The Family Office Association Audio Series: Volume 16 with Dr. Rishi Ganti

10 Things a Startup Manager Won't Ever Tell You, Ever!

FOA Audio Series Volume 16

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Rishi Ganti founded Orthogon Partners, a private investment fund focused solely on esoteric assets.

Over the last decade, Dr. Ganti in his various investment roles has deployed in excess of $700 million in investments in six continents with no losing transactions. Before Orthogon, he was the pioneer investment manager selected by Two Sigma Investments, LLC to start a group dedicated to investing proprietary capital in private investments on behalf of the firm’s principals.

Dr. Ganti received his Ph.D., A.M., and J.D. cum laude from Harvard University and his B.A. summa cum laude from Emory University. He is a licensed CPA, a licensed attorney with the New York State bar, a CFA® charterholder, an Enrolled Agent with the Internal Revenue Service, a CFP® certificant, a certified FRM®, and has professional command of six languages. He resides in New York City.

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Angelo J. Robles is Founder and CEO of the Greenwich, Connecticut-based Family Office Association (FOA), a global membership organization that delivers private educational and networking opportunities, proprietary research, and access to salient thought leadership to multiple generations of wealthy families and the professionals who run their single-family offices.

A member of the Princeton Council on Family Offices and the NYU Stern Family Office Council, Mr. Robles has a long record of leadership positions at top financial-service companies, including UBS. Before launching FOA, he founded and ran several successful entrepreneurial ventures: He served as President of the New England chapter of the Hedge Fund Association, and pioneered online retirement planning for Fortune 1000 executives with two Internet startups - 401KRollover.com and IRARollovers.com.

Author of several books and articles, Mr. Robles has appeared on Bloomberg Television and Radio, and has been quoted in the Wall Street Journal, Thompson Reuters, Institutional Investor, Opalesque, Registered Rep, HFM Week, Investment News, EurekaHedge, The Luxury Institute, Private Asset Management, The Greenwich Times and many other media outlets.

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About Family Office Association

Family Office Association is a global community of ultra-high net worth families and their single family offices. We are committed to creating value for each family that we serve; value that grows wealth, strengthens legacy, and unites multiple generations by speaking to shared interests and passions. FOA has the resources to solve your most difficult challenges and help you achieve your collective goals: to invest intelligently, give strategically, and learn exponentially.

FOA is the community leader in serving all the key imperatives for ultra-high net worth families, respecting your privacy but enabling an intimate community of global families like yours. Our organization delivers private education and networking opportunities, proprietary research, and access to salient thought leadership that will interest all generations of your family.

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FOA Audio Series Volume 16: 10 Things a Startup Manager Won't Ever Tell You, Ever!

Angelo Robles: Hello everyone. This is Angelo Robles of Family Office Association. Welcome to today's FOA audio podcast. Today's FOA audio podcast is focused on "ten things a startup manager won't ever tell you, ever. If that is not a catchy title, I do not know what is! We are joined today by Dr. Rishi Ganti, Founder of Orthogon Partners, a private investment fund focused solely on esoteric assets.

Dr. Ganti, in his various investment roles, has deployed in excess of seven hundred million in investments in six continents over ten years with no losing transactions. Before Orthogon, he was the pioneer investment manager selected by two sigma investments to start a group dedicated to investing the proprietary capital of the firm in private investments on behalf of the principles.

Dr. Ganti received his Ph.D., A.M. and J.D. Cum Laude from Harvard University and his BA Summa Cum Laude from Emery University. He is a licensed CPA, a licensed attorney with the New York State Bar, a CFA, and an enrolled agent with the Internal Revenue Service, a CFP and RFM and is proficient in six languages. He resides in New York City. Rishi, thank you for joining us today.

Dr. Rishi Ganti: Thanks for having me.

Angelo Robles: The pleasure is all mine. I am really going to enjoy our dialogue today. And maybe I will set the stage a little bit for our audience as well. I do not think I am really noting any surprises here when I note that broadly speaking we are in kind of unique times not just here in North America, but around the world. For many investors and managers, it has been a difficult last couple of years. Effectively, the broad market indices's or index investing, at least for public market equities has significantly outperformed many equity driven managers often with far more transparency, lower fees and a better tax picture than many active equity strategies.

I think some key things that we bring up here with Rishi is he did note his expertise in esoteric assets, something that would be difficult to index or to benchmark that takes a specific skill set. And there are some wonderful, wonderfully talented managers and investors out there. But for those of you that are active allocators identifying especially an earlier stage manager specifically in certain asset classes that many investors often do not totally understand as well I think creates a lot of great challenges. However, to get alpha in a challenging investment environment likely one needs to be aggressive in the approach and potentially looking to be favorably invested in certain managers, specifically if you can get some favorable terms.

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So we are going to talk about all of this today. But why do we not open the floor up to the core theme that we will be discussing, Rishi, ten things a startup manager won’t ever tell you, ever. I going to host this podcast differently then those in the past in that I’m giving the floor to Rishi to educate us sequentially on the ten. Rishi, please begin.

Dr. Rishi Ganti: Thanks, Angelo. The first one I would like to explain will take the longest, but will help set up the others that I would like to discuss. And it may come as some surprise. But one of the things that a startup manager will not tell you ever are the real reasons he or she left the prior shop.

The real reason is generally something that sounds very bad, but often is not bad at all.

