at book value. By contrast, publicly traded banks with believable balance sheets trade at 1.5 to 3.0 x book value. Assuming that the bank is publicly held and trades at 1.5 x of book value the table becomes:

<u>Scenario</u>	<u>Offshore or Tax - Exempt</u>	<u>Londoner</u>	<u>New Yorker</u>
Funds Hold	\$1.594 million	\$1.594 million	\$0.629 million
Funds Cash Out	\$1.594 million	\$0.797 million	\$0.629 million
Bank Hold	\$7.542 million	\$7.542 million	\$7.542 million
Bank Cash Out	\$7.542 million	\$6.184 million	\$5.657 million

Even better, yet. Aside from the performance superiority of the publicly traded bank over the privately held bank over the funds, there are several other benefits for investors and the asset manager if the bank is publicly traded. For the investor, there is daily liquidity rather than the potential for lock ups, periodic liquidity, notice periods, and gates.

For the manager, the bank may attract more new families than a multi-family office (other families can still access the multi-family office if they so choose) and these additional families (and the public investors) become increased AuM (and fees) that would not be otherwise available.

The public capital and any non-family external assets that convert from funds to the bank also become permanent capital and not subject to redemptions. If the family office merges into the bank, it can monetize its business value more effectively than selling out or going public.

Private Banks generally derive their operational profits from fees, rather than from spreads. Fee generation is not only independent from the level of equity in the bank, it is also independent from both a regulatory and market discipline point of view. As a rule, Private Banks are thinly capitalized, so operating profits usually exceed the 10% ROE of a lending bank and their Price to Book Value multiples are usually much higher. As such, it is arguable that a private bank should outperform the tables above.

It is not that simple. A private bank is far more difficult to build than a lending bank (although it is arguable that a true multi-family office has a serious advantage in this regard). Secondly, a Family Office that enters private banking might be inclined to capitalize it as heavily as possible, lowering the operation profits in terms of ROEs. As a generalization, a private bank should achieve at least half the difference between the funds and the bank in the tables above, but is equally likely to exceed them. A combination of private bank and lending bank should significantly outperform the tables.

Summary

Capital only works once when it invests in a diversified portfolio of hedge funds. It works twice when it invests in a bank that invests in that same portfolio. It not only earns the fund returns, it also permits the bank to take deposits, earn fees, and generate operational profits. From a risk standpoint, the bank should outperform the portfolio of funds in up markets and down markets and often when the funds are down, the bank will still generate positive returns.

If the bank is only owned by a single family that is not taxable and remains private, it should still outperform the portfolio of funds. However, if the family is taxable, the benefit differential is far greater, even if the bank remains privately held. The optimum value is in a publicly traded bank. For complex tax reasons, most Single Family Offices for U.S. families must be willing to take in non-family capital (either from other families as an asset manager or the public through an IPO) in order to achieve the results in the tables above, although this can be achieved while leaving control within the family.

If other families and the public join, then the Family Office becomes more valuable due to the increased AuM and permanent capital, and the bank becomes the perfect vehicle to monetize the value of the family office, relative to selling out (and losing control) or going public.

A new bank should take 6 to 8 months to open its doors, cost about \$500,000, and require \$10 million in capital. If a Swiss private banking component is desirable, it should take 9 to 12 months, cost \$750,000, and require \$20 million in capital. These costs do not include staff costs (\$750,000 per year for a lending bank and \$1.5 million for a private bank in Switzerland), some of which may have to be incurred prior to opening, nor do they include the costs of fixturing premises and purchasing computer systems (\$500,000), the costs of a private placement memorandum (\$250,000) or the costs of an IPO filing (\$750,000), if additional capital is part of the capital strategy.

Next: Chapter 10 – (Re)insurance or Banking?

CHAPTER 10 – (RE)INSURANCE OR BANKING?

I am often asked whether I prefer insurance, reinsurance, or banking. I tend to prefer reinsurance over insurance, simply because insurance has many more moving parts, but I am relatively agnostic between reinsurance and banking. However, a sponsor may not (and in many cases, should not) be agnostic.

Insurance is transaction and people intensive. Lots of salesmen, lots of (often monthly) premium payments and attendant collections, lots of claims, etc. By contrast Greenlight Capital Re has more than \$2 billion in assets and is publicly traded, yet has fewer than 20 employees. That notwithstanding, we are working on an insurance project as of this writing, because it is the best fit for the sponsor.

