WEALTH OWNERSHIP

Note to a Newly Liquid Entrepreneur

Congratulations!

Whether your company has IPO'd, was acquired, or just gave you the chance to take some money off the table, you are now well off. You're about to receive a lot of advice about how to do things correctly – how to balance risk, how to earn exciting returns, how your friend's startup is the next Facebook, etc.

I'm going to talk with you about how investments can go wrong.

I've seen many situations where an entrepreneur makes money the hard way, brick by brick, and then loses it in a flash due to a bad investment decision or, worse, a scam. Just as bad as the money lost are the emotions that come with it – embarrassment, shame, and a loss of trust that may keep you from working on your next project. Let's take a few minutes to save you from years of anguish and millions of dollars lost.

Here are five lines of questioning that will help you avoid the worst mistakes:

1) Alignment – *Is the manager invested alongside you? How is the manager compensated?*

2) Strategy – *Can you articulate why the investment strategy will work? How does it bring new information into the market?*

3) Risk – *What would cause your investment to fail? Is the manager intellectually honest about the risks and working to mitigate those downside scenarios?*

4) Fraud – *How can you tell if they're a fraud? Are they offering Special Access or Risk-Free Returns?*

5) Trust – *Do you trust your manager?*

Alignment

Is the manager invested alongside you? How is the manager compensated?

Finance is an odd business. It's just like manufacturing, except every few years the manufacturers accidentally blow up the factory. Your goal should be to avoid getting caught in the blast. The reason this keeps happening is that people are driven by misaligned incentives.

There are three main incentive structures in finance: transactional (commission on initial sale), management (% of assets under management), and outcome (% of profits). Every financial institution has an ongoing internal struggle between these factions. When the transactional group wins out, the institution may focus too much on trading commissions and not enough on good investments. That's when you get the potential for a spectacular blowup.

You can mitigate these misaligned incentives by having the manager invest alongside you.

Incentive Structures in Finance

Incentive Structure	Manager Compensation	Example of Blowup
Transactional	Commission per trade	Investment banks selling mortgage-backed securities to German banks, earning commissions on originations while sharing little-to-no downside risk (pre-2008)
Management	% of AUM	Guardianship abuse of elderly clients or of clients with complicated family ownership structures (ongoing)
Outcome	% of profits	Frontier market funds betting on lottery-ticket outcomes in multiple investment vehicles and then collecting fees on the winning bet while ignoring the other losses (1990s)
Invested Alongside You	Shared upside & downside	Long-Term Capital Management GPs investing with LPs but eventually being swamped by unforeseen movements against their highly levered strategies (1998)

There is no silver bullet, and a GP co-investment with the LP does not prevent an aggressive strategy from failing (see LTCM). Still, if your manager is willing to sell you a product but isn't willing to personally invest the same way, you should think very carefully about investing. Even if the manager has different financial goals or if there is a good reason why the manager can't co-invest in the same fund, you may learn a great deal by asking why.

Strategy

Can you articulate why the investment strategy will work? How does it bring new information into the market?

As I wrote in **Lembas's credo**, capital markets are information markets. I believe an asset's price is comprised of (1) an asset's cash flows and (2) the capital flows of other investors in and out of that asset. Successful investors bring new information to the market about an asset's cash flows or capital flows. That's what people mean when they say they are looking for investors with an edge.

Your advisor should be able to articulate why they think their strategy has worked in the past and why it should keep working in the future. How are they sourcing new information? You should be able to understand it sufficiently such that it's not a black box to you. Or, if it is a black box and you still want to make the investment, just recognize what you're doing and then size your investment appropriately.

Risk

What would cause your investment to fail? Is the manager intellectually honest about the risks and working to mitigate those downside scenarios?

There are many facets to risk management, but, simply put, a prudent investor tries to anticipate future risks and to stay resilient in the face of unforeseen catastrophes.

Understand what would cause the investment to collapse. As a basic heuristic, the main risks for long-term strategies are thesis (did they properly analyze the cash flows and capital flows?) and structure (can they get forced to sell too soon, even if they are right about the long-term thesis?). In contrast, the main risk for short-term strategies tends to be operational (what is their current speed and/or research edge, and why will that continue to hold 3+ years down the line?).

Your advisor should be forthright about these risks – both for your sake and as a signal that they are vigilant in their own risk management. Part of being forthright is using an accurate measuring stick. An intellectually honest advisor won't play games with portfolio marks that mask the underlying risk (e.g. make sure that no one convinces you that illiquid assets are less volatile just because there aren't publicly available mark-to-market prices).

Frauds

How can you tell if they're a fraud? Are they offering Special Access or Risk-Free Returns?

I've seen frauds come in two main flavors: Special Access and Risk-Free Returns.

Special Access fraudsters claim that *only they* can get you into the best private deals. They tend to prey on people who don't live in the region or don't work in the industry where those opportunities originate (e.g. selling Chinese monopoly stories to South Americans or selling Silicon Valley stories to Europeans). The best private investors often do have access advantages, the difference being that those are legitimate. You can sort one from the other by doing reference checks and by looking to see if other smart people in the ecosystem are also investing. For instance, virtually none of the top SF investors were taken into Theranos or Nikola.