A startup manager will not tell you ever the real reasons he or she left the prior shop. The real reason is generally something that sounds very bad, but often is not bad at all…or something that sounds good, but is not good at all.

Or it is something that sounds good, but is not good at all. Those in the former situation are forced to use euphemisms or just tell outright falsehoods on the circumstances of the departure. Those in the latter position are sitting pretty. But you would not be motivated to invest with them if you knew the whole story and had it in context. Even worse, a former employer itself will be complicit in this arrangement whether for good or for bad.

For example, there may be an agreed upon story about exit. A separation agreement with a startup manager will almost certainly have a gag role in it of some sort, a non-disparagement clause, which obviously limits what the manager can reveal. Remember additionally that references who are still at the old firm will limit what they say to avoid backlash. On another level, the old firm may be providing a bit of investment capital to provide the appearance of a good exit, which is interesting. But if you think about it, a bad exit could very well be more of a signal of value than a good one. It can show that the manager has something to achieve and could not get it done in his or her old shop.

Now investors looking at the manager do not really help the situation either. The manager musters up the courage to really tell the truth and disclose some real facts about his or her department. Many investors turn around and parrot this information to others or call up references at the old firm and ask about these facts, basically dig up a lot of all of your backlash often has no purpose. Further depending on

the employee separation agreement or hire documents, this could put the employee in legal trouble. So on balance, there is a real disincentive for the startup manager to speak freely although they will always have a story to tell.

Asking why a perspective manager left the firm, look, is an automatic question that investors ask. And here, I have two basic pieces of advice. First, if you weighed heavily that a startup manager left his former employer under a cloud, it is counterintuitive that you may be doing all sides a disservice. On the other hand, if everything is hunky dorky and all smiles, why would the manager have left at all?

Those scenarios are designed to mask the real circumstances. Second, you really cannot be trusted with this sort of information. The departure information, you should not be asking for it at all. A classic example is the former employer or the startup manager is an investment fund in which the potential capital providers invested in or interested in. In those cases, often investors quietly send the confidential presentations or the materials for the stories that the prospective manager shares with them right back to the old employer. And some attempt to create favor with their fund.

And trust me, a perspective manager really wishes they would not do that. And the investor and the startup manager who does not engage in these sabotaging behaviors has a real advantage. And if you are a good investor that way, a classy investor that way, a startup manager will be more willing to give you terms that a less trustworthy one would not get. So I will just conclude this one by saying given all this, how can an investor size up the reasons for leaving in a healthy and salient manner?

You can ask are employees at the old firm treated as interchangeable cogs. Was it a partnership environment or was it a place where equity was concentrated merely among the few? Is there a culture of selecting and encouraging employees to avoid thinking that they are entitled to upside in the firm? Does the firm historically have issues holding on to high performers? These sorts of questions are healthy ones that will give you insights while avoiding topics that the startup manager might not be allowed to tell you. So that is what I would say is the first thing a startup manager really will not tell you for real reasons that he or she left the firm.

The second thing that a startup manager or perspective manager will not disclose is that they really have no idea how to run a fund.
I like to coin the difference between being a

money manager and being an investment manager although that might be a false distinction.

And an investment manager knows how to invest. But the money manager knows how to run a business. And it is sort of like having your first child. You do not really know what it takes to do it until you have actually done it. And this means throwing all the balls that are in the air including egos at the startup, legal documentation and negotiation, how to institutionalize. Certainly, when a perspective manager is asked, there will always be some humble pie here on this. They will say yeah, I have a lot to learn. Or I imagine I am going to pick up a thing or two, but I think I can handle it. This is talk. And talk is talk. And a perspective manager has got to run a fund.

Now some managers hire someone to run the fund, which is a great idea. But use this also as a clue to the manager's ego. If the perspective manager would call this person COO instead of a CEO, which is what I imagine happens 19 out of 20 times, take notes. This team member obviously will not be restricted to operations as a COO would be, which is traditionally defined in the financial environment's clearing trades. Often, a manager does not want to give out a CEO title even though the manager is not going to be a CEO and has never really been a real executive of any sort, just an investor. And further, there will not be a CEO in their own fund, at least not if it is run right.

Personally, I would love to run a dummy variable regression on the risk adjuster in terms of managers who cannot admit that they need a CEO or the COO is really the CEO. And I wonder if that flash of ego shows up under the terms.

At the fund I started, we happen to use a system of distributed authority so that issues substantially meliorated. I do not know any other firm that is doing that. In general, most firms are topped on hierarchical organizations rather than massively parallel processing organizations. And let us admit that even talented investment managers are not executive managers in the sense of organizational behavior. So their personal defects, their egos will cause them just to recreate the same wheel that drove them out of their prior fund. And so they will eventually drive out their current employees out of their fund when they are successful. They may simply just perpetuate the cycle that they themselves are trying to break out of, which I will discuss in just a little bit.

A third thing that managers wish they could tell you, but they will not tell you is that your advisor is hiding us from you. In the end, you have to remember that your advisor wants to

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get paid. And sometimes that does not work out for you. As a quick analogy, I remember back during the financial crisis a little after in 2009 I was looking to rent an apartment here in the West Village in New York City. And I knew that it was a renters market or a buyer's market and that I was going to drive a really good deal. And the broker knew that as well.

