**Fund 3**

Basic Information

* Location: Chicago, IL
* Fund Inception: 7/1/2005
* Current AUM:
  + Fund: $1,500,000,000
  + Firm: $5,000,000,000
* Terms:
  + Redemption frequency: Quarterly
  + Redemption notice: 45 days
  + Redemption fee: 2%
  + Gates: none
  + Lockups: 12 months soft-lock
  + Management Fee: 1.75%
  + Performance Fee: 20%
* Client base %
  + Fund of funds: 5%
  + High Net Worth/Family Office: 15%
  + Friends/Family/Internal: 5%
  + CIO: 5%
  + Parent Firm (Seed): 10%
  + Institutional: 60%
* Client base #
  + Fund of funds: 10
  + High Net Worth / Family Office: 25
  + Friend/Family/Internal: 8
  + CIO: 1
  + Parent Firm (Seed): 1
  + Institutional: 30
* Largest Clients
  + Top 1: 10% (Parent Firm)
  + Top 3: 19% (Parent Firm, CIO, Institutional)
  + Top 5: 25% (Parent Firm, CIO, Institutional, Institutional, Institutional)
* Employees: 53 Total – Includes resources shared across firm
  + 1 CIO/Portfolio Manager (Managing Partner)
  + 10 Sector PMs (Partners)
    - 20 analysts, 2 per sector pod
  + 1 Head of Risk (Partner)
    - 3 Risk analysts
  + 1 COO/CFO\*
    - 5 Operations Analyst\*
  + 1 CCO \*
  + 1 General Counsel\*
    - 2 lawyers\*
  + 1 Head of Marketing/Client Service\*
    - 1 Marketing associate\*
    - 1 Client Service associate\*
  + 1 Head of IT\*
    - 2 IT\*
  + 2 admin/reception\*

\*Shared resource, parent firm

* Employee Turnover (last 2 years): 7 (1 PMs, 3 analysts, 1 Operations analysts, 2 Risk analysts)
* Employee Turnover (last 5 years): 17 (4 PMs, 6 analysts, 3 Operations analysts, 2 Risk analysts, 2 Client service associates)
* Segregation of Duties:
  + Portfolio Management: CIO, 10 PMs
  + Reporting, performance analysis\*: 1 Head of Marketing/Client service, 2 associates
  + Strategy, research and development: CIO, 10 PMs, 20 analysts
  + IT/Programming\*: 1 Head of IT, 2 IT analysts
  + Administration: 2 admin/reception
  + Risk Management: 1 Head of Risk , 3 Risk analysts
  + COO/Operations\*: 1 COO/CFO, 5 Operations analysts
  + Legal\*: 1 General Counsel, 2 lawyers
  + Compliance\*: 1 CCO
  + Marketing and Business Development\*: 1 Head, 2 associates

\* Shared resource, parent firm

* Ownership
  + Vast majority owned by the CIO
  + Parent firm owns passive, minority stake
* Registration
  + SEC: Yes
  + Other: FSA
* Service Providers:
  + Prime Broker: Reputable, Multiple
  + Administrator: Reputable
  + Legal: Reputable, multiple
  + IT: In-House
  + Compliance: In-House
* Investor Reporting
  + Weekly estimated performance
  + Monthly estimated/final performance
  + Monthly newsletter
  + Quarterly letter
  + Quarterly update calls
  + Monthly Risk Report
  + Monthly Performance Attribution Report

Biography and Experience

* CIO
  + 50+ years old
  + Undergrad Economics and Engineering
  + 4 years boutique advisory firm
  + 7 years analyst at large, well-known Equity L/S HF
    - Sector generalist, Domestic Equities
    - Partner and PM after her fourth year
  + Launched Fund 3 in July 2005
* Average PM Profile
  + 35-40+ years old
  + Undergrad Finance/Accounting/Econ
  + 15-20 years Investment banking or Buy-side Analyst experience
  + Most have some amount of prior PM experience as well
  + 5 years with firm
* Average Sector Analyst Profile
  + 25-35+ years old
  + Undergrad Finance/Accounting/Econ
  + 5-10 years Investment banking or Buy-side Analyst experience
  + 3 years with firm
* COO/CFO
  + 50+ years old
  + Undergrad/MBA Accounting
  + 5 years in Public Accounting
  + 5 years as hedge fund research analyst at corporate pension fund
  + 15 years in senior back office roles at several small to mid-sized hedge funds
  + With firm for 12 years
* Head of Risk
  + 30+ years old
  + Undergrad Engineering
  + 10+ years in various trading, quant research, and risk management roles
  + With firm for 4 years
* Average Senior professional (e.g. Chief XYZ, Head of XYZ) experience
  + 40-50+ years old
  + Relevant Education and Credentials
  + 15-25+ years in various trading, quant research, and risk management roles
  + With firm for 9-5 years