As to whether a HF, FoHF, or Family Office should enter the (re)insurance or banking business (or both), largely depends on the sponsor's investment strategy, strengths and weaknesses, objectives, and the degree to which he or she wants to be involved in the (re)insurer or bank on an ongoing basis.

Some investment strategies, such as credit or those of a typical Family Office, naturally lend themselves to lending and private banking respectively, while others, such as insurance-linked securities, naturally lend themselves to insurance and reinsurance. Beyond that, to invest reserves in an alternative asset strategy, reinsurance requires an investment strategy that is highly liquid, because regulators, ratings agencies, and Wall St. analysts require that cross border liabilities be secured by letters of credit.

In early 2010, a publicly traded company with more than \$100 million in equity capital announced that it was changing its entire business to meld new reinsurance acquisitions with asset based lending funds on the premise that reinsurance premiums can be used to acquire additional ABL fund assets. I have studied this transaction and cannot see how it can work, because the ABL funds and their underlying loans are too illiquid to be used as collateral for letters of credit. (This company's shares were recently suspended from trading on the New York Stock Exchange and it is now in the process of being de-listed).

The simple test as to whether or not an investment strategy can underpin the reserves of a reinsurer is whether or not a prime broker or other lender will lend against the assets of the investment strategy on a loan to value (LTV) of 50% or more. If the answer is no, the reinsurance business has virtually no chance of being able to invest the entire float in the strategy.

However, it is entirely possible to use an illiquid investment strategy in reinsurance, provided that it is limited to a majority of the equity capital of the reinsurer (Buffett has bought more than 80 whole companies), but if the sponsor wants to benefit from investing the leverage created by the reinsurers reserves, it must have some liquid investments to support those reserves, or compete on underwriting skills (a losing game at best) with the rest of the reinsurance industry, because there is no investment edge at the margin. There are some rare exceptions (Blackstone comes to mind) that could utilize a private equity strategy for some of the equity and a fund of funds strategy for the reserves.

Beyond these investment management distinctions, the next consideration will be risk management. Simply stated, risk management in the insurance and reinsurance industries is all about liability management. Risk management in banking is about asset management and avoiding a run.

HF, FoHF, and Family Office managers are already in the asset management business and usually know how to manage asset risks. Alternatively, they know how to hire people to manage them, proscribe boundaries, and monitor compliance within the parameters.

For most HF, FoHF, or Family Office managers, entry into the insurance or reinsurance business requires them to learn how to manage a portfolio of liabilities or learn how to hire people who know how, proscribe limits for them, and monitor their compliance. This is more than possible, but takes some effort. Buffett and David Einhorn of Greenlight are self-taught and have successfully mastered it.

Since I am also self-taught, I believe that anyone smart enough to play in the hedge fund business or in a Family Office at a high level can also master it, if they make the effort. If they are not willing to make the effort, they must find people that they trust who will either execute or monitor those who execute.

Other considerations have to do with the differences in starting or operating the businesses. Reinsurers cost far less and take far less time to license. Furthermore, their reserves are more permanent than banking deposits. Lastly, reinsurers are far simpler to operate. These differences will be covered in Chapter 15.

Next: Chapter 11

CHAPTER 11

Like the 13th floor in an office building or a hotel, Chapter XI should generally be avoided and we have.

Next: Chapter 12 – Two More Opportunities to Invest \$1 Million?”

CHAPTER 12 – TWO MORE OPPORTUNITIES TO INVEST \$1 MILLION

Opportunity #1

It is August of 2004. You are looking to invest \$1 million and have narrowed your decision to four potential investments: (1) Berkshire Hathaway; (2) Goldman Sachs; (3) a long/short equity fund called Greenlight Capital, which is run by David Einhorn, who has never had a losing year and has generated returns of 29% over 8 years since inception but does not believe he can achieve anyway near that in the future (echoes of Buffett in 1969); or (4) a \$10 per share (book value) investment in Greenlight Capital Re, a startup reinsurer that will have its investable assets managed by David Einhorn, expects to go public within 3 years, and will try to take advantage of Berkshire Hathaway's structural benefits (except that it will be in the Cayman Islands and not subject to corporate taxes on its earnings). Again, you are:

1. An American, resident in New York. Which of the four do you choose if you are going to remain invested after 2010? If you are going to cash out on Christmas Eve in 2010 to start fresh in 2011 and live out your days in the Big Apple? If you are going to move to Florida before cashing out, cash out on Christmas Eve in 2010 to start fresh in 2011?
2. British, domiciled in London. Which of the three do you choose if you are going to remain invested after 2010? If you are going to cash out on Christmas Eve in 2010 to start fresh in 2011 and live out your days in London? If you are going to move to Monaco before cashing out, cash out on Christmas Eve in 2010 and start fresh in 2011?
3. An offshore investor who pays no income or capital gains taxes. Which of the three do you choose if you are going to remain invested after 2010? What if you are going to cash out on Christmas Eve in 2010 to start fresh in 2011?

Opportunity #2

It is May of 2007. You are looking to invest \$1 million and have narrowed your decision to four potential investments: (1) Berkshire Hathaway; (2) Goldman Sachs; (3) Greenlight Capital, the long/short equity hedge fund; or (4) the IPO of Greenlight Capital Re (symbol – GLRE) at \$19 per share. You are:

1. An American, resident in New York. Which of the four do you choose if you are going to remain invested after 2010? If you are going to cash out on Christmas Eve in 2010 to start fresh in 2011 and live out your days in the Big Apple? If you are going to move to Florida before cashing out, cash out on Christmas Eve in 2010 to start fresh in 2011?
2. British, domiciled in London. Which of the three do you choose if you are going to remain invested after 2010? If you are going to cash out on Christmas Eve in 2010 to start fresh in 2011 and live out your days in London? If you are going to move to Monaco before cashing out, cash out on Christmas Eve in 2010 and start fresh in 2011?
3. An offshore investor who pays no income or capital gains taxes. Which of the three do you choose if you are going to remain invested after 2010? What if you are going to cash out on Christmas Eve in 2010 to start fresh in 2011?

NEXT: CHAPTER 13 – How Your Additional \$1 Million Would Have Performed

CHAPTER 13 – HOW YOUR \$1 MILLION WOULD HAVE PERFORMED

Opportunity #1

Please look at the following table of **gains** from August of 2004 through the end of 2010:

Investor	BRK	GS	Greenlight Funds	Greenlight Re (GLRE)
American - Hold	394 k	996 k	678 k	1.681 mil
American - Sell & Stay	296 k	747 k	678 k	1.378 mil
American - Sell & Move	336 k	854 k	678 k	1.546 mil
British - Hold	394 k	996 k	724 k	1.681 mil
British - Sell & Stay	315 k	824 k	362 k	1.277 mil
British - Sell & Move	394 k	996 k	724 k	1.681 mil
Offshore	394 k	996 k	724 k	1.681 mil

Under all circumstances, from August of 2004 through December 2010, you would have been far better off investing in GLRE, David Einhorn's reinsurance startup, and your returns would have almost been more than any two of the other three combined over roughly 6 ½ years. The S&P insurance index? A loss of **(\$321k)**. Who would have imagined that Berkshire would have been such a laggard?

Opportunity #2

Please look at the following table of **gains** from May of 2007 through the end of 2010:

Investor	BRK	GS	Greenlight Funds	Greenlight Re (GLRE)
American - Hold	103 k	-254 k	172 k	411 k
American - Sell & Stay	77 k	-254 k	172 k	308 k
American - Sell & Move	90 k	-254 k	172 k	349 k
British - Hold	103 k	-254 k	232 k	411 k
British - Sell & Stay	80 k	-254 k	188 k	337 k
British - Sell & Move	103 k	-254 k	232 k	411 k
Offshore	103 k	-254 k	232 k	411 k

Whether you missed the original opportunity in 2004 (and the 900k return in 2 years and 9 months – annualized at 26% p.a.) or not, you still should have bought GLRE on the IPO. As of the end of 2010, GLRE shares were up 41.1% since the IPO, clearly outperforming the other three combined and the two gainers combined over the same period of time. The S&P insurance index? A loss of **(\$501k)**.

Next: Chapter 14 – Why Should Anyone Care?

CHAPTER 14 – WHY SHOULD ANYONE CARE?