And every time I tried to schedule going to this apartment (it actually was a townhouse) the broker broke off the meeting. Always something came up. And the issue was that there was going to be a cut in the rental price of the apartment and the broker was going to take it on the chin. And the way the broker dealt with that with me was just never really to meet. Now that was apartments and apartment rentals, which is a fascinating topic in New York. But the analogy carries directly to a startup essentially.

I, personally, in raising money for Orthogon have met advisors who are certainly very trusted by the capital providers who rely on their counsel. But they told me I would only be introduced if I made "a financial arrangement" for them. And that is what I call a distortion, distortion due to cash.

Besides the distortion due to cash, one can be due to credit. So there are a number of advisors certainly again very trusted by those who seek their counsel. But I was not really able to work with them because they did not want me to raise a fund and said they wanted Orthogon to source deals that they would come in directly on. And quite transparently, it would look as if this advisor had sourced the deal and would appear smarter, etcetera. And if that was not going to work, well then Orthogon, however, value added it might be for an investor would never be known.

Finally, besides reasons due to cash or reasons due to credit, there are even reasons due to cutting corners. I once was introduced to a wealth advisor who insisted that the NDA that we signed, we provide a NDA because our proprietary technologies are trade secrets. But the NDA that was signed was their form. That is fine. We can do that. It was extremely cut down and off marketed. In fact, it all fit on a single page, which anybody who signs an NDA and is not a lawyer would know it is a tough trick to pull off.

And the reason with that, they really just could not handle tracking different NDAs who would sign with different managers even if it were their own form. And then I later realized that the simple act of insisting on an off market NDA was preventing their investors from hearing a bunch of ideas.

Now what is the key common thread in

whether a distortion is introduced for cash, for credit or for cutting corners? The common thread is you will never know. You are not getting told. As an investor, you have a selection bias because you only see the deals or the managers that your advisor is showing you. And if those work out, you might incorrectly assume that your advisor is doing a good job. And without question, you love your advisor's personality. They have always been warm, cordial to you and very caring. But all of that is selection bias.

Maybe you would have loved what you did not see even more. And data analysis are basic rules you cannot draw an inference if you do not have the entire panel or at least an unbiased capital panel.
And I know what some people are thinking – not my advisor or advisors. He or she or they are such great people, such great friends. And I like to think that is all the parents who hear that half their teenagers hear the stat that half of teenagers have had sex before they are out of high school. And 90 percent plus of the parents in the room think not my kid. So that can be a frustration as well.

A fourth point is a subtle one. That is if the perspective managers, distorted manager, really engaging the deployment of a strategy? Let me explain further. There are lots of reasons not to back the startup manager and only a few reasons to inform them why. Your reasons will depend on the perspective managers' reasons for starting up a fund. Why is he or she starting up a new shop?

Look more for something like this strategy works and it would squash my old firm for structural and political reasons that relates back to the first item I brought up versus I want to run my own shop, name it after myself and get paid more. The latter is fine. But you have to ask yourself is this going to be an investment vehicle or is it going to be an ego vehicle?

You have to ask yourself is this [new shop] going to be an investment vehicle or is it going to be an ego vehicle?

If it's just pursuit of a strategy, would not the startup manager have been better off pursuing an existing fund with an existing infrastructure and investor base? That saves the manager a ton of money, time and bandwidth, just the managerial attention. Why does the manager not port the strategy into a Soros or HighBridge style arrangements? Why add on all the duties of HR, IR, operations and etcetera?

Those managers focus on alpha who want to be free of those considerations. And I am thinking that the managers' motivations might not be that great in these scenarios. Then again, poor motivations do not necessarily result in poor returns. But just beware.

A fifth component, a fifth idea or notion that the manager will not reveal ever is that one of the manager's key concerns in this entire enterprise, is you. I will start again with an analogy like my West Village analogy.

A number of friends of mine work in medicine here in the city in operating rooms, emergency departments, etcetera. And there is a ton of dead weight loss, of time lost due to parents, relatives, husbands and wives calling in and asking to speak to the doctor or surgeon for an update. And here is the harsh reality that my friends tell me. Your speaking to the doctor actually does nothing to advance care of the patient. All it does is pull medical personnel away from treating the patient. They are calling because of a psychological need. But often, it can cause real harm.

In economics, we can this negative "actionality" because the private strategy, which is calling in to check on things can cause a social, which is drawing medical personnel to the phone instead of to patient care. You can probably see where I am going with this.

Not all investor money in this sense is equally green to the manager. In a mature shop, the manager might be choosy. A mature shop is a shop that has lasted five or ten years. He or she might think that a perspective investor is just too high maintenance and might be a tax so to speak on the human capital of the firm. Sometimes the payment of this tax is formalized and that mature shops often have substantial investor relations personnel. But since these personnel are paid for by the management company, one, they do not work for you. And two, they will never be fully staffed because they are a cost center. And so they are just for pure draft on the firm.

The startup manager by contrast cannot really refuse your money. We all know how difficult it is to raise capital in this environment. So he or she runs wrong way risk. The startup shop in that sense is both understaffed and subject to adverse selection for high maintenance investors.

For an investor, everything here might just cause them to be indignant. This is an observation that they would reject. They would say that they have a right to communicate with the manager frequently, especially a startup manager to check out how things are going and make sure things are developing

correctly, to request use of Socratic drill downs on reporting. And they argue that they are helping the manager with helpful criticisms and observations and other forms of business development. And all of these statements are true. But it still ends up being a little more like the emergency room scenario than anything else. And is a startup manager going to tell you this? No.

