What Others Are Saying About Doug Allen and Why Start A Hedge Fund: For Entrepreneurs, Traders, and Active Investors



"Doug, you're a genius!"

-Tony Robbins, best-selling author and peak-performance expert

"I never heard Allen's tips or teachings in Business School or any other *Financial Service Company. He is an innovator in the field."*

-Isadora Cardenas, Pompano Beach, FL

"Doug Allen's program has heart, warmth and compassion. It was worth the entire cost of the program. ***Totally unbelievable****! A mindset adjustment toward financial freedom and a life of abundance in all areas."*

-Richard Orwig, Rockaway, NJ

www.LaunchYourFund.com

"Doug, it is my belief that there are maybe one in ten-thousand people who are enlightened, and even less who share the magic with others. You are truly a diamond among the common stones."

-Dan Hassler, San Diego, CA

"Doug, thank you for all you do. Your mentoring and teaching is priceless."

-Connie Wilkens, San Diego, CA

"Doug, we cannot possibly place a dollar amount on what your education, mentoring, and contribution means to us."

-Shari Wilson, San Diego, CA

"Doug, your contribution, genius, and selflessness are legendary. Thank you for everything."

-Deb Flores, San Diego, CA

"I would personally like to thank you for sharing your experience with us. Thanks to you, I am now realizing money is just a tool to help provide for the future of one's family and to help out those in need. Thank you for taking the time to help me break through that barrier. Give with Passion!"

-Anthony Figuero, San Diego, CA

"Doug, that was a great story! You really are a great giver and your enthusiasm for this and for life shows through in your writing. You are a great role model. Thanks, you've created some wonderful emotions; and not only in my world either!!"

-Ian Robinson, San Diego, CA



Doug Allen night The Destiny Partnership was created Sept. 8, 2010.



Doug Allen Speaking At Harvard University's *Mindset of Success* Event



Doug Allen's "What is Money?" TED Talk.

For more information on how to start your own fund go to:

www.LaunchYourFund.com

Why Start A Hedge Fund:

A Simple Guide To Successful Independence For Entrepreneurs, Traders and Active Investors

By Doug Allen

Go to **www.LaunchYourFund.com** to schedule a free consultation on whether it would make sense for you to set up your own fund.

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Contents

Preface – Why I Wrote This Book 9

Introduction – Why Read This Book? 21

Why Start A Hedge Fund? 33

How I Went From Making $60,000 A Year to
$2.2 Million in One Day 39

Step 1: Face It – You Have Problem 57

Step 2: Seek Advice From Experts? 95

Step 3: I Can Do This Better Than The "Experts" 99

Step 4: Research and Education 105

Step 5: You Must Have A System That Makes
Money No Matter What Happens In The Market 115

Step 6: Find Your Edge 119

Step 7: Scale Your Edge And Make Millions 133

SECTION 2: Frequently Asked Questions 151

1. What are hedge funds? 153
2. Why invest in hedge funds? 161
3. How are hedge funds different than
   mutual funds? 169
4. Are hedge funds just for the wealthy? 177
5. Aren't hedge funds more risky than
   mutual funds or stocks? 185
6. Why doesn't my stockbroker tell or investment
   advisor tell me about hedge funds? 197
7. Who can start a hedge fund? 199

8. How does the hedge fund keep track of my investments? 205
9. Who regulates hedge funds? 215
10. Why do hedge funds always get bad press? 221
11. What's the hidden risk of being in a hedge fund? 229
12. What's an accredited investor and why do I need to know this? 237
13. What's a non-accredited investor and why is this important? 247
14. What's a special partner and why does it matter? 255
15. What's a lock-up period? 261
16. How long does it take to get money if I want to withdraw funds? 271

Preface

Why I Wrote This Book

The reason I wrote this book is simple.

I know that the money you have in your bank account isn't just money – it's the result of countless hours of blood, sweat, and tears from you, or somebody you love. The money represents the time of your life, both you and your family's past, and your future.

I was raised by my grandparents. I saw how much time and energy my grandfather put into his business. He did this for one reason – to provide for his family. It's the same reason his father started the business. I was the beneficiary of their commitment, their desire, and their sacrifices. The only reason I was able to get a great education is because of the money from this business. Everything I've accomplished professionally in my life has been a direct result of their efforts.

And I know if you're reading this right now, you probably can relate to this story. Maybe you're in your prime, having created a successful business yourself. Maybe your parents created a successful business. Maybe you have children who you've spent your life working to provide for.

When I think of money, I don't think of numbers on bank statements. I think of the time, the lives of people who worked and sacrificed to put the money in the bank. Money is a measure of value added. If you have an abundance of money it means you or somebody close to you has added massive value to other people's lives.

That's why I want you to have the benefit of everything I learned about how to go from making money from a job, to making money as a business owner, to making millions of dollars simply by managing my own investments.

I've mapped out the steps that I have taken to go from making $60,000 a year at my job to making millions of dollars in the financial markets.

These are not just my steps.

These are the steps that everybody who has ever become successfully independent in the financial markets have also taken. And when I say "successfully independent" I don't mean simply replacing the income from their job with passive income from trading or active investing.

I first started trading to make enough money, $15,000, to pay the legal fees to adopt my daughter from China. She just turned 17. My next goal was to make enough money from trading to replace my $60,000 a year job.

Within a year I had made $60,000 in one-day. In less than two years after starting my first hedge fund, I made over $1 million in one day. In fact, the first time I made over $1 million in one day, I made over $2,200,000 in ONE DAY.

I'm not telling you this to impress you. I'm sharing this with you so you know it's possible. I was working at my job and had ZERO experience in the financial markets at the age of 35 when I first started trading.

I lost money. A lot of money.

Then I figured some things out. What I figured out are the steps I've outlined in this book.

You don't have to follow these steps, or even believe their possible. You don't have to decide once and for all that to change the results you're getting you need to change your approach.

You don't even have to read another page of this book, or read to the end.

But my guess is if you're reading this right now it's because we're kindred spirits of sorts. You know that you're capable of much more than you're producing right now. You probably know that there is an entire quality of life that's calling to you that you don't have right now, but that you would love to experience.

I call this successful independence.

Anybody can be successful. You could be a successful lawyer or doctor. You could be a successful sales person or engineer. The strategy for success in anything is so easy, it's almost become a cliché. Tony Robbins has been teaching the same formula for over 30 years now. It's nothing new.

1. Know your outcome.
2. Take Action.
3. See the results you're getting, and modify your actions.
4. Model somebody who's already successful to accelerate the process.

Success is not complicated.

Neither is independence. I have lots of friends in the "spiritual" community who are independently broke. They answer to nobody, have very few responsibilities, and are

perfectly happy "being in the moment" and not having money in their bank accounts.

There's nothing wrong with this. This is not a moral judgment. This is reality. Independence is very, very easy to achieve. Just quit your job and do your own thing. Every day I see a lot of independent homeless people begging for money at intersections. They don't need me or anybody else individually. They scrounge up enough money every day to buy some food, some cheap wine, and sleep under the bridge.

What's a bit more elusive, and why you're probably reading this right now, is because you want successful independence. You want success, and you want to be free to enjoy your success.

This is the formula how to achieve that. It's a simple formula. I'll give it to you right here:

1. You must face the reality that what you're doing right now is not going to make you successfully independent any time soon.

2. You must seek help from experts.

3. You realize you know more than most "experts" when it comes to the financial and investing world.

4. You know you have to do your own research and educate yourself, just like anything else.

5. You realize that to achieve financial independence and success, you can't make investment decisions based on better which way the market will go, or hoping it keeps going up. It won't. It never has.

It's a crap shoot whether it will be up ten years from where it's at now. You don't want to risk your future, you life, on hoping your bet on the market is right.

6. You know you need some sort of an investing edge or strategy, and preferably more than one. This is the only way to give yourself a chance at exponentially compounding your money with low risk. You realize all the people who are making real money have been using strategies and tactics that your investment advisor or stock broker probably never even heard of.

7. You figure out how to make money from the financial markets while lowering your risk. In fact, your gains are increased because you've lowered your risk. You've also figured out the million dollar secret to increasing your rewards without taking on any additional risk. You layer your way to generate profits on top of other people's money. You go from making $50,000 a year from your investments to maybe making $500,000 a year or more, making the exact same trades you would have made on your personal account. You then realize you can leverage other traders who also know how to make money so you can lower your risk even further and make even more consistent, scalable returns.

This is the "Holy Grail" strategy for traders and what I call active investors. This means you're actually taking responsibility for your financial results and implementing a sound and proven plan to limit your risks and make more money.

I've shared this plan with many people.

Nobody has objected to the plan.

The only doubts they have is whether it will work for them. Believe me, I had the same doubts when I started. Know that if you have any doubts about being able to achieve virtually unlimited, successful independence, it's not your fault.

All of us have been inundated by a financial drive-by media that's bought and paid for by advertising from mutual fund companies and brokerage houses. They aren't going to interview the principles of mutual fund companies and ask them which hedge funds they're invested in. That's not how the game works.

Instead, they want you addicted to daily moves in the market (as if they mean anything in the big scheme of things) and daily news stories and analysis explaining these daily moves in the market.

If you step back and look at it objectively, at some point you're going to realize it's probably one of the stupidest things you've ever seen. There's an entire culture built around watching attractive "talking heads" read stories from teleprompters that are written by people with degrees in journalism from places like NYU and Boston College. Not that there's anything wrong with those schools. They are great at giving 18-22 year olds a sound education in the fundamentals of journalism.

That said, I will assure you that the professors at these schools do not know how to consistently take money from the markets. In fact, the intelligentsia who work at these schools think, because they haven't figured it out

themselves, that's it impossible for anybody to beat the markets. They even have given out self-congratulatory awards, like the Nobel Prize in Economics, to people who write fancy papers describing why it's impossible to beat the market.

Meanwhile, I can go sit in offices of fund managers who work and live 10 minutes away from NYU who are consistently making tens of millions of dollars actually beating the markets instead of coming up with theories, and then trying to prove the theories, about why they can't.

If you're reading this right now I have a good idea that you're one of the people who has already seen through the nonsensical world of academia and the financial media. You not only want to make money and become successfully independent, you already believe it's possible.

You just want to learn how to do it.

Keep reading. How to do it is very simple.