Company History

After successfully running her own diversified, US equities long/short book at a premier hedge fund, the CIO set out to launch her own fund. The CIO found difficulty in raising enough money as she was unproven and had no track record to show during the asset-raising phase (employment agreement prevented her from taking this with her). She was later approached by a decently-sized, up and coming hedge fund that already had existing Private Equity and Fundamental Credit L/S vehicles. They liked her pedigree and were looking to diversify their product offering. She ended up accepting a deal whereby the new parent firm would take only a passive, minority stake in her company (the firm shares in equity and profits, but not decision-making) in exchange for a $100 MM fund investment (same terms as other investors, but longer lock up), office space, systems, established brand, and other shared resources, including people. Along with the parent firm’s investment, the fund launched with $50MM of additional capital, which included friends and family money as well as a significant portion of the CIO’s liquid net worth.

The departure from her previous employer was contentious. While she had a consistently stellar performance track record, she was also perceived as being very competitive with the other investment teams and somewhat of a snob, never sharing what she was seeing in the market and always keeping her cards close to the chest. The CIO took with her all 3 of her analysts from the previous firm. She was required to sit out for a full year to fulfill a non-compete clause in her contract (as did the 3 analysts). During this period, the CIO and her team spent a lot of time traveling, spending time with family, and casually trading their own money to stay on top of the market. The prop trading conducted over this period produced underwhelming returns, +2% vs. the S&P 500’s +10%. The CIO notes that this track record isn’t shared with potential clients of the new fund since it was not truly indicative of Fund 3’s strategy.

The newly formed fund began trading in 2005, utilizing the same strategy that the CIO and her team had previously incubated at their old fund. Over time, assets grew as did the size of the investment team. The CIO saw no shortage of long and short opportunities in the market and thought it prudent to adjust the bandwidth accordingly by hiring sector-specific specialists as PMs to man individual sector books. The strategy/investment team structure would eventually evolve into its current iteration, which resembles more of a multi-PM structure with coverage spanning 10 sector classifications. Sector coverage was ultimately the same as before, but spread across more people. The CIO would maintain her own center book which was sector agnostic. The same can be said about investment decision making.

There are currently 10 sector PMs managing individual books (sector pods). Finding talent in this area was never a problem for the CIO. She targeted experienced PMs that sought greater autonomy and had an entrepreneurial spirit that would normally only come with running one’s own hedge fund. She benefitted from an environment that was difficult for small funds to grow. Each PM has 2 sector analysts dedicated to helping that PM with idea generation, research, position monitoring, etc. In terms of compensation structure, all PMs are paid on their individual book’s P/L. The payout is noted to be very high compared to industry standards. PMs have the option to receive all or some of the payout or re-invest into their books on a fee-deferred basis. The CIO believes that having the sector PMs work in silos eliminates peripheral distractions and outside noise that might come with sector generalist models. Her philosophy is that having a singular focus allows the PMs and their teams to build a specialized expertise that ultimately translates into superior risk-adjusted returns at the aggregated portfolio level.

Investment Strategy

The fund invests long and short in listed equities across all market caps and sectors. The vast majority of names in the portfolio is domestic, though there is discretion among the PMs to opportunistically invest in Developed Europe. The manager does not consider itself to be market neutral, but all PMs tend to manage their individual books with a variable, low net exposure profile. This is something the manager took into account when hiring and vetting the PMs. Shorts are largely directional bets used by the PMs used to generate alpha while a smaller portion represents general sector or thematic hedges. Sector coverage is exhaustive enough that it covers the vast majority, if not all, of the listed equities universe. Over time, the manager hopes to achieve a profile consistent with high-single digit returns (~8-10% ann) with low single-digit volatility (~5% ann).

PMs are responsible for generating ideas for their own respective books. There is no “firm view” and PMs are neither encouraged nor discouraged from interacting with one another. Sources for ideas can come from anywhere: newsflow, industry contacts and relationships, industry conferences, Street research, meetings with company management, names they’ve traded in their personal trading accounts, brokerage desks, proprietary research, screens, expert networks, etc. Because the PMs have covered their sectors for many years, they’ve looked at many of the companies in their space in the past and often draw on this intimate familiarity as well.