And the sixth thing (I think we are up to number six at this point) is the real extent of key man risk. And I think a startup manager is not going to tell you the degree of key man risk or key person risk because he or she has never really thought hard about it before. The perspective manager might have some answer concerning it just like we – just like in our discussion here about money managers versus investment managers. It will be a padded answer.

And the sixth thing a startup manager is not going to tell you is the degree of key man risk or key person risk because he or she has never really thought hard about it before.

Now Orthogon, we have highlighted this as a risk upfront in investment taking cap instead of a side benefit of mitigating this concern. But in general, we are the exception rather than the rule. In order for a manager to conceptualize key person risk, the manager has to have a kind of intellectual independence from the strategy, an ability to observe the strategy dispassionately from afar like a fly on the wall rather than just being someone who can really perform the strategy.

As a quick jolt to reality, how many of us have thought about food poisoning the last time we went to eat at a restaurant. I will tell you probably none of us. We just sat down and looked at the good stuff on the menu and ordered. And key man risk with managers is kind of like food poisoning to a diner. A real risk, but something that really does not cross our minds even if we are really smart people.

Now granted, there are some investment funds that have really locked this down safely. But they are unlikely to be startups. They are even less likely to be startups that, for example, name the firm after the founder, right. If the ego is wrapped in the name of the fund, the manager probably does not think the strategies out to think himself or herself, right? Now there are firms that are certainly exceptions. I worked for HPK Investments in Dallas about ten years ago, which clearly survived after Harlan Korenvaes left. But it is not a great signal. And that is one thing I would warn allocators about.

As a seventh item, I would continue to scheme what a manager does and does not know and say to what extent are the results skill versus luck? And this is that great classic truth of the investment industry. But when a manager's up, it is skill. And when he is down or she is down, it is bad luck. And I generally believe that managers genuinely believe that this is true. Though if someone is deeply trained in empirical methods, I am convinced that you can get just about anyone to believe almost anything with very little data.

I think skill versus luck is one of the great inferential problems facing an allocator. And it is extremely tricky. Let me demonstrate. Let us suppose that there is a long short manager who outperforms his benchmark by take a number. I will call it two percent. Over a long enough time horizon, this would rank the manager as one of the best in the business. It seems like skill. But let us suppose the manager has been boosting returns through exposure to a low probability, but never the less, extremely severe risk, something like selling deep out of the money puts.

Then actually that extra two percent, there is no alpha in those returns. And the strategy actually is not outperforming. But until that low probability risk eventuates, no one will ever know. So the trouble is you cannot depend on quantitative analysis to track record to make this inference. You have to depend on softer factors. But this can lead you astray as well.

One of my favorite scenes is in the movie Money Ball, which I really recommend based on the book by Michael Lewis. And there is a scene where there is a round table discussion between Billy Bean who is played by Brad Pitt in the Oakland A's for recruiting for next seasons players. And his scouts were all talented and deep in the business cite a number of factors that are all plausible and I mean it – all plausible for judging a player like the beauty of a player's swing, the posture or attitude of his batting stance or even how good looking his girlfriend is because that is a test of a player's confidence. And a player's confidence is really important.

But at this point in the movie, Billy Bean actually believes that the only thing that matters is on base percentage. And everybody I know who is finance and saw that scene loved that scene. But how many of us in our daily lives in finance do the same thing? How many of us actually judge a manager more because he or she shows well or has the right pedigree or similar. I would suggest that managers – investors, excuse me, looked at the ego of the manager first and secondarily to what I call strategy fragility. The strategy is fragile, but depends excessively on expertise. And if an extreme amount of expertise

is required to extract alpha then you can probably bet that any pervasion to the system will throw the strategy off. And if the strategy has been doing well so far, basically, luck has been keeping the strategy going. That is one way to deal with this influential problem. For the manager who is going to save course, good results of still. He will not even know himself the response.

A very important and overlooked area I think that a manager or perspective manager is not going to volunteer to you is who his or her real competition is. And I mean this particularly in the liquid spaces. Certainly ask. A good manager perspective or established will direct you to other managers that they admire or like.

Rather than ask directly who the competition is, ask "If you had to put your money with a manager, who would it be?"

But they will not necessarily be in precisely the same space. Now regardless, take these referrals seriously. But in my experience, investors never ask for them. In fact, I am personally sending out an email very soon making an offer to investors in our fund saying hey, you did not ask, but I have some views on who I like out there as investment managers and service providers if you would like to know.

I think sometimes people forget that funds are actually partnerships and not just in legal form, but in actual form. And everybody should act like partners. But back to the topic. Go ahead and ask directly who the competition is. But you might get misdirected to – yes, managers in the space, but who are faring more poorly, right. That makes the perspective manager look much better.

So instead, ask a different question. If you had to put your money with a manager, who would it be?

Now a clever manager will point to a manager in a different space. So, example, a long short manager will mention a great credit manager. And a credit manager will mention a real estate manager because he or she does not want to say there is anyone here she admires, right? But ask that directly. No, no, do not like the perspective manager off the hook. Who is the best manager in your space? And also, at the same time, perhaps ask the three managers that most overlap with this manager's strategy. And do not just take the answers and just write them down.

Observe how the manager answers the question. It does not matter if it takes forever

to answer. That is a bad sign because it is not really because the manager is unaware of his or her competition or who is out there, okay. The manager instead is pausing to formulate the answer in his or her head, edit it and testing it to see if it is going to sync his or her chances at your money. A confident manager who believes in his or her strategy will be very straightforward. They will even compliment the competition. Look for that.