We've been taught and conditioned that the way to success is through incremental improvement. That's true for a lot of things, like getting stronger and losing weight. It's true if you're trying to cut down on your time to run a marathon. It's true if you're working your way up through the corporate world, getting small bonuses and raises every year.

I'm going to guess that's not why you're reading this book right now. You don't need this book to make small, incremental changes in your investment or trading results. In fact, because there is such a high random component in the markets, small incremental changes are often masked by random, unpredictable factors.

No, I'm guessing if you're reading this now it's because you want a major breakout in your financial results. Notice I didn't say "breakthrough."

To me, a "breakthrough" is when you are struggling at something and through persistence, or maybe through dumb luck, you breakthrough the barrier that's been stopping you.

What self-help gurus usually leave out is that with each new "breakthrough" you almost immediately come face-to-face with another problem, another belief system that holds you back, or another obstacle that you need to "breakthrough."

That's a great model for self-help gurus to teach because with each "breakthrough" you get to learn something about yourself, and the world around you.

What I'm interested in is a "breakout" in your financial results. A "breakout" is just what it sounds like. It's a measurable, dramatic improvement in your finances, just like when a stock breaks out of a long-term resistance level.

Breakouts in results usually don't happen just from incremental improvement alone. Breakouts in results, especially financially results, usually happen when you see things from a totally different perspective. My friend, Van Tharp, one of the legends of the trading world, describes these perspectives as games we play. Breakouts in financial results happen when you get a new perspective, and suddenly you quit playing the losing game that other people want you to play, and instead define your own game, with your own rules, that you have designed for yourself from the start so you can win.

This is what this book gives you.

It gives you a different game to play that you absolutely can win. Everything you need to win is in this book. Even if you don't know how to consistently make money trading, the answer is in this book.

That's because when you're playing this game I'm about to teach you, you don't need to know how to make money trading. All you need to know is how you can leverage other traders who do know how to make money.

Once you get the big picture of how this works, there's no going back. It's like another of Van Tharp's metaphors for trading. Once you get the big picture and how easy it is for you to make 10x the money you're making now with ZERO additional risk, it's like taking the red pill from the movie, *The Matrix*. Van even named his latest best-selling book, and his new trading course, *Trading Beyond The Matrix*.

Here's the quote from the movie:

"This is your last chance. After this, there is no turning back. You take the blue pill - the story ends, you wake up in your bed and believe whatever you want to believe. You take the red pill - you stay in Wonderland and I show you how deep the rabbit-hole goes."

The very first group training event I ever did, way back in August of 2000, I gave everybody in the room a red jelly bean and a blue jelly bean. I told them if they wanted to stay the entire weekend, they'd have to take the red pill.

Before I knew what was happening, everybody in the room was throwing their blue jelly beans at me.

At the end of that event I selected 5 traders out of 40 who attended the event be part of my private coaching group. All five quit their jobs. In a short period of time all five made more money trading their accounts than they ever did from working at their jobs.

One of my best friends, who I taught how to trade almost at the same time I was learning myself, turned his $60,000 retirement account into over $900,000 in just a few years.

His company eventually stopped allowing him to trade because he was making too much money. His retirement account was nearly double the size of the President of his company.

He broke that game.

When I was meeting with one of my billionaire clients in New York, he told me the goal of any financial game was to "break the game." I didn't quite understand it until my friend got stopped from trading his 401(k) account. He broke the game. The reason you want to break the game is because there are other people playing the game who are also trying to break it. Whoever breaks the game first makes the most money.

Keep that in mind as you read this book. You about to discover the game, and how to win very easily. The best suggestion I can give you is that you need to suspend belief that YOU can't win this game.

You're going to read things that might make you think, "Yeah, big deal… I already know this."

A few years ago my daughter came home from school as was disgusted that one of her friends got in trouble for

using the "F" word. My daughter said, "I don't know why they think the "F" word is a bad word. You know what the worst two words are in the English language, Dad?"

I was a little nervous waiting to hear what she was going to say. I thought I might have fallen behind on the latest swear words the kids were using.

"The worst two words in the English language are 'I know.' As soon as you say 'I know' you immediately shut yourself off from learning anything new."

Keep that story in mind as you read this book.

Every time you catch yourself thinking you know something, ask yourself, "Yes, that's true. How can I act on that right now to make progress towards achieving my financial goals?"

Introduction

Why Read This Book?

I'm sitting in my office looking at a giant white board on my wall. I started to write a short summary for a very wealthy friend who asked for some investment advice. She's a very successful entrepreneur. She's worth millions. She's spent her entire life building her business.

She asked for investment advice because she's not happy with the results she's getting from her investments.

There's only one problem.

Even though I started my first hedge fund in 1998, I don't give people investment advice.

Why?

The short answer is because that's entirely the wrong focus.

I've partnered with some of the most financially successful people in the world. None of them look for investment advice.

It's not because they're such astute financial experts, or because they follow the markets religiously.

It's because they understand that looking for investment advice is the wrong frame. Success in anything begins with what you focus on, and what you believe about it. Questions control what you focus on.

The difference between people who are incredibly wealthy and those who feel uncertain about what's going to happen with their investments is their frame. The most financially

wealthy people I know don't care about what's going to happen in the market or the world economies.

It's not because they have so much money that they don't care. It's the opposite. The reason they have so much money is because they quit betting on what they thought was going to happen in the future and instead implemented a plan that was going to make them money no matter what happened in the future.

Their investment returns are not dependent on what changes in the world.

They've learned that betting on one future or the other isn't the way to become financially successful. In fact, they've learned the opposite. Even if the odds are stacked in your favor, betting on one future compared to another is a guaranteed way to lose a lot of money.

Why?

Because nothing is certain. It's like playing Russian Roulette. Sooner or later, even when the odds are stacked in your favor, sooner or later something bad is going to happen. It's not theory, it's a mathematical certainty. 1 in a million events happen every day. The illusion is that when things happen, like the LTCM crisis in 1998, or the terrorist attacks in 2001, or even the financial crisis in 2008, they're anomalies.

They're not.

They're guaranteed to happen. The worst financial crisis hasn't happened yet.

I was in Washington, D.C. speaking at a hedge fund conference in September 2008 when the financial crisis

hit. I was having breakfast with fund managers that had worked on Wall St. for 40 years. My friend, Ira Goldstein was on the phone with his wife. She was panicked, asking him what was going on. She just heard the news that the U.S. Government was taking over AIG with a $85 billion "investment." The day before Lehman Brothers, a 161-year old financial institution, one of the largest investment banks on Wall St., filed bankruptcy.

I overhead the conversation Ira had on his cell phone with his wife:

Ira's wife: *"What's going on? Did you see the news about AIG?"*

Ira: *"How the f*** should I know? This never happened before."*

The funny thing was Ira wasn't upset. He was more amused and perplexed. He wasn't worried.

Why?

Because Ira managed a $4 billion investment partnership. He personally had over $200 million of his own money in his fund. He created the fund *because* he knew events like the 2008 financial crisis were going to happen.

Some people, like Paul Tudor Jones, made a fortune when the markets collapsed in 2008. He had big bets on the financial markets collapsing. PTJ did the same thing back in 1987 when the financial markets collapsed and the market dropped 22% on October 19, 1987, also known as Black Monday.

It was the same back in 2001 when the 9/11 attacks happened. A billionaire friend of mine made 25% on his

investments in the weeks after 9/11. During the one of the biggest stock market crashed in history from 2000-2002 my hedge funds made money.

To put this in context, look at what happened to the markets from 2000-2002:

To put the downturn of 2002 in perspective, here is a look at annual U.S. stock market declines in 2000, 2001, and 2002:

NASDAQ

In 2000, the Nasdaq lost 39.28% of its value (4,069.31 to 2,470.52).

In 2001, the Nasdaq lost 21.05% of its value (2,470.52 to 1,950.40).

In 2002, the Nasdaq lost 31.53% of its value (1,950.40 to 1,335.51).

That's a 67% loss in three years.

So let me ask you a question:

How much money would you lose if you lost 67% of your money in the next 3 years?

I had a close friend who had $567,000 in her retirement account at the age of 44. She was given advice by her investment advisor that we hear all the time. Stocks are the best long-term investments.

At the very best, the most educated and highest quality investment advisor can only look backwards. I listen to a radio show on Saturday's where some guy proclaims he's an expert on mutual funds. I have no doubt that he's memorized the returns of every major mutual fund company, and the ones he doesn't know, he looks up on his computer in a matter of seconds.

Here's the truth, like it or not: There is absolutely ZERO statistical correlation between the past performance of a mutual fund and its future performance. In fact, there are studies that have hinted at a negative correlation. In other words, some people suggest that the best performing mutual funds last year are less likely to be top performers again.

Why?

Because markets tend to move in cycles based on price and perception of value If something is perceived as under-valued people will rush to buy it until the price moves up and it is no longer under-valued.

What happens next?

No, the price doesn't drop. What usually happens next is even more people will buy, causing the price to push even higher, making the underlying holding over-valued. This can keep going on for some time until something causes the price to drop and people run for the exits.

When investment advisor spout off historical returns it means less than nothing.

So back to my friend who started with $567,000 in her retirement account at the age of 44. Her investment advisor told her that since she was only 44 she should

invest in top quality mutual funds. There is not such thing as a top quality mutual fund. That's a story. A mutual fund is nothing more than a basket of stocks bought and sold by a management team. But my friend bought into this advice, and put her money into mutual funds.

The investment advisor told her she should diversify, so she split up her money between 8 different mutual funds. That's not diversity. Since most of these funds gauge their performance against the S & P 500, what happens is that the bulk of their holdings are S & P 500 stocks. They try to outperform the S & P 500 by cherry picking and buying the stocks they think are the best and not buying the stocks they think are the worst. In other words, if they can eliminate the stocks they don't like from their portfolio, and add stocks they think are good, they believe they'll outperform the market.

Rarely does this work.

Burton G. Malkiel wrote a classic book called *A Random Walk Down Wall St*. that details why trying to outperform the market is futile. Burton G. Malkiel is no light weight. He has a masters degree in economics from Harvard, and a Ph.D. from Princeton. He's the Chairman of Chemical Bank. His basic thesis is that all the information that determines the price of a publicly traded asset is known and already valued into the price. Trying to be smarter than the cumulative knowledge of the market is a futile proposition because the price represents all the combined information that exists and any individual will only know a small subset of the information.