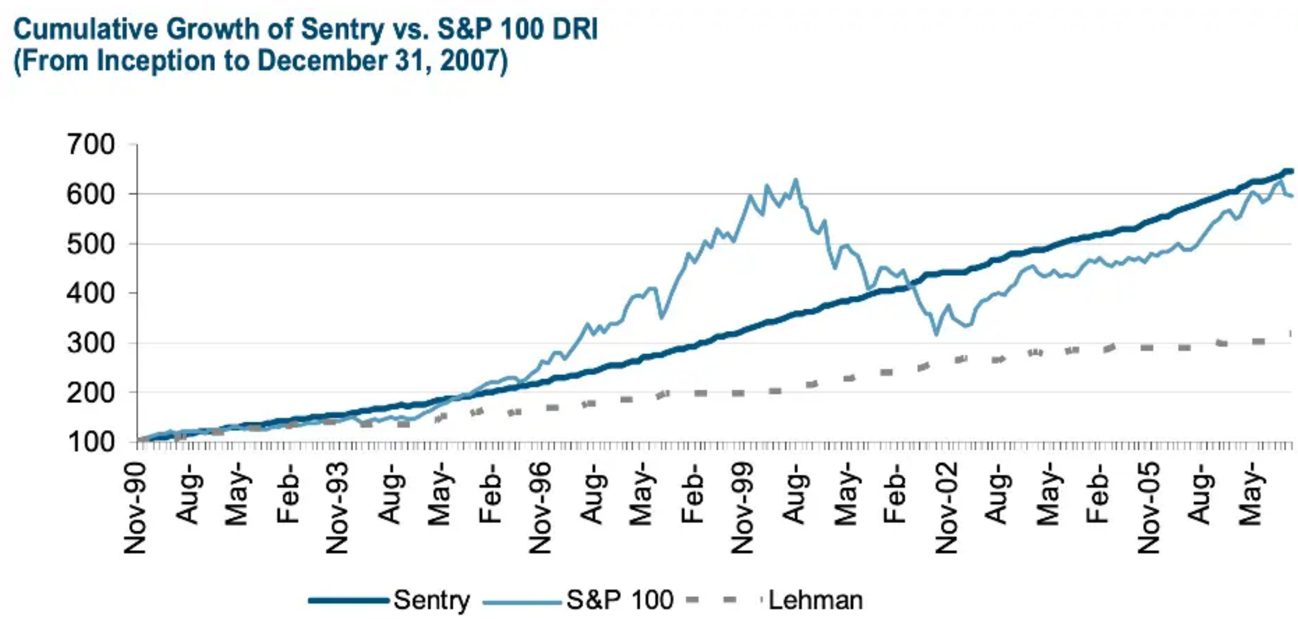
The Risk-Free Returns fraud is more insidious. It's so hard to earn that initial capital that you will naturally be protective of it. Every wealth manager will tell you to keep a portion of your wealth in low-risk, low-return investments. Someone may approach you to tell you about a way to earn a little bit of a higher return with no added risk, month in and month out. It sounds too good to be true. It often is.

The soft version of the Risk-Free Returns fraud is a misrepresentation of an investment strategy. Many funds generate returns by selling insurance (aka short volatility). They collect premiums every month like clockwork. There's nothing wrong with the insurance business, so long as you are amply compensated for the risk you are insuring. The problem is that, someday, the bill will come due. You shouldn't evaluate that kind of fund without recognizing what kind of major risk is being insured and what the true downside scenario entails.

The hard version of the Risk-Free Returns fraud is simply made-up returns. Bernie Madoff is the prime example here. Many Jewish charities in the New York and Palm Beach communities were ruined by the promise of steady, low-risk returns that were just a bit better than the standard low-risk low-return options.

To give you a taste of what to watch out for, here's a snapshot of how Madoff presented his Sentry fund to his clients. You can easily imagine how he sold the story — *do a bit better than the market with none of the downside*, *long track record of steady returns*, *lets you sleep soundly*.

Bernie Madoff's "Risk-Free Returns"