Number nine, one query I would have and I do not think again managers really thought about this and I do not really blame them for not really volunteering it is how in the new startup fund the managers want to avoid the same kinds of pitfalls that caused the manager's departure. And I could talk about his all day. But I will simply focus on one thing. I do not know why history seems doomed to repeat itself. But a manager who leaves a shop due to great ambition or even greater frustrations still ends up re-fighting the last battle. They are so intent on the consummation of their investment strategies that even a good deal is forgotten – excuse me. A good deal is forgotten about the stifling environment that they just left.

For example, one of the reasons managers leave is what I call the tenured professor prop. They feel that they are providing the returns, they are making the alpha, but they are not getting the payout because they did not found the firm that they are working for. And the fact is that there are equity partners in that firm that they might consider beneath them or that they consider to be not that hard working. But regardless, they have got the equity and this grade is unknown and they cannot advance. So naturally, they leave the firm.

What is the first thing they do when they start their own firm? They found the firm. And then they hand out equity to themselves and to their fellow founders and continue oblivious to the fact that they are just continuing the cycle that they were trying to break away from.
Again, we have solved this problem by becoming a firm where partnerships stakes are variable and decided now by the firm as a whole. But I do not really think that other firms are generally doing it because it takes a great deal of selflessness of the founders to do that. That is at the very moment that he or she (assuming there is a single founder) can have the line share of equity to resist that temptation and instead reserve it for the common good or for the partnership as a whole. I have always personally wanted to do that and break that cycle. But it is something to think about. It can be posed as easily as the question well you are leaving your current show, why won't five years down the line, talented investors with yours.

As an investor, you can pose a question like

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that gently to the manager and see what the reaction is. How is it going to be different in your firm? If you get a completely puzzled look, well political philosophy and governance probably were not on the reading list for this person's undergraduate times. I will help them out, give them some pointers on what we would like to see so that the cycle breaks. And personally, I think the producing alpha is bigger idea than any one person. And so personally, I would be favorably disposed to managers who are going to stare and think ahead this way. Although again, I do not think I can prove they perform any better or worse than more short side managers.

The last thing is that the manager has a great deal of interest and not revealing at that moment how many balls he or she is keeping in the air.

And that leads us, I think, to the last one that I discuss, number ten. And that is that the manager has a great deal of interest and not revealing at that moment how many balls he or she is keeping in the air.

Startup managers, especially the savvy ones know the value of being selectively transparent. They do not give you a tour of the whole house. They will just let you look in through certain windows and you will like what you see back there.

One manager I know and admire, I think this is a great shop, left his fund and pulled a number of colleagues with him. During his time at the old shop he had not been paid that much. And in leaving, obviously, he gave up all his deferred compensation. Compounding this, he was recently married and he had a kid on the way. And look, he is a great investor. He has got nerves of steel. And now he running hundreds of millions of dollars with his partners. Frankly, how he got through that I do not know.

A startup manager's team wants to know – or perspective team let us say want to know if there is investment capital coming. But the investment capital wants to know it is pristine. It is a catch 22. And if you add on parasitic activities by cap intro or those personally motivated advisors we talked about earlier and marriage/family issues with kids, then there is a swirl of activity that is just beyond the perceptive horizon of the allocator. And if the manager has his way, it is going to stay like that. I think these are the ten things that a manager either does not tell an allocator either because they do not want to, because they do not know any better or because they cannot.

Angelo Robles: That was fantastic, Rishi.

And often, my audience is best served by me being quiet and having someone so thoughtful like you explain in such great detail the ten core issues facing investors on emerging managers.

Dr. Rishi Ganti: Thank you.

Angelo Robles: I am going to ask you a couple of follow up questions from that, that are going to build upon those ten core areas relative to an investor or even broadly anyone who is a significant allocator investing in effectively third party managers. And a little bit of a focus on the opportunity of investing in startup managers. One of them, why backers of startup managers are often among the smartest of the "smart money." Why is this?

Dr. Rishi Ganti: Actually, one of the most fun things about raising money over the last year that I have had is the kind of investors that I was able to speak with. They were certainly very, very sophisticated. I think that there is a different level of investment analysis that most investors have not reached. And that is a focus on making managers work for you rather than simply getting an allocation for capital. This means that the manager optimizes for your tax position providing reporting that ports you well with your risk management. Listening to you guide the manager on asset or transaction types that you do or do not like. Getting direct deals and co-investments at low fees or zero fees.

I think to reach this level of thought, right, this plane of existence, there has to be a certain level of jadedness in the investor. I am talking about something deeper than your experience. I mean I have kind of been there, dumbed out mentality. Cynicism about the fees that managers earn, doubts about manager's claims of finding alpha, concerns about how a manager treats you in face to face interactions versus behind closed doors and the kind of tiredness of the over promises on risk controls, returns, correlations to market, hedging, being underwhelmed by lots of things.

And at that moment I think and in this light, strategy differences like real estate versus private equity or venture capital versus macro, they all sort of vanish in the haze. And these sophisticated investors visualize a new strategy space, one where you have established managers who do what they do. And really due to the fact that they have been around so long and have techniques for staying around so long centered on the stickiness of capital and other deep crevices of investor relations. And that is what they are going to do. And you can take it or leave it.

