Memo to: Coleman and Zhang Clients

From: Gavin Coleman

Re: Why Coleman and Zhang (The dawn approaches)

I hope this memo finds you as it leaves me: in good health and in high spirits.

As an undergraduate at Harvard University, Ken Griffin had a satellite dish installed on the roof of his dorm so he could trade convertible bonds. After eavesdropping on a passionate talk to his friend about his investment strategy, a retiree gave him $50k for his fund. That retiree would become Ken Griffin's first client. During the summer between his freshman and sophomore years, he raised $265k, laying the foundations for the launch of his Citadel hedge fund in 1990. But it wasn't until the high-profile collapse of hedge fund Long Term Capital Management at the end of that decade that he realized Citadel's potential, Griffin recalls in an interview. As the financial markets were "turned upside down," Citadel avoided losses and seized on the opportunity to make money, he says. "This unlocked a substantial number of doors both in terms of our ability to attract talent and to attract capital."

Griffin, Founder and Head of the most successful hedge fund ever, recently remarked in an interview: "The stories of markets are always stories of cycles and strategies that come and go in terms of popularity, clearly right now the multi-strategy managers are very much in vogue. When you're most popular is probably when you're reaching the top of the cycle."

Citadel was among the first of the so-called multi-manager funds. The rise of the firm, which now has $62bn under management, represents the rise of the multi-manager model. The appeal/pitch of this strategy is simple: you focus on investing, while the platform takes care of everything else, from operations to marketing. The pitch to potential clients is that thanks to their ability to nimbly switch money between different trading strategies, multi-manager funds can deliver strong returns with low volatility while carefully controlling risk. The groups vary in the nuts and bolts of their approach but they typically employ between tens and hundreds of autonomous and highly specialized risk-takers in teams or better known as pods. Over the past five years in particular, it has emerged as the fastest-growing and most profitable corner of the global hedge fund industry.

The first generation of hedge funds, ran by star managers like George Soros, Julian Robertson, and Paul Tudor Jones, made their profits and their reputations by taking big thematic bets. Pioneers of the multi-manager structure include Griffin and Izzy Englander, founder of $60bn firm Millennium Management. Both firms launched more than three decades ago and still account for around two-fifths of assets run by multi-manager platforms. But they're now confronting challenges wrought by capacity constraints, including a ferocious and increasingly expensive talent war. Investors have also started to question multi-manager funds' high fees, demands to lock away cash for years, recent rapid growth, capacity challenges, and more muted performance.

According to eVestment data, multi-strategy funds have around $670bn under management. There are only around 40 of such multi-manager platforms globally, according to estimates from prime brokers, running around $300bn or 8 percent of the hedge fund industry's overall $4tn under management. But they punch above their weight: as of 2022, Goldman estimated multi-managers account for 27% of the total hedge fund industry's holdings in US equities, up from 14% since 2014. The march of the platforms has gained further momentum in the past five years. Goldman estimates that between 2018 and 2022, multi-manager assets increased by 150% while the rest of the hedge fund industry grew by just 13%. If there are too many people doing the same thing, the return gets arbitraged away and it's more likely you'll see the performance of the platform funds fading away, rather than some grand tragic ending. "There's only so much alpha in the world," remarks Paul Britton, chief executive of $12bn hedge fund Capstone Investment Advisors. "Alpha" meaning "returns superior to market average."

Referring to their leverage problems, which we use none of, they use large amounts of borrowing to magnify their positions and amplify returns: an average of more than five times their assets, Goldman recently reported, and far more in fixed income. So their shifting presence has a disproportionate impact on global financial markets. Since the global financial crisis, this corner of the hedge fund industry has been among the main beneficiaries of the Volcker Rule, which restricts banks from trading risky assets on their own account. That shifted such risk-taking to less regulated parts of the financial system. The strategy has become so popular and there is a tremendous amount of leverage, such that an unwinding of multi-strats is likely to resemble the ‘quant quake’ of 2007. During that episode, a number of quantitative hedge funds faced substantial losses and a mass sell-off of their positions negatively impacted the markets.

The labor intensity of multi-manager hedge funds means that they account for a quarter of the sector’s total headcount despite representing 8% of its assets, according to the Goldman report. They invest millions of dollars each year in technology, systems and data in their pursuit of an edge over rivals. This high cost base is enabled by the defining characteristic of their businesses: the “pass-through” expenses model, where instead of an annual management fee, the manager passes on all costs to his or her end investors. While the hedge fund industry’s standard levy of 2% of assets as an annual management fee and a 20 per cent cut of any gains as a performance fee has faced downward pressure for years, costs in the pass-through model vary from 3 to 10% of assets each year. That covers everything from office rents, technology and data, salaries, bonuses, and even client entertainment. A performance fee of 20 to 30% of profits is typically charged on top.

The Goldman report says multi-manager funds employ as many investment professionals as they do non-investment staff. As one hedge fund chief executive puts it: “These furnaces need fuel.” After raiding investment banks for traders, the platforms are now increasingly hiring them from one another, making use of the pass-through expenses model to leave investors with the bill for their increasingly costly talent. Sign-on packages of $10mn to $15mn are not uncommon, according to market participants, and guaranteed payouts can stretch into tens of millions of dollars. They often include upfront payments to make up for forgone bonuses and two-year guarantees that are paid out regardless of whether the hire lasts the course.

In recent years, Citadel and Millennium have returned billions of dollars to clients and switched into longer-term structures that require investors to commit funds for multi year periods.

A similar story and a different strategy, Coleman and Zhang will approach the market with its own guiding philosophy. Let these fractions of our philosophy give you insight into our decision making:

- The market in the short run is a reflection of the consensus opinion, while in the long run, fundamental value will win.
- Be uncomfortably idiosyncratic!
- Information that's already disseminated through the market won't be the source of superior returns.
- Leverage is a great source of danger used mostly in undisciplined convictions, thus we invest within our means.

Today, after a review of the problems that confront it, the multi-manager model, while having great success, is not in the best interest of clients. Coleman and Zhang not only relies on philosophy to guide our investment decisions but we instill these principles into our thoughtful care for our customers, which we believe the industry so desperately needs. After our incubation and at the introduction of our first clients, Coleman and Zhang will offer lockup periods of no more than six months (the lockup period being two years industry wide) for the convenience of our clients, with quarterly redemptions. We make highly liquid investments for this reason, i.e. equities and short term bonds. Fees will only go higher based on excellent performance, not with rising costs to pay for bonuses or additional employees. And if you think your money is safer in a large fund, I'll tell you this: small to mid-sized hedge funds have an advantage over their peers because they are more nimble and can add meaningful returns by taking advantage of market inefficiencies with smaller, less liquid securities that are followed by only a few, if any, Wall Street firms. Small hedge funds ($10mn or less) have been proven to have a higher year-over-year risk-adjusted return on average than large funds. We hope our investment philosophy aligns with your interests; and while we're derivatives of Ken Griffin's, Howard Marks's, and many others' work, I hope that our approach, like theirs, will someday bring a new age to investing. A new day is upon the horizon and the dawn approaches!

Sincerely,

Gavin Coleman