Why Should an Investor Care?

First of all, an investment in a (re)insurer or bank that allocates some or all of its assets to a given strategy provides significantly superior returns than a fund that uses that same strategy without a proportionate increase in risk. In GLRE's case, roughly 60% of the outperformance was attributable to market multiples (it trades at 1.31x of book value) and the remainder is attributable to higher ROEs. However, GLRE uses far less leverage than Berkshire and using Berkshire's (conservative) levels of leverage as a standard, the drivers of superior returns would normally be 60-40 the other way.

Secondly, if privately held, it offers identical liquidity to a fund (there are some caveats, though), and if publicly traded, it offers daily liquidity. During April of 2011, GLRE traded roughly \$3.0 million worth of shares each day. By contrast, when Greenlight Capital is not closed (which it normally is), Greenlight Capital fund investors are subject to two year lockups, periodic liquidity, and notice periods.

Lastly, taxation is not an issue for most non-U.S. investors, but it is an issue for UK and U.S. investors. GLRE does not pay corporate income taxes on its earnings and is exempt from PFIC taxation for U.S. investors. Thus, for the New Yorker, the drivers of the differences in value between GLRE and the Greenlight funds are 49% market multiples, 31% increased ROEs, and 26% tax. Again, since GLRE uses lower amounts of leverage, the breakdown would normally be expected to be 55%, 35%, and 10% respectively.

If a manager that an investor likes is sponsoring a (re)insurer or bank that will allocate assets to him, each of his investors should take a close look at it. These structures generate so much Structural Alpha with relatively little additional effort that it is arguable that every alternative asset investor should actively look for managers moving in this direction as vigorously as they look for funds to invest in.

Why Should a HF Manager, FoHF Manager, or Family Office Care?

Compared with an identical investment in a fund, an investment in a (re)insurer or a bank that allocates all of its investable assets to that same manager, significantly improves the investor proposition and that should be reason enough. This is doubly so, since the manager is often the largest investor in his funds.

However, the manager also gains the benefits of permanent capital and earns fees from a significant increase in AuM (that are far easier to raise than fund assets) that he would not otherwise manage. He also controls a vehicle that offers a superior way to monetize his management business. Lastly, the (re)insurer and/or bank can co-exist with the manager's funds and do not inhibit any other alternatives that the manager has for managing assets, raising AuM, or monetizing his business.

Put another way, if a (re)insurer or bank announced that it was going to allocate all of its investable assets to a managed account run by one manager, most managers would love to be anointed. Unfortunately, they would have to compete with a myriad of other managers. If one sponsors the (re)insurer or bank, he does not have to compete and the (re)insurer or bank is simply another client (pair passu with domestic, qualified, and offshore funds) of the fund manager that happens to have a managed account.

Next: Chapter 15 – OK, OK, I'm Sold How Long Does It Take and How Much Does It Cost?

CHAPTER 15 – HOW LONG DOES IT TAKE AND HOW MUCH DOES IT COST?

How high is up? It depends

In general, startup insurers and reinsurers take far less time than start up banks, cost far less to get into business, and require less capital for a license. In normal times, startups and acquisitions take about the same amount of time and cost the same (not counting any premium to book in some acquisitions).

However, 2011 is not a normal time and bank regulators want fresh capital to prop up the sick ones instead of competing with them, so a change of control often takes less time and costs less than a new license in banking. As a rule, we do not like acquisitions. They often have legacy issues and cost a premium to book value (very important to avoid if you want to maximize compounding).

In these times, the premium to book has often vanished and there are clean insurers, reinsurers, and banks available at book (or even a slight discount), because the owners want or need to get out and regulators make liquidation a drawn out process. Thus, the only way to get the money out in the near term is to sell and not drive too hard a bargain in doing it.

That said, let's look at the timing and costs of startups. Insurers and reinsurers in offshore jurisdictions take roughly two months to get licensed and operational at a cost of roughly \$100,000 and minimum capital of \$1 million. At the other extreme, Switzerland might cost as much as \$300,000, take six to nine months, and require \$5 million in capital. The choice of jurisdiction will determine which extreme or point between and will largely be dependent on the choice of line of insurance or reinsurance.