Now the other side of this strategy spectrum, you have new or emerging managers who

have strategy perhaps no worse than the big boys and perhaps better. But are more malleable, more like clay right as you mold it. And I think that the smartest of the smart money is very attractive to that side of the spectrum to that strategy space. They appreciate how everything is protean and shape shifting. And they roll up their sleeves and go out fishing for perspective managers. And I think in the end these smart money investors get superior returns. They get real risk control. They get a disposed portfolio that is tailored to their needs and views. I feel that these investors are a step ahead.

If you are an investor, say a pension fund who considers startup or emerging managers to be completely radioactive, if you are taking a career risk because the startup manager does not work out, six subcommittees where you work are going to fire you or demote you. Then you are going to live in a high fee, it works until it does not work type of world where you may hit or miss allocations to managers in to which you have little insight or control although I am sure they are very nice to you than the higher departments are. And other capital, super, super sophisticated capital goes completely in the other direction. And that is why – that is what I have found. And I have really, really enjoyed the conversations that I have had other the past year certainly.

Angelo Robles: How can startup managers potentially significantly reduce the tax burden to taxable, ultra-high net worth investors in family offices? Not a challenge that institutional investors have to worry about. And if the manager came from a big shop that was primarily focused on institutional investors, this is a real area that I have been writing about, that I have been talking about effectively the debt effect net return post taxes has been an abysmal for many actively trading managers. I would love to hear your opinion at how this could be better addressed.

Dr. Rishi Ganti: Angelo, I think is one of my favorite areas of discussion with you. We see very much eye to eye here. As a trained lawyer, a CPA and an enrolled agent with the IRS, I would not call myself a tax geek. But I am definitely a tax aficionado. And I do not think that the industry really promotes this sort of thinking even though it is what you keep that matters, not what you earn.

Just a little bit of background, we all know that for high net worth individuals that ordinary income, for example, interest earnings are not a qualifying dividend income. It is pretty hostile to a top bracket taxpayer.

A simple technique that I am not going to talk about here is to elbow your favorite manager in the ribs. And if it is a startup manager that

elbowing hurts all the more. And say hey, do not do that. Stop earning that income. I do not want to spend too much time on the elbow in the ribs technique because whatever I say, SFOs and MFOs, excuse me, single family offices and multifamily offices still allocate very heavily to credit and lending funds. They get

Elbow your favorite manager in the ribs. And if it is a startup manager that elbowing hurts all the more. And say hey, do not do that. Stop earning that income.

absolutely destroyed under 1040-Es when K1s come in. But nothing changes.

Again, as I said, it is not what your earnings would keep. But this principle is not often adhered to in practice. And I do think for lack of knowledge. I consider this form to be called tax alpha to be a super low hanging fruit. But I will just leave the topic there.

Instead, I would like to talk about one of my pet peeves, which is Section 212, which is a fascinating part of the U.S. tax code if you want to find taxes interesting as I do. There is no logical basis for Section 212 in my opinion except to raise revenues for the federal government, which admittedly needs the revenues.

Now what Section 212 does is it buckets certain kinds of expenses. Let me explain expense bucketing and why this increases tax revenue to the detriment of the tax payer. A quick analogy: let us suppose you have a lemonade stand that makes ten dollars and has four dollars of cost. So ten dollars of revenue and four dollars of costs. So that is six dollars of profits. Let us suppose that you pay one-third of it in taxes. So taxes of about two and six minus two leaves four. So that is your after tax profit.

Now let us suppose instead that the IRS ring fences the costs and just says you cannot really use them. So instead of getting tax on six of profits you get taxed on all ten of revenues. Well then the taxes are one-third. Well then you are paying taxes of three, not two in the previous example. And profits are not four as they were in the previous example. They are now three. So your after tax profits went down from four. You just lost one-quarter of your income. Why? Because the IRS said you cannot net the costs against the revenues. Not being able to net costs against revenues can be very, very expensive.

And guess what? Section 212 works just like that lemonade example except in the extent of lemonade stands, it works on investment funds. It subjects certain kinds of expenses, particularly management fees in the liquid

funds to expense bucketing. Now I will explain a little more about that later. But just to go back to the example, the relevant tax brackets all in city, state, local, etcetera, Obamacare and federal, let us say it is about 50 percent for U.S. net worth individuals for easy math.

So what you think might happen if you give up one hundred dollars to a fund and it makes a ten percent return, well there is four of expenses on that. You have six in pretax return. And you think you get three after tax if you are in a 50 percent bracket. But instead, let us suppose in those expenses that four of expenses two are bucketed away. They are not able to be used. So you have made ten and you can only deduct two against it. So that is eight. The IRS will force you to pay 50 percent on that. So that is four if you are following along. You now end up with two dollars in after tax profits, not three. And guess what? That is one-third less. These are huge effects due to Section 212. And which items are captioned at 212 net? I mean what is actually bucketed for the purpose of the IRS? A fund is either a trader fund marking to market or an investment fund, which marks for tax upon realization.

Now if you are a high frequency trading firm like Two Sigma is, my former employer, you would be the former. But if you are a PM funder engaging with the liquids that really sort of make an investment, wait and get a realization, you are in the latter group, okay. You are an investment fund.

Now a trader fund treats fund expenses as under Section 162 as ordinary business deductions. And that is a really good treatment in your K1 comeback looking nice. But if you are in a liquid fund, you are basically restricted to treating these investments as miscellaneous itemized deductions under Section 212.