													Fairfield Sentry Ltd.	Certificate*
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Year	Year
1990												2.77%	**2.77%**	**6.79%**
1991	3.01%	1.40%	0.52%	1.32%	1.82%	0.30%	1.98%	1.00%	0.73%	2.75%	0.01%	1.56%	**17.64%**	**38.52%**
1992	0.42%	2.72%	0.94%	2.79%	-0.27%	1.22%	-0.09%	0.86%	0.33%	1.33%	1.36%	1.36%	**13.72%**	**30.39%**
1993	-0.09%	1.86%	1.79%	-0.01%	1.65%	0.79%	0.02%	1.71%	0.28%	1.71%	0.19%	0.39%	**10.75%**	**21.96%**
1994	2.11%	-0.44%	1.45%	1.75%	0.44%	0.23%	1.71%	0.35%	0.75%	1.81%	-0.64%	0.60%	**10.57%**	**18.05%**
1995	0.85%	0.69%	0.78%	1.62%	1.65%	0.43%	1.02%	-0.24%	1.63%	1.53%	0.44%	1.03%	**12.04%**	**19.67%**
1996	1.42%	0.66%	1.16%	0.57%	1.34%	0.15%	1.86%	0.20%	1.16%	1.03%	1.51%	0.41%	**12.08%**	**21.09%**
1997	2.38%	0.67%	0.80%	1.10%	0.57%	1.28%	0.68%	0.28%	2.32%	0.49%	1.49%	0.36%	**13.10%**	**23.83%**
1998	0.85%	1.23%	1.68%	0.36%	1.69%	1.22%	0.76%	0.21%	0.98%	1.86%	0.78%	0.26%	**12.52%**	**22.32%**
1999	1.99%	0.11%	2.22%	0.29%	1.45%	1.70%	0.36%	0.87%	0.66%	1.05%	1.54%	0.32%	**13.29%**	**25.27%**
2000	2.14%	0.13%	1.77%	0.27%	1.30%	0.73%	0.58%	1.26%	0.18%	0.86%	0.62%	0.36%	**10.67%**	**14.28%**
2001	2.14%	0.08%	1.07%	1.26%	0.26%	0.17%	0.38%	0.94%	0.66%	1.22%	1.14%	0.12%	**9.82%**	**17.79%**
2002	-0.04%	0.53%	0.39%	1.09%	2.05%	0.19%	3.29%	-0.14%	0.06%	0.66%	0.10%	0.00%	**8.43%**	**17.74%**
2003	-0.35%	-0.05%	1.85%	0.03%	0.90%	0.93%	1.37%	0.16%	0.86%	1.26%	-0.14%	0.25%	**7.27%**	**15.48%**
2004	0.88%	0.44%	-0.01%	0.37%	0.59%	1.21%	0.02%	1.26%	0.46%	0.03%	0.79%	0.24%	**6.44%**	**12.20%**
2005	0.51%	0.37%	0.85%	0.14%	0.63%	0.46%	0.13%	0.16%	0.89%	1.61%	0.75%	0.54%	**7.26%**	**10.50%**
2006	0.70%	0.20%	1.31%	0.94%	0.70%	0.51%	1.06%	0.77%	0.68%	0.42%	0.86%	0.86%	**9.38%**	**13.59%**
2007	0.29%	-0.11%	1.64%	0.98%	0.81%	0.34%	0.17%	0.31%	0.97%	0.46%	1.04%	0.23%	**7.34%**	**7.58%**
2008	0.63%	0.06%	0.18%	0.93%	0.81%	-0.06%	0.72%	0.71%	0.50%	-0.06%			**4.50%**	**5.40%**

Source: Bernie Madoff's Sentry Fund

Unfortunately, even the most prestigious private banks have little to offer but an apology when you invest in a fraud through them. This is **Union Bancaire Privée's statement** to their clients after Madoff was uncovered. The good news is that an experienced fund manager could have spotted the problem immediately (as many did).

If you're approached with any special access, structured product, or volatility selling strategy, make sure that you understand the true risk profile or that you speak with someone who does. Many of those structures are fine, but the dangerous ones are the ones that blow up the factory.

Trust

Do you trust your manager?

All of this comes down to trust.

The best advisors will want to build a lifelong relationship with you. They'll strive to earn your trust, and they'll be figuring out how much they can trust you too. Outcome-driven investors look for clients who will back them to deploy capital during market downturns, just at the exact moment when others are uncomfortable doing so too. Great clients really do help investors earn great returns.

I don't think there's any trick I can tell you about assessing who you can trust. I'm sure you've had to figure this out in your own business, and I don't think it will be any different here.

What's Next?

It's always exciting to see a project come to fruition, and it's just as exciting to start the next one. I hope you can build on your success as a source of strength, not as a burden to be carried.

Wealth ownership can be a significant life transition. There are libraries of material to read. If you wanted to narrow it down to two selections, I would recommend **The Destructive Power of Family Wealth** by Philip Marcovici (a book on wealth planning by the former chair of Baker McKenzie's wealth management and tax practices) and **Letter to a friend who just made a lot of money** by Graham Duncan (an essay on managing yourself and selecting a wealth manager by the head of a major family office).

Those should cover the basics, and I'm happy to go into more detail as specific questions come up. From there, you just have to pick and choose what works best for you.

Congrats again, and can't wait to hear what you're up to next,

Luke

Thanks to my friends in wealth management who helped me first learn these lessons, and credit to Benn Eifert for the factory analogy.

This essay was inspired by conversations I had with two friends who recently came into wealth – one a young SF tech executive whose company was sold, one a middle age Middle East entrepreneur who took a dividend from his family business. As with everything open to the public, these are my personal opinions and not to be construed legally as financial advice. Please select your advisors with care and consult with them directly.

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