Unfortunately for my friend, she listened to her investment advisor.

She lost $184,00 in a short period of time. Her account went from $567,000 to $383,000.

That's when she decided she was going to go to Plan 2 – guessing which way the market was going to move. She had the worst luck in the world – she was right three times in a row. She was buying stocks, waiting for them to move up, then selling them. When they dropped back down, she would buy them again. They went up, and she sold them.

There was only one problem with this strategy. What happens when the stocks keep going down instead of going back up?

My friend did what so many people do, including professional traders that I know. When the stocks kept going down, she bought more. She "averaged down."

Averaging down is one of the easiest strategies to sell because at first it makes so much sense. If you bought a stock at 100, and it's now at 80, you just buy more stock so that your average price you paid per share is $90. This way, the stock just needs to go up $10 for you to break even.

What if it keeps going down?

Simple. Just keep buying more so that your average price keeps going down.

The problem with this strategy is that it works – most of the time. The bigger problem is that when it doesn't you blow up your entire account, which is what my friend did with her retirement account. She kept averaging down until her account that was originally worth $567,000 was worth just over $113,000. And she still insisted all her losses were just "on paper."

Of course they're on paper. So are your bank statements and brokerage statements. The reality is that she lost $454,000 in real money in a few short years by attempting Plan 1 and Plan 2. Then she gave up and put her money in a money market account that's getting about 2% interest.

So here's the question I have for you:

What's your current plan? What's your outcome? What strategy are you implementing right now in hopes of achieving that outcome?

There are only three basic plans that anybody can possibly have:

1. **Plan 1 - Buy and Hope:** You can plan to ignore the market moves and rely on conventional wisdom that the markets will always go up in the long-term. Who follows this plan? The masses. People who don't know any better. If you're serious about simultaneously protecting and growing your wealth, you cannot rely on this strategy.

2. **Plan 2 - Predict the Future:** You can try to predict the future and change your investments ahead of major market moves. Who does this? Just about everybody tries to do this at some level. Who does this successfully? Only the most astute investors in the world. They're who you'll be competing with if you try this.

3. **Plan 3 – Treat Your Investments Like a Business:** This means that you must create a plan that implements a system to protects and grow your

> money in anticipation that everything as you know it now WILL change. Change is not an "if," it's a certainty.

Who treats their investments like a business?

The wealthiest people in the world.

They've progressed through Plan 1 and Plan 2, and realized that Plan 3, managing their investments like a business, is the only way to both protect and grown their wealth.

The reason these people have incredible amounts of wealth is because they've evolved and learned that Plan 1 and Plan 2 are plans for guaranteed failure.

Every one of the people I've met who has figured this out has gone through the same steps:

Step 1: They realize that their investment strategy is fatally flawed.

Step 2: They seek help from people who they think are experts.

Step 3: They realize they know as much, or more, than the experts.

Step 4: They begin to do research and study.

Step 5: They have "aha" moment when they realize they must anticipate and plan for everything changing – they create a system to protect and build wealth simultaneously.

Step 6: They realize they need an edge and find one.

Step 7: They scale their edge and turn create a business around their investments.

Here's the reality. As I'm writing this in 2014, NASDAQ Index closed at 3999.73. 14 years earlier in 2000 the NASDAQ Index was at 4069.

From 2000 to 2002 the U.S. market dropped 67%.

From 1907 to 1933 the U.S. stock market dropped over 50%. If you would have been invested in the market during those 26 years you would not only have lost half your money, you would have waited 26 years for any gains.

Between 1929 and 1954 the U.S. stock market dropped over 35%. Again, if you would have been invested in the stock market you would have lost over 1/3 of your money and waited 25 years to see a positive return.

Between 1965 and 1983 the U.S. stock market lost over 20%. Again, if you would have been invested in the stock market during this period you would have lost 20% of your money and 18 years of your investment life waiting for the market to go up.

So here's the question for you:

Imagine your life 20 years into the future. **Do you really want to rely on the world economies to build your wealth "automatically" just because you hold assets?**

If you're reading this right now you're smart enough to know that asset prices just don't automatically go up.

You're also smart enough to know that nobody has a crystal ball to predict the future. Even the smartest financial minds in the world with all the latest technology and access to every possible bit of real-time and historical information cannot predict the future with any degree of certainty.

Why?

There's too many variables that are changing too fast to create models that not only prove to be historically accurate, but that can anticipate new variables being added to the system in the future.

I was talking to one of the top executives at CalPERS, California's managed retirement fund for public employees. CalPERS has about $280 billion dollars under management. We were at a hedge fund conference in Bermuda having drinks after he finished his keynote speech. He told me something very profound about his approach to investing. He said there are only two ways to be successful:

1) You have to have more information than your competition, or
2) You have to be able to analyze the information better than your competition.

We now live in a world where everybody has instant access to all the information about any market.

We live in a world where there are unlimited tools to help analyze the information.

With unlimited information, and unlimited tools, how can anybody find an edge?

Why Start A Hedge Fund?

Where: Palm Beach, Florida
When: January 27, 2001
Subject: "I have something I want to give you…"

I was nervous.

I had never been around anybody with so much money before.

I had been running my hedge fund for two years, and had close to 100 clients. Before accepting anyone into my hedge fund as a limited partner they must submit a financially summary. Most people who trust me with their money had a net worth in the neighborhood of $20 million. Dean Rhoads had decided to personally invest $20 million of *his own* money with me.

I was sitting in his dining room at his Palm Beach estate. His assistant handed us printed menus from the kitchen.

No joke.

His kitchen staff printed out menus for lunch in his home. Granted, there were only 2 soups, 3 appetizers, 2 entrees, and 3 desserts to choose from, but still… I was used to asking my kids if they wanted chicken or fish for dinner.

Mr. Rhoads was a very distinguished and elegant man. He wore a navy blue blazer and white open-collared shirt. His face was perpetually tan from spending time on one of his 8 boats. When I first visited his estate on a lake in the Adirondacks my jaw dropped when he showed me his 5 boat garage. His Florida estate had only 3 boats, but one of them was a 40 foot yacht. I was nervous when he asked me

if I wanted to drive his yacht that morning when we took it out on The Intracoastal for a short sight-seeing trip. He laughed and reassured me that it's hard to screw up driving a yacht – just don't hit any other boats.

After eating my salad, shrimp cocktail, chicken cordon bleu, and crème brulée, we got down to business. I had no idea why Mr. Rhoads had asked me to meet him. All he told me was that he wanted to see me right away, so I booked a ticket from Pittsburgh to Ft. Lauderdale, rented a car, and drove to Palm Beach.

"I have something for you…" is all he said during our after dinner cup of coffee. He slid a plain, white envelope across the table.

I'm not sure but I was a little nervous. I opened the envelope, which wasn't sealed. All that was in it was a check made out to me.

$996,726.41

Why did I get a check for that amount? Because that was 20% of the money I had made for Mr. Rhoads the previous year. I put $5 million in his bank account in less than 12 months.

How?

That's what this report is going to show you.

This isn't about how I made money for myself. It's about how I made money for some of the wealthiest people in the world. It's about what I learned about how they made their money, protected their money, and grew their money in a way that most people don't even know exist.

I've had the honor and privilege of partnering with some of the most successful business people in the world. Billionaires. A man who made over $400 million in one day.

I know how they did it. They invested their money with me. As part of that process they provide me personal financial statements, and financial statements for their businesses.

Every single person who I worked with who was worth well over $100 million follow the same steps.

What you're about to learn are the steps each one of these hundred millionaires have taken to create a incredible financial wealth for themselves, and for the families for generations to come.

What's amazing about this process is that it was the same for everybody. It was also something that the average person doesn't even know exists. Nobody teaches this is school. I've spent a lot of time at Harvard University and there's no course on this there. I've read hundreds of books on wealth and investing and I've never seen a book that teaches how the ultra-wealthy turn their life success into $100 million+ financial operations.

The process is simple. That doesn't mean it's easy.

Before we go any further I want to make sure we're crystal clear on who this book is for.

It might be better to start with who it's not for.

This book is <u>NOT</u> for you if…

- You're looking for some secret tactic on how to get rich or make a millions of dollars.
- You want your own business just to say you have your own business,
- You're looking for lazy ways to learn how to create passive income streams,
- You're tired of your job and want freedom that comes from financial independence.
- You're net worth is less than a million dollars.

This book isn't for lazy people who want to push the "easy" button to become wealthy.

What this book does do is reveal the actual secret used by the richest families and business owners in the world. The secret is in the structure and strategy, not some transient, small-minded tactics.

That said, this report is going to be incredibly valuable to you if:

- You want to protect and grow your wealth,
- You are already worth well over a million dollars,
- You're a successful business owner,
- You have somebody managing your investments for you,
- You manage your own investment accounts,
- You're not thrilled with the results of your investments,
- You're concerned that the uncertainty of the world economies could hurt your investments,
- You take a financial hit when the stock markets drops,
- Your time is your most valuable asset,

- You have children and other family members who depend on your financial success,
- Your net worth would take a hit if during the next a "black swan" event,
- You would like to leverage your time and your money to create passive income and exponentially grow your wealth.

It doesn't matter how you've become financially successful.

What matters it you're already financially successful and you've come to a point where you realize one of the following things:

1. Your financial investments are substantial, but you are not quantifying and managing your risk. You're one "black swan" event away from losing many years of hard work that built up your financial accounts. I don't' want you to lose what you've spent your life creating. If you're financially successful and you're not sure what a "black swan" event is, then you definitely must read this report. Sometimes just awareness is curative.

2. You have a greater vision for what you want to create financially. If you're worth $20 million or more life is great. Maybe you want a bigger house. Maybe you want to make some huge impact on the world. Maybe you want to create a legacy that lasts long into the future and affects generations to come.

Whether you're a business owner, a successful professional, inherited a decent amount of money, or have money from a divorce or legal settlement, this report is going to show you how to solve your biggest problem.

How do I know your biggest problem?

Because I've already been through this process. Let me give you some background before we get started.

How I Went From a $60,000 A Year Job To $2,200,000 in One Day

In 1997 I was working at my grandfather's factory. I was in charge of two things: making sure all the computers and software worked, and taking care of all the estate planning for my grandparents. The business was around since 1914, and we have been making sausage linking machines since 1949. My grandparents, and the company, had built up decent sized bank accounts. At the time we let a stock broker from Kidder-Peabody invest the money for us.