And for nearly all individual investors in the fund treating fund expenses as Section 212 expenses causes that bucketing. And that results in a very substantial tax penalty and is sort of the simple math that we went through before where you could lose one-third of your returns to tax.

Most individual investors do not obtain relief from Section 212 expenses. Why? Because these expenses are subject to two percent of the AGI floor. So when your K1 comes in, you have to test it against two percent of the AGI floor. But if you are a high net worth individual, your adjusted gross income is very high. Two percent of a very high number is still very high. So basically, all the expenses will be thrown away.

At Two Sigma, I actually coined a term, which was called a 212 Bad Expense meaning if I

could identify a line item and I thought it would get captured by 212, I would say that is a 212 Bad Expense. And established funds are not going to help you out here, okay.

You may have your fee structure set up. You have your management piece set up. Their investor's relations department, again, will be very interested in your diatribe of the loss of the third. Go ahead and play this part of the podcast right to them. And they will be very flattering to you. But after all of that, they are not going to do anything.

In fact, if anything, after you leave, if they do not have a two percent management fee already, they are out of your ear shot probably scheming on how to get to one. But if you are working with a startup, it is different.

There are a couple of approaches with a startup. One is you can lower the management fee because the management is the source of 212. The problem is the startup probably cannot afford a low management fee. The startups already have a tough time funding themselves from the beginning. And it is probably more sensible to pay them something so they can keep the lights on.

One way you can make the naïve approach a little less naïve is perhaps you will have a deal with the startup manager that yeah, you pay some percent now, 2 percent – 1.5 percent as a management fee or what have you. But over time, those management fees zero out. That helps your tax position. Definitely, you should go for that instead of saying lowering the incentive fee you pay, which actually has good tax character.

However, a much better approach for the manager and for you, for the high net worth individual, the U.S. taxpayer is do not pay a management fee. Again, that is a source of 212. But provide some startup capital. Just spray it out, a onetime payment to startup capital. And the manager has cash to live on then and it actually gives you an asset in the firm, right. Because you giving capital for something. You are probably taking equity for it.

A third approach that is very 212 aware is that to the extent that you have equity or you are getting a payment or revenue share (I will talk about that in a moment) that you direct it towards the management fee. And this is something I have done a number of times. For example, you owe the startup manager some money, say a management fee. But the startup manager owes you some money because of an equity share or revenue share. So you net them. On a pretax basis, nothing has happened. There is no difference. But on an after tax basis, a lot has happened because

your K1 will come back. And line items that are due to 212 will be lower to the extent that you are able to net.

I have already talked about zeroing out management fees over time. And I will just mention very quickly that there is a third – there is a last kind of approach, which is use private placement insurance to an insurance dedicated fund. But that is beyond the scope of this particular discussion. I will just say that the insurance vehicles for investing are legally sanctioned with decades of pronouncements supporting them. And that can potentially provide tax free investing to high net worth individuals. In my unscientific pool, this technique is vastly underutilized. But it does take work. It does take structuring. Just remember, it is far easier to structure with the startup manager that you have total control over – not total control, but a lot more influence over than with a firm that is established that is only partially hearing what you have to say.

There are lots of things you can ask for. Most investors do not even realize all the different things that they can ask for.

Angelo Robles: I think what you said about investors and startup managers and taxes was wonderful and transitions into my next question very well, especially with the opportunity of a family office, say a super high net worth individual, more than simply an early investment, but potentially have some other favorable economics than early stage manager. Let us talk a little bit about co-investments, capacity rights, speed preferences and effectively directs and zero fees.

Dr. Rishi Ganti: That is right, Angelo. We have kind of hinted at this before. In some sense, this just appears to be kind of a smörgåsbord for a potential investor. There are lots of things you can ask for. Now I will say one thing is knowing what you can ask for. And a second thing is knowing the right things to ask for once you know what they are. But most investors do not even realize all the different things that they can ask for. If you just ask for cheap fees for your startup manager, I liken that to those people who when they get bumped on a plane to another flight, they just take the new flight. They do not ask for a food voucher or a travel or a travel vouchers worth hundreds of dollars off their next flight, a hotel stay, an upgrade on what you are being bumped to, lounge access, drink vouchers, extra frequent flier miles. I mean there are so many things they could ask for. But people do not know. So they do not ask.

One thing is E preferences. Definitely, if you

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are helping a startup manager start off, you need MFN, most favored nation's clause. You got to work to make it airtight. And that means that you get at least as good a deal as anyone else. Remember, it has to apply to lots of different vehicles that a startup manager might come up with. An MFN that is not written robustly might fail because the fund raises capital through a FMA if you are a subsequently managed account or some other culture under the vehicle that you cannot participate in. And it is nobody's fault. But the startup may create a funding channel that you just cannot enter for tax reasons or due to a jurisdictional bar. So the MFN has to consider this.

The second thing with all these different techniques is to think about how they evolve over time. So you can carry your fee preferences here to future funds. That is good. Your fee preferences could also improve over time, right? You could start out paying a startup manager 2 and 20. That is very high fees in today's environment. But just to start to make sure that they can put food on the table. Maybe it drops down to a 0 and 15 over a hard hurdle later. You could get creative. I have never seen a hard hurdle and a soft hurdle at the same time. But there is no reason mathematically that it cannot be done. You could have a hard hurdle set as say at four or five percent and a soft hurdle set at eight percent where a catch occurs.