To illustrate this point, Hurricane Katrina made landfall at the end of August in 2005. Anticipating a sharp rise in reinsurance rates, Aon Benfield assembled a management team, obtained a license, and secured commitments from 6 strategic investors. Less than 4 months from Katrina's landfall, Lancashire Holdings raised \$1 billion during Christmas week in its IPO on the London Stock Exchange.

A startup bank is far more complicated, time consuming, and costly. On the short end, a new lending bank can take 6 to 8 months, costs about \$500,000, and requires \$10 million in capital. If a Swiss private banking component is desirable, it should take 9 to 12 months, cost \$750,000, and require \$20 million in capital.

These costs do not include staff costs (\$750,000 per year for a lending bank, insurer, or reinsurer and \$1.5 million for a private bank in Switzerland), some of which may be incurred prior to opening, nor do they include the costs of premises, systems, policy and procedures manuals (as little as \$100,000 for insurers or reinsurers or \$500,000 up to gazillions for a bank) or private placement memorandums, (\$250,000) and/or an IPO filing (\$750,000) if additional capital is part of the capital strategy.

Next: Chapter 16 – Seriously, Do Not Try This at Home

CHAPTER 16 – SERIOUSLY, DO NOT TRY THIS AT HOME

Just as many forms of daring entertainment warn against trying a given stunt at home, I also advise against trying to set up a hedge fund oriented (re)insurer or bank without the assistance of someone who has real hands on experience in doing it. Our major competition has always been in-house people deciding to try to do it themselves to maintain privacy, cut out the middle man, and/or look like heroes. They are abetted by lawyers, accountants, and bankers, who look at it as a simple exercise in formation.

The risks can be substantial for failing to get it right. Most failures are a combination of strategy, staffing, and operating mistakes. Consider the following list of managers, all of whom either consulted with us but later decided against using our services or used our services for a while and then decided to proceed on their own. (1) Commodities Corp (Goldman Sachs) – Stockton Re; (2) Mariner – Select Re; (3) APAM – First American Life & Health; (4) Highbridge, Alliance, and JP Morgan – Hampton Re; (5) Kenmar – Greenwich Re; (6) Clinton Group – the company was never named; and (7) Citadel – CIG Re.

Every one of them failed at considerable cost to their investors and managers except Kenmar and Clinton and they failed to launch (also costly for the manager in terms of actual expenses as well as an opportunity missed). Why the failures? The in-house persons and the trusted lawyers, accountants, and bankers naively underestimated the potholes, speed bumps, and brick walls, because none of them had any hands on experience with the marriage of hedge funds and did not know how to hire those who did and monitor them. While it is possible that they might have still failed if we had been involved, the specific causes of each failure would never have happened if we had been involved.

Kenmar failed to launch because they failed to raise the capital and Clinton suffered a run on their funds before the permanent capital vehicle was in place. I believe that our experience in raising capital and speed to market would have made enough of a difference that they both would have been able to launch if they had availed themselves of our services. (We also consider Scottish and Max Re to be failures, because they failed to remain true to the investment strategy and seriously underperformed).

I debated with myself repeatedly on whether to use the names in the preceding paragraphs (and Robertson's, Ainslie's, Bacon's or Lampert's earlier in the piece) as it could be taken by many, including each of them, that I am dismissive of them. Actually, each of them has achieved far more than most people even fantasize about and each is due a significant amount recognition for his achievements (I am firmly in that camp). However, success in one area is not omnipotence in all areas (most great traders are only right slightly more than 50% of the time) and it is their success in their primary activities that makes using their names so important so that the examples are concrete rather than generalizations.

Our list of successful hedge fund or FoHF sponsored (re)insurers and banks dwarfs the number of companies listed above. Not one of our launches or acquisitions has ever failed during our involvement for operating reasons. Those launches or acquisitions that have failed while we were involved were asset management related failures (which were sometimes fatal to the fund management business itself) and they make up only a fraction of our transactions. Of those that started the process and failed to launch, virtually every one had performance problems and was unable to bring their investors along.

No one can guarantee that a launch or acquisition will succeed or that it will perform to potential. But, our level of experience in launching or acquiring hedge fund, FoHF, or family office sponsored banks or (re)insurers probably exceeds everyone else's combined. By using our services, many opportunities to fail should be avoided and the likelihood of underperformance should diminish substantially.

Again, thank you for the time you have spent reading this piece.