I was a 4th generation office worker and made $60k a year. By the time I was done paying my bills I had no savings at all. The only money I had was about $90,000 in a retirement account. Not too impressive 13 years out of college. That comes out to saving $7,000 a year for retirement.

I knew I had to do something different. I hated living from paycheck-to-paycheck. I also had over $32,000 in credit card debt. That started when I got married and put my 3-week European honeymoon on 5 different credit cards. I also had car loans, a home equity loan, and a mortgage.

My daughters, Alexis and Summerlee, were 2 and 4 at the time. They were getting to the age where I started wondering how I was going to pay for their school. Alexis just started into a $2500 a year pre-school, and I knew the schools in my school district were terrible. I was constantly wondering how I was going to either move or pay to send my kids to a good school.

One night at 2 AM I was laying on the couch, watching television. I was watching girls beach volleyball on ESPN2. During commercials, I flipped the channels to see what else was on. I kept going back to what I thought was a show where they were interviewing people who made money. It turned out the show was a Tony Robbins infomercial. I watched bits and pieces until the beach volleyball came back on. But during commercials I kept going back to the Robbins infomercial because I needed money and they had people on the show saying how much money they made. I thought it was nonsense.

Then I saw Quincy Jones being interviewed on the infomercial. As a music producer, I knew Quincy Jones was one of the most respected people in the music industry. I also knew Quincy Jones never endorsed any products or musical instruments. He was so far above doing commercial endorsements. So when Quincy Jones described how Tony Robbins changed his life, I decided to order Tony Robbins' Personal Power II CD program.

I ended up doing the CDs over the next 30 days and I was totally blown away. First, the ideas were so simple, and at the same time very profound. I started first by focusing on my health. By doing one or two exercises (and I mean pencil and paper exercises, not physical exercises!) I lost 25 pounds in the 30 days.

What amazed me was how easy it was. And you know what else amazed me? Realizing that with anything there are only three basis parts –strategies, psychology, and an implementation plan. The strategy for losing weight is simple -eat healthy and exercise more! Anybody can figure out a strategy to lose weight.

The reason I was overweight was because I ate Big Macs and fries, and drank milkshakes and cokes for lunch and dinner. I knew this wasn't the strategy for being healthy, but I did it anyway. But after I understood the psychology for being healthy it was easy to follow anybody's strategy for being healthy. All the strategies work. But without the psychology, you'll never lose weight, or if you do lose weight, you'll probably put the weight back on later.

But once you condition the psychology, you'll become healthy and stay healthy. Your body, and your life, will transform for the long-term.

You're probably wondering, "What's this have to do with me, and what's this got to do with a hedge fund???"

Since focusing on my psychology worked so well on my health, I decided to apply it to making money. My financial situation sucked. I tried starting a lot of different businesses, and was terrible at all of them. I tried publishing music contacts for the music business and all I accomplished was spending $3000 on graphic design and incorporating a C-Corp that was useless. Then I tried running a recording studio and being a music producer. I tried renting video machines in grocery stores. I almost bought a video store. I was thinking about getting into the construction business, but I know now I would have probably failed at that too.

Then I got lucky.

It turned out as soon as I finished the Personal Power CDs, Tony Robbins was offering an investing seminar in Pittsburgh where I lived. I know a lot of people think this "Tony Robbins stuff" is nonsense and hype. To be honest, some of it was. I went to this seminar called *Financial*

Power. I had no idea what they were going to teach there. Turns out it was like the Tony Robbins' CDs -except they taught trading strategies along with the psychology of becoming wealthy.

Like I said, strategies are easy to find. Don't get me wrong –strategies are critically important. You'll never become successful if you don't have the right strategy. Like Robbins teaches, you can be totally motivated to find a sunset. But if you go running to the east looking for a sunset, you'll never see one. It's the same with "positive thinking." You can't just say, "There are no weeds. There are no weeds. There are no weeds," and hope your garden doesn't have weeds. At some point you have to work to pull out the weeds.

What really changed my financial life was understanding the psychology of wealth, and the specific psychology to be successful at trading. I didn't realize it at the time, but Tony personally coaches one of the most famous and most successful traders in the world. He modeled the psychology of trading from this gentleman who is known for making over $500 million in one day. I can't say his name. What I can tell you he's featured in one of Jack Schwager's iconic *Market Wizards* books.

The *Financial Power* seminar was only a 2-day introductory course. The next event on Robbins' schedule was an event called *Wealth Mastery*. As it turned out, it was the final time Tony Robbins personally taught this course himself. *Wealth Mastery* was 6 straight days of Tony teaching the psychology of wealth and trading, modeled after one of the single best financial traders in the history of the planet. Tony's premise is you find the best in the world at something, and copy what they do, and you'll get the same results they get.

Wealth Mastery was more than just teaching information. It was having us go through exercises and processes, using NLP strategies like time distortion, anchoring, future pacing, etc., that created an immediate and lasting changes in a person's psychology. It takes more than just intellectually "getting" something. It takes actually having an emotional and physical transformation to break the old patterns and to condition the new patterns. Once somebody goes through these processes failure is no longer an option because the thought of failure literally becomes too painful to bear.

The main reason I was doing this was to make sure I could take care of my kids. I needed $300,000 put away to be able to pay for their school -and that was just their schooling before college.

But the more immediate reason I wanted to master trading was to make enough money to adopt my daughter from China. My wife at the time saw a television show that talked about China's one child policy, and how many women either gave their baby girls up for adoption, or actually killed them because they wanted a boy. It haunted me to think that there was a baby somewhere out there in the world that I could bring into our home and take care of, but the only thing preventing me was that I was too lazy or too incompetent to be able to pay what it would cost. At the time it cost $15,000 to adopt a baby from China. So when I started trading, my goal was to first make $15,000 to pay for the adoption, and then build on this until I had $300,000 saved to pay for my kids to go to school.

After having been taught for six 18-hour days by Tony Robbins at *Wealth Mastery* I was totally transformed psychologically. I wiped out all the old patterns and beliefs that were holding me back. Equally important, I was on

fire, 100% driven to do whatever it was going to take to become successful at trading -a *Wealth Master* as Tony called it.

I started trading my retirement account using the strategies I learned and found out just how fast a person could lose money. I learned that real life the trades don't turn out like they do in theory. When "experts" teach trading strategies they make it look like making money is easy. But they usually don't teach things like how stocks can gap down 50% overnight, or how money management is as important as the strategies.

At this point I got discouraged. I had lost $7,500 on an option trade in a matter of 10 minutes. I was watching Maria Bartiromo live on MSNBC and made a trade based on a story she reported on about Warren Buffet buying Nike. After I bought the options Ms. Bartiromo reported that the story wasn't really a story, but was actually a rumor. I immediately sold the options I just bought at a $7,500 loss. My income at my job at the time was $5,000 a month.

I had to go back to the drawing board. I knew I had to have an edge.

I knew that I already had two edges. First, my psychology was better than 99% of the people trading. But that didn't stop me from losing $7,500 in ten minutes! I knew I had to use my other edge more effectively.

My other edge was my education.

I had graduated from Carnegie-Mellon University with degrees in Electrical and Computer Engineering, and Biomedical Engineering. I was also a computer programmer. When I graduated from college I went to

work for an engineering company that made test equipment for the U.S. Navy's nuclear fleet. I wrote software to analyze and model data streams representing measurements of the nuclear fuel rods. I reasoned that writing software to analyze stock market data couldn't be that difficult.

I was right.

Analyzing the stock market data was easy. The problem was that figuring out a way to make money wasn't so easy. Just about every theory about the stock market, when actually quantified and tested, didn't make money in the long run. Most of these strategies didn't even make money in the short run. I started with using simple moving averages, Bollinger Bands, MACD, etc., etc., etc. I copied exact trading strategies from every book I could buy on trading. I programmed these into my software and nothing worked.

I had become very discouraged. I thought the whole thing was a scam to make money for the brokerage companies. I even thought Tony Robbins was just scamming people to fill his seminars. But at the same time I knew that there were people who were outrageously successful at trading. So I kept plugging away, educating myself anyway I could. I went to a day trading course in New York and watched from behind a glass window as a 21-year old Russian kid named Serge made $30,000 a day, day trading like he was playing a video game. That course ended on a Friday, and I immediately went to a Saturday/Sunday seminar put on by Victor Sperandeo, one of the traders featured in *New Market Wizards*. I was totally committed to do whatever it took to master trading.

On that beautiful June morning in New York, while I was sitting in an office around a large conference table listening to Victor Sperandeo teach how he made money, my wife and daughters were getting ready to go to the Bronx Zoo. I began to second guess everything I was doing. "What's the point of making money if it meant I'd be sitting in front of a computer trading all day while my kids were at the zoo?" I thought. I knew these were moments I would never get back. I knew the reason for mastering trading was so I could spend time with my kids, not so they'd go to the zoo without me. So right in the middle of the $2500 seminar I got up and bolted out the door. The office was near Wall St., and I was desperate to catch a taxi back to 51st and Park Ave. before my kids left for the zoo. I got there just as their taxi was pulling out. Luckily, I was able to flag down their taxi, and had one of the best days of my life with my kids at the zoo in New York.

But that still left a problem. I was no closer to mastering trading than before. Actually, thinking that I was no closer *was* the problem.

I remembered back to one of the things Robbins taught at *Wealth Mastery*. He said that the point where most people quit is when they are so close to breaking through. Learning and mastery follows a predictable pattern according to Tony Robbins. You begin by knowing nothing and your learning accelerates rapidly at first. Your results lag behind, but still you can see tangible improvement. Then you reach a plateau. This is to be expected. Sometimes your results even get worse as you're about to transform to the next level of mastery. The difference between successful people and those who quit is that successful people keep pushing forward when they hit

obstacles because they know and anticipate they're going to hit the obstacles.

When I remembered this, I realized that I was totally wrong to think I was no closer to being successful. I was only 2 millimeters away as Tony likes to say.

I went home and asked myself some better questions:

"What is it that I'm not seeing?"

"What assumptions am I making that I don't know I'm making?"

"How can I make money trading by only spending 15 minutes a day trading instead of sitting in front of the computer all day?"

"How can I trade in a way that I know the results ahead of time?"