Just remember, your manager has to survive. So paying them too little in the beginning will have pernicious results if not now than later. Meaning years from now when they just hate you and just have been dreaming of the time when they could do something. Do not create that relationship. They are stewards of your money. So they are being nice to you. But also be nice to them.

The next thing to consider is capacity rights. Future funds, I mean your right to fund at the fee preference cannot be unlimited. Because by definition, you are getting a big, big break on fees. And if you negotiate a deal that has unlimited rights to have those fees over unlimited amounts of money, you should walk away from the manager because the manager is just stupid. You cannot be 0 and 15 and take 100 percent of the new capital. The manager basically is not going to make it over the long haul. But you could take 20 percent of the new capital or something like that. If your fees are more sustainable like 1 and 15 or 1 and 20 and maybe size would not be as much of an issue be-cause the manager should have pulled the allocate away from you for higher fees.

One of my favorite, favorite perks has got to be zero fee co-invest, right. The manager has got

a deal. Again, this relates more to a liquid fund. The deal is too big and will bust the manager's port-folio diversification requirements, right. Those are the requirements that you negotiated. So never ever take a manager's word for portfolio diversification requirements in the LPA. You can take the excess of that deal at zero fees. And I did not say low fees – zero fees, no management fee, no incentive fee, just sort of the general fees that are already embedded in the trade.

So let me just put all of this together – the last two answers together with the smörgåsbord and the earnings. So overall, I do have a particular opinion on the best way to structure a GP interest or revenue share, fee breaks and things like that.

First, we already know that the U.S. high net worth individual (that is to whom this particular comment is directed) should be avoiding 212 Bad Expenses. That means providing startup capital if the manager needs it in return for zeroing out a management fee. It also can mean if there are management fees that they reduce over time as AU1 [PH] grows.

But what about equity upfront? This might be surprising. But my advice is to avoid taking a piece of the GP that a share of the GP is a profit share. But if you have a profit share and the GP means nothing because they have manufactured their expenses to equal the revenues, then you get a share of zero, which is zero.

Remember, as a share of the GP, you have just introduced an incentive to the manager to bring his GP at zero profits because that reduces their value transfer from them to you. And how does a man-ager do that? Well it is simple. All it takes is for the manager to increase salaries or other line items, flying Net Jets and these are all things that managers want to do. I mean which manager out there does not want to increase salaries for himself or herself and their staff. Suddenly, you have a man-ager who can raise expenses to match any arbitrary level of revenues. You are left holding a GP stake that is not worth anything.

To control this tendency, investors or peak shares react by trying to provide budget constraints and GP oversight. Yet that solves one problem, but it creates another since it poisons the partnership process. Instead of being on the same side of the table with the manager, you are now in an acrimonious finger pointing debate over whether someone should be taking subways or a taxi much less Net Jets, which I mentioned before, whether meetings should have soft drinks, water or something equally innate. You do not want that kind of conflict. You do not want to be a bean counter for this guy. You just want them to go

make money.

So instead of taking a stake in the GP, I recommend a revenue share. A revenue share is similar in many ways to a GP share. But it is a top line cut, not a bottom line cut or profit share. So if the manager pulls in four million dollars of revenues that year and you have a ten percent revenue share, you get four hundred thousand period. The manager's expenses are up to the manager – Coke or Pepsi at the meetings or soft drinks or water. The manager's expenses can be smaller. Your cut is the same.

So now the incentive for the manager to manipulate operations has been removed, broadly aligned and less conflicted and more efficient with your time. If you put it all together, if you have equity upside, it should be a revenue share, not a GP stake. It should come as a first against management fees to zero out Section 212 Bad Expenses. Once that is done, excess rebates should be netted against incentive allocations.

Only if all fees are zeroed out by netting and you have some revenue share left over, then take it. This way, you reduce all your taxes. Ask for the highest tax and lowest tax before you, yourself, have a taxable item on your K1. There is no change in the pretax result. But there will be investors after tax bottom line, a much better solution. You will stay broadly aligned with your manager. You will have a great relationship over time. And if you really, really want to be efficient, you can actually reduce your revenue share in early years to help the manager out and let them keep that money and increase in the later years when the manager is bigger and better able to pay it. And I think that is a great approach that investors can take with respect to startup managers that they really like.

Angelo Robles: Rishi, I really enjoyed this dialogue. I wish we had more time. It feels like the hour just flew by. There are so many things to follow up. And I am sure my audience is going to be in-credibly interested given your amazing background and how well you articulated yourself in your thoughts in this dialogue in terms of what you are doing and some of the things that you are specifically seeing now. We will likely have to save that for our conversation part two sooner rather than later. However, those that happen to be listening in or to the recording that would like to learn more or follow up with you, is there a website? Is there contact information you could give out or share? I am sure people would love to follow up.

Dr. Rishi Ganti: Yeah, I would be happy to do that. We are still getting our website together. Oh, the woes of being a startup manager. But

those listening to this podcast can email me at rishi@orthogon.partners. And I would be happy to answer their queries. And maybe, Angelo, the web site might be when the podcast is up too. But I hope this was helpful. And I really appreciate the time even just to talk about these sorts of issues.

Angelo Robles: Rishi, thank you so much. I look forward to the next one. Everyone, this is Angelo Robles at Family Office Association. Thank you all for listening in to our FOA audio podcast today. Look forward to the next one. Rishi, have a great day. Thank you so much.