After identifying potential long and short ideas, the PMs and analysts will walk the names through their preferred research processes. Each team has their own style and process, influenced by what the PMs have done for years at previous employers. Generally speaking, however, the processes will not differ dramatically. The research will typically entail speaking with contacts, participating in quarterly earnings calls, meeting with companies’ management teams, dissecting financials, churning out valuation models, upside/downside/price target analysis, assessing the competitive landscape, talking to parties up and down the supply chain, defining various risks, etc. Sometimes the research will lead to new ideas or will uncover new potential longs and/or shorts. All the work is documented in informal write-ups and informal reports that can be revisited and updated in the future. This process leads to a thesis and an investment decision.

The CIO is generally laissez faire when it comes to managing her PMs and their books and she’s historically been very good about not micromanaging, even during periods of poor/underperformance. However, the CIO is also notoriously hard to please and places great emphasis on individual performance and beating relevant benchmarks. PMs perform 100% of their own books’ trading. As long as the firm’s mandatory risk limits aren’t breached, position sizing, portfolio construction, and diversification are entirely left to the PMs’ discretion, at the sector pod level. In general, each PM tends to run a well-diversified (in terms of names, # of positions) book. At the larger portfolio level, the CIO has full discretion as to the allocation of capital among the PMs/sectors. Allocation of portfolio capital to the sector books has traditionally been determined by the PMs’ performance.

In addition to the 10 sector pods, the CIO and risk manager co-run a center book (CIO book). The book is primarily intended to be the CIO’s own pod which operates mostly like the sector pods in terms of profile (exposure, leverage, number of positions, etc) but has a wider mandate. Two notable differences are that the CIO may invest across all sectors and may selectively add onto individual positions that exist in the other PMs’ portfolios, thereby increasing the fund’s exposure to individual trades that she likes. Lastly, the PM and Risk Manager use the book as a vehicle to hedge others’ positions or hedge the larger combined portfolio’s aggregated exposures.

Risk Management

Risk management has become an increased emphasis in recent years. The firm has a dedicated Risk Manager who is assisted by 3 Risk analysts. The role of Risk Manager, as well as the existence of the risk team, is a relatively new addition to the firm and is exclusively dedicated to Fund 3 (not a firm-wide shared resource). The CIO created this group around 2010 in an effort to, among other things, strengthen their monitoring processes and add additional oversight to growing number of sector books and positions. The Risk manager has complete autonomy and policing authority, even over the CIO’s trading levels. In practice, the Risk manager will first speak with the individual sector teams to discuss positions that have breached limits or are approaching them, for example. The PM then has to get these limits back in line within a trading day before the Risk manager sizes down or takes off (or offsets) positions.

Like most other things, sector PMs have discretion over hedging. Each PM has their own style and philosophy and traditionally sticks to what has worked for them over the years. The CIO and Risk manager can hedge via the CIO book.

The firm has also invested heavily in external risk systems and the development of a proprietary risk system. The systems help the investment teams monitor their individual books with real-time pricing and P/L data. In turn, the interface summarizes virtually everything at the portfolio and book levels including, but not limited to, exposures, correlation, risk metrics, concentration, liquidity, risk limits, etc. The risk team shares visibility into the same feeds in order to adequately stay on top of the sector books’ movements.

Sector Level (Invested capital)

* Gross Exposure: 300% max
* Net Exposure: -20% min to +20% max
* Sector Limits: N/A
* Region Limits: At least 90% of gross exposure must be US
* Instrument Limits:
  + No more than 15% of gross exposure in options
  + At least 85% of gross exposure of common stocks, equity/index swaps, ETFs, or index futures
* Market Cap Limits:
  + At least 30% of gross long exposure invested in large cap or bigger
  + No more than 25% of gross long exposure invest in small or micro cap
* Liquidity: At least 95% of gross exposure can be liquidated within 5 trading days based on 20% of 30 day average daily trading volume
* Position Size :
  + Long : 10%
  + Short : 10%
* Stop/Loss : Strict, staggered triggers at various points

CIO book/Risk mgmt overlay

* See Sector and Portfolio level risk guidelines

\*Some limits may not apply given the mandate of this book

Portfolio Level (Inclusive of all PMs’ invested capital and CIO’s invested capital)

* Gross Exposure: 400% max
* Net Exposure: see Sector level limits
* Sector limits: none
* Region limits: see Sector level limits
* Instrument Limits: see Sector level limits
* Market Cap Limits: see Sector level limits
* Liquidity: see Sector level limits
* Position Size :
  + Long : 20%
  + Short : 20%
* Stop/Loss : see Sector level limits