"How can I slant the odds in my favor and be like I 'own a casino'?"

"How can I find repeatable and predictable patterns that give me an edge?"

Then I went back to work on my software. I knew I didn't need to find dozens of strategies that worked. I needed to start by finding one. Then I needed to use that one strategy over and over, knowing that the odds would be in my favor in the long run.

Finally I found a trading strategy that worked.

I immediately started trading my retirement account using this strategy. Within six months my account went from $83,000 to $108,000. That's a 30% return in 6 months.

I asked my father to let me trade his money. Problem was, he didn't have much saved either, except his retirement account. At the time he had just turned 60, and had about $400,000 to his name. I would have never asked him to let me trade his account unless I was 100% sure that the strategy worked. He agreed to let me trade his retirement account that day.

The first 12 months I didn't have a losing month. I made 63% on my money and my father's money. I taught my best friend, David, how to trade his retirement account. He started at $62,000 and within a couple of years broke $500,000. I told my friends that I was doing pretty well trading, and pretty soon people wanted me to trade their money for them. That's when I started a partnership to invest other people's money. That's also what's known as a hedge fund. I had never even heard of a hedge fund at the time.

Within 3 years my retirement account went over $1 million. My father's account went over $3.2 million. An elderly gentleman from Florida saw my name in a magazine and began calling me to ask me questions about my trading. It turned out that this gentleman was a billionaire who had his own Fund of Funds. That's the first time I ever heard of a Fund of Funds. Basically, a Fund of Funds has so much money to invest that the manager can minimize risk by divvying up the money between traders and other funds that have different trading styles. This gentlemen started by giving me $100,000 of his money to trade. At the time I thought that was a huge amount! Within a year he had given me $25 million to trade.

Then I went back to see Tony Robbins teach a new time management seminar called OPA. OPA stands for

Outcome Focused, Purpose Driven, Action Plan. During this seminar he talked about how important it was to focus your actions and time on your most important outcomes. Because of this, Tony decided he wasn't going to teach *Wealth Mastery* anymore. Ever since I first did the *Personal Power* tapes and lost 70 pounds in 4 months I had wondered how I could ever repay Tony or thank him enough for how he had helped me. When he said he wasn't teaching Wealth Mastery anymore I knew how I was going to repay him.

I signed up to do Tony's *Date With Destiny* seminar at his resort in Fiji called Namale. Part of *Date with Destiny* is a goal setting workshop. You put your goals on a big poster board, which I still have. One of my goals was adopting my daughter from China within the year. Another was teaching *Wealth Mastery* for Tony. So the last day of the event I saw Tony eating lunch and got the courage to approach him. I had my laptop with me, and told him about the trading strategies I was using. I told him it would be an honor and privilege to teach what I learned at Wealth Mastery because I knew I could help everybody who came through the program. Surprisingly, Tony said yes. He invited me to be one of the teachers at his *Wealth Mastery* events.

Within 4 months I was the opening presenter at Tony's *Date With Destiny* event in Maui. Within 7 months I had adopted my daughter, Loren, from China. The first time I made over $1 million dollars in one day was less than 2 years after I started trading. I made $2.2 million in one day – all because I ordered some CDs after watching an infomercial.

In the course of a few years I had made more money trading than most people make in a lifetime. More

importantly, I was able to help my closest friends and family become financially independent as well. The family business that was founded in 1914 would have been gone bankrupt -except that I traded the business' money. I turned the business' $400,000 investment account into an $800,000 account in less than a year. I created my own seminars, and appeared on national television as an expert on the financial markets. I paid off all my debts, and even bought my father a Rolls Royce for father's day.

Then it all fell apart.

Without getting into the details, I went through a divorce. Needless to say when lawyers smell money, bad things happen (for whoever has the money! Not for the lawyers!).

The courts froze all my money. I found this out one day when I went to pay for my kids' lunch and the waitress told me a special code came up on her credit card machine to seize my credit card. The State of Pennsylvania actually removed all the money from my personal bank accounts without warning. I had no access to any money to pay my office staff or even pay my rent. I had lay off all of my employees who ran my office, leaving me to do the best I could to do the jobs of 5 people by myself, all the while not being able to take any money out of my business.

What's worse is the courts froze all of my father's retirement money, and the family business' money. It took almost a year and $100,000 in legal fees to get them to release my father's retirement account and the family business' savings. My business, which took 5 years to create, was destroyed in a matter of weeks.

And in the middle of all this the court appointed psychologists recommended that my three daughters be taken from me.

Sometimes I wonder how I made it through everything. Then I remembered the two "edges" that I had that made me successful trading. One was knowing strategies. The other was my psychology. I needed both the best strategies and a complete mastery of my own psychology to keep from having my life totally devastated.

On the strategy side, I was aware the courts were going to freeze my assets. I could have easily moved the money out of the country but my lawyer adamantly advised against it. I later found out that the reason he advised against it was because he wouldn't have been able to get his legal fees paid. The way the game worked was the court "un-froze" money every few months to pay the legal fees, which eventually totaled close to $1 million.

But the strategy I did use that was 100% responsible for saving me was that I transferred all of my assets into a fund of funds, the same structure that the elderly billionaire from Florida used to invest money with me.

How did this save me?

Because I was able to invest my money with other fund managers who were out of the jurisdiction of the Pennsylvania courts. When the court ordered $543,000 transferred out of my account, I forwarded the order to the manager of the fund of funds. It just so happened that the fund was in New Jersey, AND it had a five-year lock up period, so the lawyers couldn't get paid. It was amazing how fast the case settled when the lawyers couldn't get their hands on the money. I was able to be with my kids

almost full-time. In fact, once the lawyers left the picture, I became very good friends with my kids' mom again. She just made me dinner last night! :)

But the damage was done.

My business was totally shut down, and once again I was back to square one. I eventually represented myself in court. The settlement was simple. I agreed to give all of my assets to my kids' mom, and her lawyer agreed not to file any actions to attempt to get into the trust I set up for my kids, or to file any suits trying to get my father's retirement account.

Then it hit me.

Looking back at the last 12 years, I have a lot to be grateful for. I still have means to travel the world. My kids' are financially set. My father is financially set. My family business survived the worst recession in decades thanks in large part to the money I made trading. But looking back, what really means as much as anything to me is knowing the people I helped.

One woman in particular stands out. Her name is Sylvie Brown, and she's from New Zealand.

I went to Fiji for another event with Tony called *Life and Enterprise Management*. By this time I was a featured presenter at his *Wealth Mastery* events, and was given VIP treatment. I was given the best bure at Namale (think a grass hut run by the Four Seasons!). Everybody at the event knew who I was, and I was trading most of the other VIPs money. My time was becoming more and more in demand, and I was stretching myself very thin. That's why I went to this event -to learn how to prioritize and manage my time and my businesses. By the end of the event I had

decided not to teach seminars anymore. It was taking up too much time, and wasn't the most effective use of my time. Or so I was told by everybody around me.

Then at the end of the event something happened to change my life.

Tony was sitting in the dining room and caught my attention. He yelled across the room, "Allen! Get over here!"

He looked very serious. I honestly thought he was going to yell at me for peeing on the banana tree outside my room the night before! I walked over to the table and he handed me an envelope. All he said was, "It looks like you got your outcome."

Then I remembered back to when I first asked him if I could teach at *Wealth Mastery*. He asked my one question: "Why do I want to teach at *Wealth Mastery*?"

My answer was that I wanted to teach at *Wealth Mastery* because I knew I could make a huge difference in their lives. And it was the only way I knew to give something back to Tony -by contributing to the people who came to his event based on their faith that Tony would deliver results he promised.

I went back to my room with the envelope Tony had handed to me. I had no idea what was in it. I opened it and it was a fax from the Robbins' home office. It was from a woman in New Zealand name Sylvie Brown. I won't go into the entire details here, but to paraphrase, she sent it to thank me. Turns out her teenage son had gotten in with a bad crowd in their neighborhood. She used all her life's savings to go to *Wealth Mastery* to hear me speak. She went back home and made enough money to move from

the bad neighborhood so she could get her son away from the druggie crowd he was hanging out with. She basically thanked me for saving her son's life.

At that point I remembered the reason why I started trading in the first place. It wasn't to make money. It was to make a difference in other people's lives. My children. My family. My friends. People that I never even met. And I realized that almost all of the gratification I felt was when I was focused on how I helped other people. The best times in my life were when I was in the front of the room, speaking to three thousand or more people, teaching them how they could model exactly what I did to become financially independent exactly the way I had done it.

So now fast forward back to today.

I was talking with somebody I had recently met who wanted to learn how to make money trading. He was thinking about whether to pay me $8500 for one day of consulting, or $22,500 for six days.

He asked me a great question. He said, "As somebody with so much experience, knowledge, and understanding of trading... If you were just starting out like again, what are the most important things you know now that you would teach yourself?"

Ok... I know that's sort of a Dr. Brown, Back to the Future time-warp type of question, but it's a great question!

Then I thought of the Fund of Funds that my kids' and my father's money is in. And then I thought of a great question:

"What are the most important things I would teach somebody who was trading my kids' money? What are

the most important things I would teach my own kids about how to manage and trade their money?"

That's what you're about to read next.

My daughter, Summerlee, is attending NYU's London campus. She's going back to New York with the plan of graduating from the Stern School of Business. Either that, or she wants to go to the London School of Economics. Her goal, at least now, is to work in the hedge fund business. Even at the age of 19 she "gets" that the hedge fund business model is different and potentially more lucrative than anything she's ever seen.

So be aware as you read the next chapters, I wrote them with the idea I was writing them for my kids to read. I'm not holding anything back, and I'm not trying to over-hype anything so I can sell you consulting or get you to invest in my fund.

This is hardcore, right to the point information that I want my kids to have. It's the best of what I know about how to transcend into the realm of being successfully independent without having to do anything more than just follow the steps I've laid out.

This isn't some unproven theory. It's exactly what I did, and exactly what every one of the guys I know who started their own hedge funds did. It's not rocket science. It's not even exceptionally difficult. True, it requires a certain amount of commitment and effort.

But did you think making millions of dollars every year wouldn't require effort and commitment?

Step 1:
Face It – You Have Problem

Before we begin, I wanted to share with you the biggest problems I faced when before I started my hedge fund business.

The biggest problem?

I wasn't even aware I had these problems!

Why?

Because our culture and mainstream media conditions us to believe that these problems don't exist.

And why is that?

Think about it. It will make total sense when you see the big picture.

The entire financial media is driven by advertising revenue. Who do you think spends billions of dollars on advertising in the financial media?

Mutual fund companies.

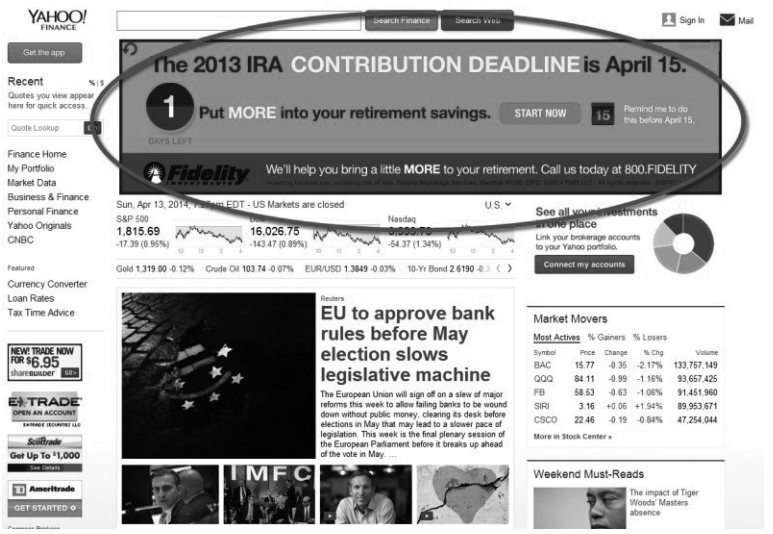
Mutual fund companies, also known as financial service companies, drive the entire financial media business. This means every television show you watch, every website you visit, and every radio show you listen to is paid for my advertising dollars being spent almost exclusively by mutual fund companies.

These mutual fund companies are just like any other company. They need customers to stay in business. That means they need to market to customers. They have sales teams just like any other company. Their business model is just like any other business. They need to acquire leads and convert the leads to customers. They do this through advertising.

And what exactly do mutual fund companies advertise?

That's an interesting question since their advertising content is highly regulated by the SEC. Basically, they can't promise any future results. They can simply tout past performance, but they need to include a disclaimer that past performance does NOT have anything to do with future results.

Here's a screen shot from Yahoo Finance:



Notice that huge green rectangle at the top of the page on Yahoo Finance?

That big green rectangle in the middle of the screen is paid advertisement for Fidelity Investments. Fidelity is the largest mutual fund company in the world, both in terms of assets under management and in terms of number of funds under managements.

The second largest mutual fund company is Vanguard. Vanguard became successful marketing their low management fee Index funds.

The amount of money Fidelity, Vanguard, and other mutual fund companies spend on advertising is staggering – well into the billions of dollars a year. Both Fidelity and Vanguard have approximately $1 trillion each under management.

That's Trillion with a T.

So why do the masses put trillions of dollars into mutual funds?

Surely, it's not because the funds mitigate risks or enhance returns compared to putting money into the major stock indices. They don't.

In fact, all you need do to is spend about 5 minutes looking at mutual fund charts and you'll see two things – almost all funds closely mirror the stock indices they're modeled after, and that rarely do these funds outperform those indices.

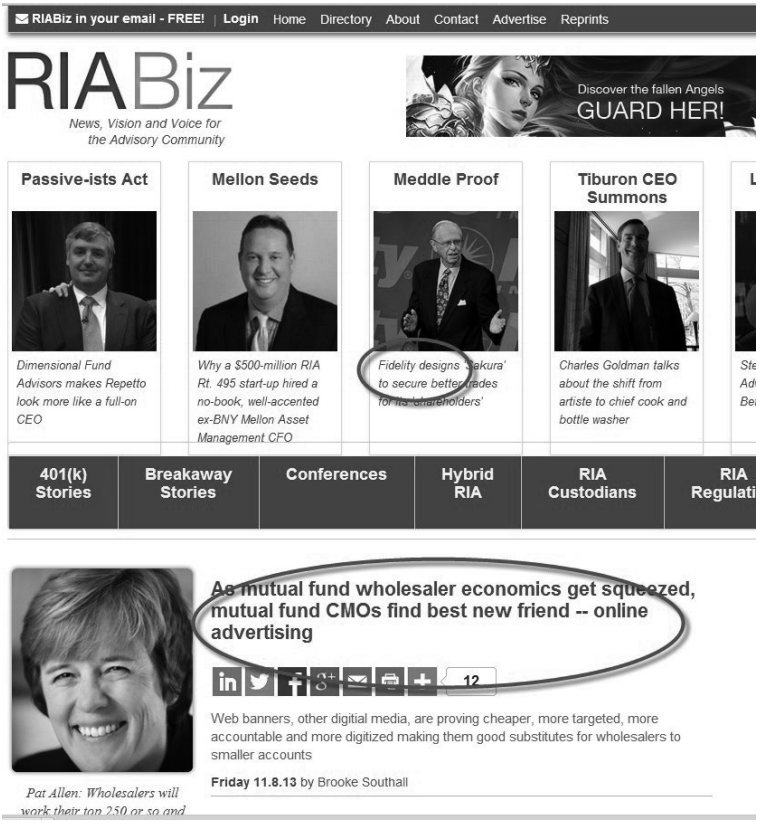
The problem isn't that the mutual fund companies don't outperform the markets. The problem is that the basic

marketing philosophy of the mutual fund companies has permeated the mainstream media and popular culture.

The problem is that the general public doesn't know there's a problem because the financial media has a direct conflict of interest. The advertisers who subsidize every aspect of the financial media where we all get expert advice are mutual fund companies.

Don't believe me?

Check out this website for Registered Investment Advisors:



Brooke's Note: Ignites Research shares an owner, Financial Times, with Ignites, the online publication for mutual fund companies that sells some advertising (to supplement subscription fees) to them, hence you could say there might be a glancing conflict in providing this data. Ditto for RIABiz for covering the study, except with RIABiz we are almost soley dependent on revenues from online ads, including some placed by mutual fund companies. But the placement of Ignites and RIABiz in the food chain also gives them/us a front row seat on this shift. RIABiz advertising chief Frank Noto says these purported changes toward online dollars and consciousness at fund companies ring true on two levels. First, more people at mutual funds are reaching out directly to him — not from the marketing department but from the people whose job it is more holistically to reach RIAs. Second, when mutual fund companies run ads they are no longer content to ask us for our metrics. They put their own de facto LoJacks in their banners on our pages, called tags, and they watch the behavior of that banner visitor as they advance to a landing page, white paper etc. With any luck, this marketing trend will lead to funds and service being customized more effectively to the advisor, the investor and the fund company. Costs will come down and customization of product and service will go up.

Read the above disclaimer.

This website is owned by one of the most influential financial media companies in the world, Financial Times. The author points out what she calls a "glancing" conflict of interest.

"Glancing?"

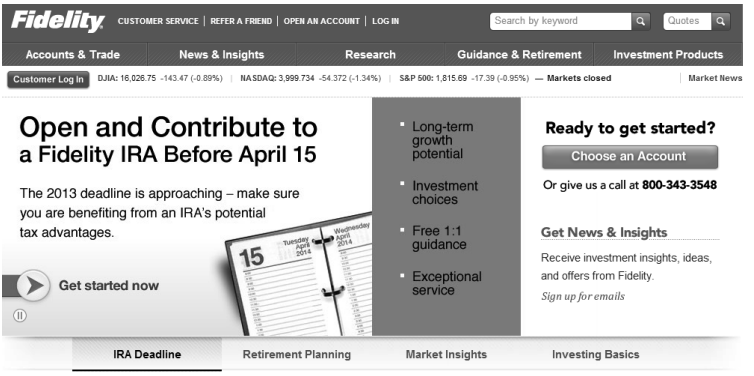
The financial media is controlling the frame. The frame they control is a non-stop analysis of which markets are growing, which funds are best, and what the future might hold. This not only sells newspapers, it sells mutual funds. It's a perfect incestuous relationship. It's like the kings of the dark ages telling their subjects to attend church, and the churches telling the subjects that the kings were divinely chosen by God.

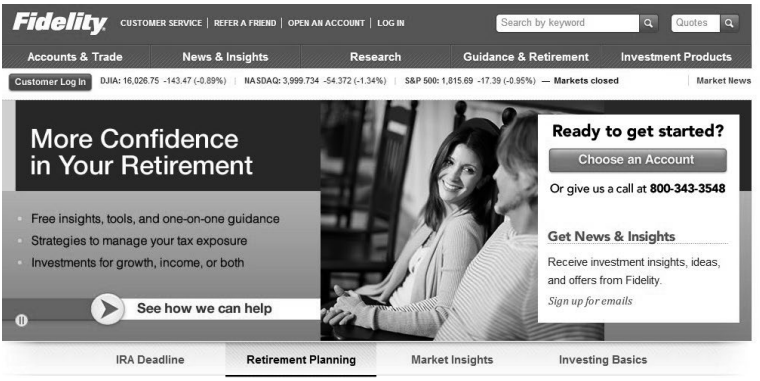
The frame shouldn't be what's going to happen with the markets, or what funds to invest in. The frame should be whether the global strategy of handing over your money to mutual fund managers and then not worrying about it is a sound strategy.

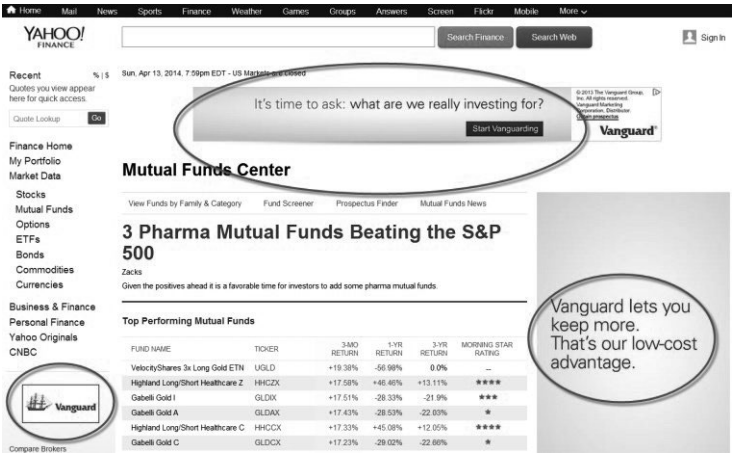
It's not.

It's a horrible strategy.

What the mutual fund companies promote is saving money. Look at where you go when you click on the ads for Fidelity:







This screen shot shows Vanguard bought 3 banner ads on the main page for Fidelity's Mutual Fund Center.

Sunday, April 13, 2014 | Stay Connected

HOW THE MARKET WORKS.com
Your *Simple* Guide to the Stock Market!

Home | Stock Market Game | Sign Up | Contests | Trading FAQ | **Education Center**

EDUCATION HOME | LEARN STOCKS | LEARN ETFS | LEARN MUTUAL FUNDS | GLOSSARY

Mutual Fund Families – Largest Mutual Funds – Mutual Fund Family

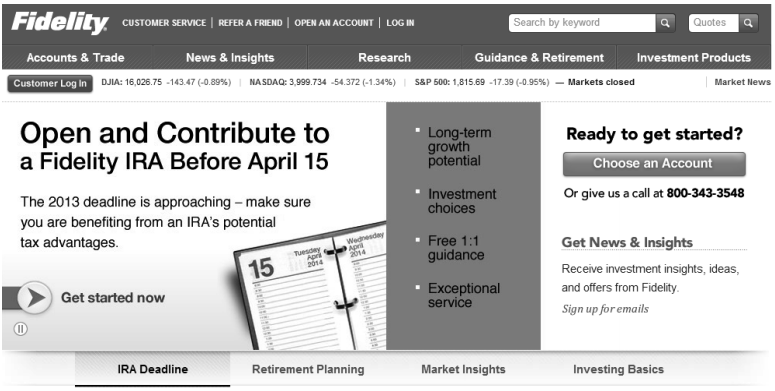
Join TD Ameritrade. Trade free for 60 days + Get up to $600



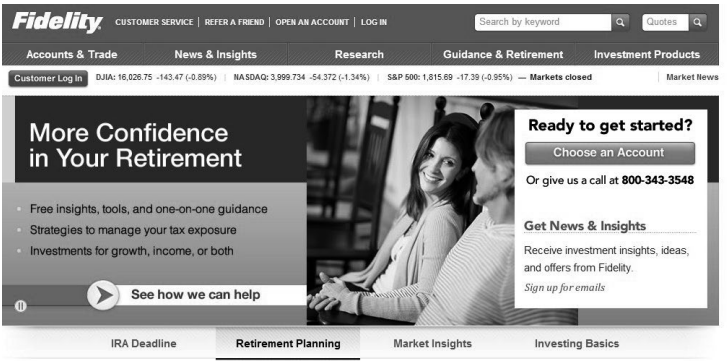
The following list is the 100 biggest Mutual Fund Families according to Morning Star. The top mutual fund family as of 2013 is Fidelity Investments.

Mutual Funds

	Family	Retail Net Assets	# of Distinct Funds
1	Fidelity Investments	$984,173,589,258	315
2	Vanguard Group	$962,331,327,507	148
3	American Funds	$956,584,547,987	42
4	Franklin Templeton Investments	$377,385,331,414	122
5	T. Rowe Price & Co.	$345,725,591,811	110
6	Columbia Management	$167,493,529,444	140
7	Dodge & Cox	$126,826,526,974	5
8	OppenheimerFunds	$125,473,946,434	72
9	John Hancock Funds	$119,789,419,458	225
10	Pacific Investment Management Co.	$118,411,876,036	73



This first page is nothing more than reminding people to contribute to their IRA before the April 15 deadline. That's great. It's great for people to save money for retirement, right?



The next page is telling people that they will feel more confident about their retirement if they use Fidelity's tools and guidance.

Feeling confident is an emotion.

People pay to have their emotional needs met. Feeling confident has zero to do with how much money you make

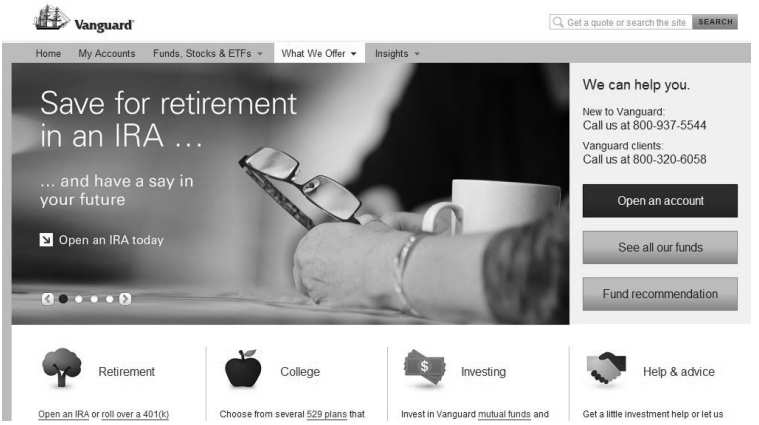
from your investments. In fact, feeling confident is probably inversely related to how much money you're going to make from an investment.

Why?

Because people pay a premium to meet their emotional needs. Every market crash in history started in an environment where everybody felt so confident that there was no one left to buy. In 1999 a stock broker friend of mine told me that his pastor called him and wanted to know what stock he could buy that would double the money in the church's building fund –in four months.

When a pastor of a church is looking to buy stocks that are going to double in four months you can be sure that there are very few people left in line behind him to buy. When there's nobody left to buy, the inevitable will happen. The market will drop.

Vanguard's ads are almost the same as Fidelity's ads:



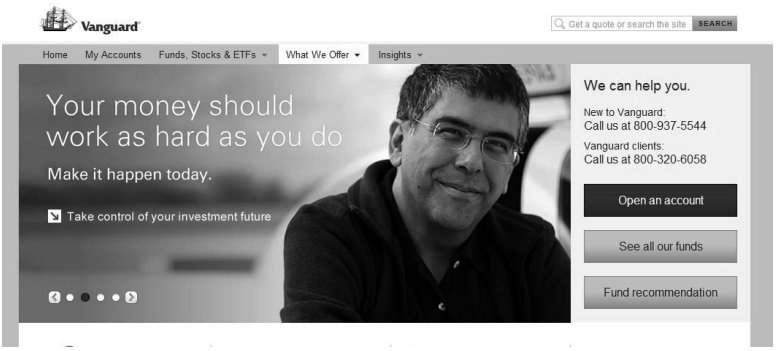
Yes, saving money for retirement is a good thing. That's the large print.

Having a say in your future because you dumped money into an index fund? Not so much.

I take that back.

Yes, you're having a say in your future by relinquishing your financial future to the whim of the stock markets. True, the markets have historically gone up. So has inflation. If you're ok with running the risk of having less money in 25 years than you do now, buying mutual funds can be a great strategy. So can going to a casino and betting on red every time at the roulette wheel. If you hit a good streak you'll make money. If you hit a bad streak you'll lose money.

Vanguard's next ad is a classic…



You're money should work as hard as you do?

Guess what?

Your money doesn't work. Money is an inert object, a concept, a belief system around value. Taking control of your investment future is not what you're doing when you

send your money to a multi-billion dollar corporation to buy baskets of stocks that mirror indices.

Keep in mind, if you're reading this right now and you have money in mutual funds, there's nothing wrong with that – if you don't care if your accounts drop 50%.

But I'm sure you wouldn't be reading this right now if you didn't care about your accounts dropping 50%. People tell me all the time, "It doesn't matter how much the market drops, it will come back…"

Maybe, maybe not.

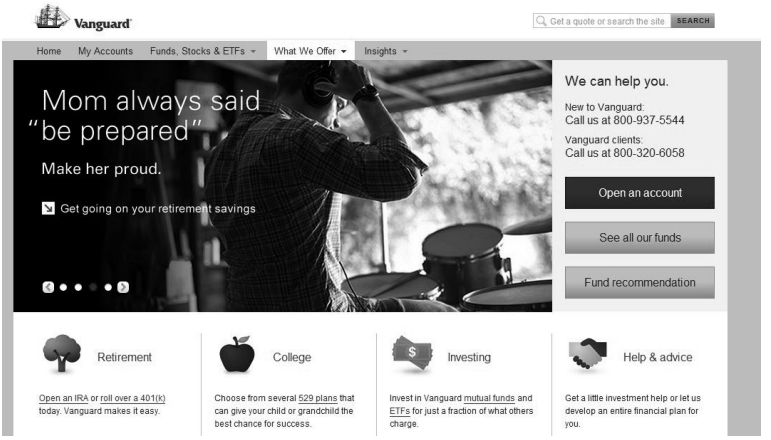
But even if it does "come back," wouldn't you be better off if you had 100% of your money to participate in the "come back?" If you're account drops 40% it means you need to generate a 66% return just to get back to where you were before you lost the 40%. It's just math. If you start with $1 million, lose 40% that takes you to $600,000. To go from $600,000 back to $1 million, you need to make $400,000, which is a 66% return on the $600,000 you had left.

Yes, it's great to save money.

But that's not the frame. That's the mutual fund companies controlling the frame.

The frame shouldn't be whether you save money or not. The frame should be how to protect your money and grow it exponentially.

Vanguard's next ad is one of my all time favorites:



Mom always said to be prepared? Make her proud?

Seriously?

If you're reading this right now and looking at the above ad, you're obviously not somebody who's investing to make your mother proud. Again, this is an emotional play, just like the Fidelity ad telling you that buying Fidelity mutual funds will make you feel confident about your future.

It would be easy to see these ads and write them off to CMO's who have too much time on their hands or people in Vanguard's marketing department desperate to convince people why they should buy Vanguard's products.

The problem isn't that simple.

The problem is that the $1 trillion of money being held by Vanguard was put their by a large number of investors who are actually swayed into investing by emotion-based advertising and marketing campaigns.

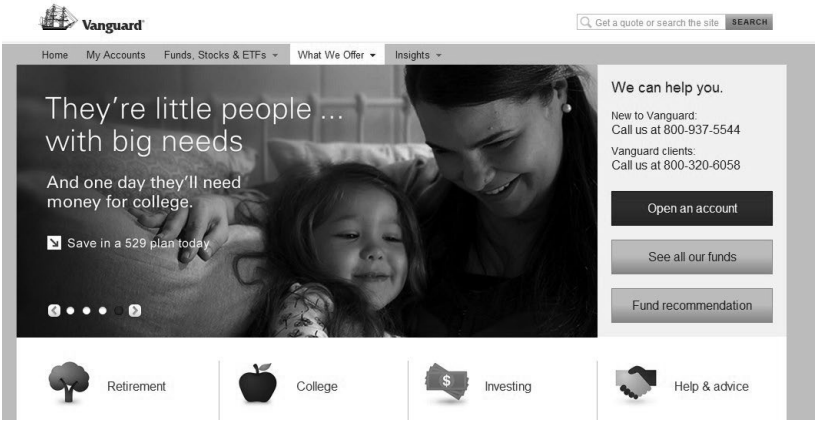
If millions of people are investing because it makes them feel good, how fast do you think they're going to want to pull their money out of the stock market when it stops feeling good?

This is the classic bear market capitulation we've seen time after time. The market will at some point crash. Stock prices will drop for months, maybe years. All the people who were so optimistic they were doing the right thing by "saving" money are going to see their accounts drop 10%. The people with the highest need for certainty will sell first. That will drive the market down another 10%. At 20% down a huge group of people will sell their stocks, putting their hard earned money into the safety of a money market account. This will drive the market down even farther.

This will continue until the last people holding out will finally capitulate.

This is the most predictable pattern in the history of financial markets because it's based entirely on human psychology. When you see mutual fund companies getting people to give them money based on emotions you can bet those same people will sell based on emotions.

Here's the last ad I'm going to show you from Vanguard.



Again, this is following the same predictable dynamic. One day your young children will need money for college. Yes, that's true. Starting a 529 college savings account might be a great idea.

But once the money's in the 529 what do you do with it? Put it into the stock market with the wish that 14 years from now when your child is ready to go to college you'll have more money in the account than you do now?

Maybe you will.

Maybe the account will have even less than you put into it.

Vanguard isn't promising anything. All they're doing is selling you on the concept of saving money for you children's college education, and doing it through them.

By now you should see that there's a major problem in the way the financial service companies are in bed with the financial media companies, and how the frame of everything you've been told is designed to move money from your account to mutual fund companies' accounts.

Being aware of the frame is what's most important. The entire frame of the financial industry is that a) it's good to save money, b) you're in it for the long-term (retirement and college funds), and c) mutual funds are the presumptive best way to invest your money.

If you're serious about investing your money in ways that protect your money and grow it then you need to have a different frame. In fact, you need to have several different frames.

To be clear on what I mean when I say "frame," imagine holding an empty picture frame in your hands. You can hold it up and look at anything in the room through the frame. You control the frame. You can hold up your frame and look outside at the sunset. You can hold up the frame and look at the dirty dishes in your kitchen sink. Both the sunset and the dishes exist either way, but where you put the frame controls what you'll be looking at.

The mutual fund/financial media partnership controls every investing frame in way that funnels your attention towards putting money into mutual funds. I've partnered with some of the most successful and wealthiest people in the world. That's not their frame.

Here' are the frames through which they look at their financial investments:

1) What is their risk? How do the identify and manage risk?
2) What is their edge? Do they have an edge? Can they scale their edge?
3) What experts do they go to? Do their experts have a measurable edge?

4) Are they leveraging their time? Are they leveraging their money?
5) Is their investment portfolio strategically diversified, or does it just have an illusion of diversity?

If you're not looking at your investment through these frames then you're like me when I started – your biggest problem is you don't know you have a problem.

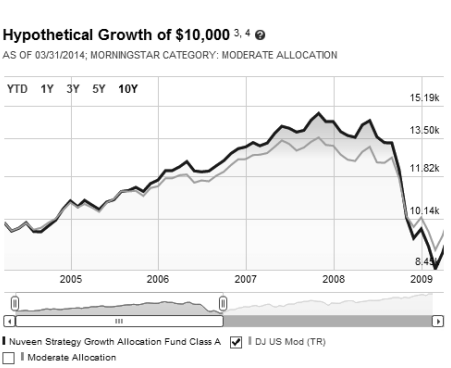
Some experts think the equity markets are going to be decimated. Other experts think the markets are poised for a once in a lifetime run-up to new all time highs.

The problem is both experts are right. The bigger problem is that if you haven't created a systematic business model for your investments you're going to be at the whim of the markets like the rest of the masses who see things through the frame of the financial media.

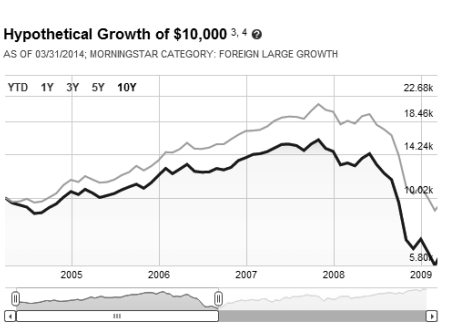
Let's take a closer look at each of these problems the average investor isn't even aware they have.

Problem 1: No Risk Management

This is common



4/11/2014	
30-Day Yield [5] 2/28/2014	1.21%
Weighted Avg Maturity 2/28/2014	13.45 years
Duration 2/28/2014	6.97 years
Exp Ratio (Gross) 12/31/2013	1.44% ($14.40 per $1000)
Exp Ratio (Net) 12/31/2013	1.35% ($13.50 per $1000)
Load (Load waived at Fidelity)	5.75%
Minimum to Invest [5]	$3,000.00
Turnover Rate 8/31/2013	15%
Net Assets ($M) 3/31/2014	$95.77
12 Month Low-High 3/31/2014	$11.63 - $13.17



4/11/2014	
Exp Ratio (Gross) 12/30/2013	1.17% ($11.70 per $1000)
Exp Ratio (Net) 12/30/2013	1.17% ($11.70 per $1000)
Redemption Fee	1.00%
Redemption Period	30 days
Minimum to Invest [5]	$2,500.00
Turnover Rate 10/31/2013	136%
Net Assets ($M) 3/31/2014	$990.07
12 Month Low-High 3/31/2014	$13.79 - $17.05

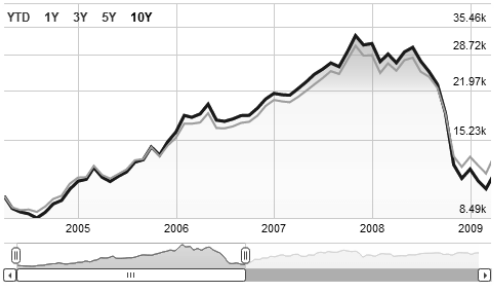
Chart Fund Price (NAV)

Top 10 Holdings [6]

AS OF 12/31/2013

Hypothetical Growth of $10,000 [3, 4]

AS OF 03/31/2014; MORNINGSTAR CATEGORY: DIVERSIFIED EMERGING MKTS



4/11/2014

Exp Ratio (Gross) 12/30/2013	1.09% ($10.90 per $1000)
Exp Ratio (Net) 12/30/2013	1.09% ($10.90 per $1000)
Redemption Fee	1.50%
Redemption Period	90 days
Minimum to Invest [5]	$2,500.00
Turnover Rate 10/31/2013	119%
Net Assets ($M) 3/31/2014	$2,144.84
12 Month Low-High 3/31/2014	$20.97 - $24.73

Chart Fund Price (NAV)

Top 10 Holdings [6]

AS OF 12/31/2013

Hypothetical Growth of $10,000 [3, 4]

AS OF 03/31/2014; MORNINGSTAR CATEGORY: FOREIGN LARGE GROWTH



Compare Chart | Fund Facts Search

Exp Ratio (Gross) 12/30/2013	1.17% ($11.70 per $1000)
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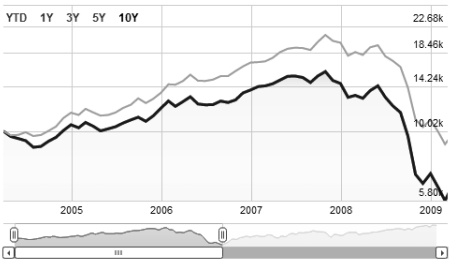
Chart Fund Price (NAV)

Top 10 Holdings [6]

AS OF 12/31/2013

Hypothetical Growth of $10,000 [3, 4]

AS OF 03/31/2014; MORNINGSTAR CATEGORY: FOREIGN LARGE GROWTH



Fidelity® International Capital Appreciation Fund ☑ MSCI AC Wld xUS (Net MA)

☐ Foreign Large Growth

Compare Chart | Fund Facts Search

The performance data featured represents past performance, which is no guarantee of future

4/11/2014

Exp Ratio (Gross) 12/30/2013	1.17% ($11.70 per $1000)
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Chart Fund Price (NAV)

Top 10 Holdings [6]

AS OF 12/31/2013

Hypothetical Growth of $10,000 [3, 4]

AS OF 03/31/2014; MORNINGSTAR CATEGORY: MODERATE ALLOCATION



Nuveen Strategy Growth Allocation Fund Class A ☑ DJ US Mod (TR)

☐ Moderate Allocation

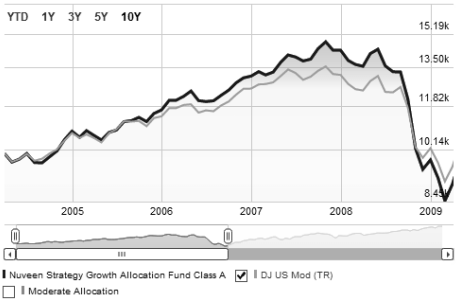
Compare Chart | Fund Facts Search

30-Day Yield [5] 2/28/2014	1.21%
Weighted Avg Maturity 2/28/2014	13.45 years
Duration 2/28/2014	6.97 years
Exp Ratio (Gross) 12/31/2013	1.44% ($14.40 per $1000)
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Chart Fund Price (NAV)

Hypothetical Growth of $10,000 [3, 4]

AS OF 03/31/2014; MORNINGSTAR CATEGORY: MODERATE ALLOCATION



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Problem 2: No Edge

We live in a world where all the information in the history of planet earth is accessible from the phones we carry around with us.

When I first started trading I had to buy a little black box that looked like a transistor radio that picked up a radio signal feeding me updated stock quotes. Floor traders used to have a huge edge on the rest of us because they had access to the real-time order flow and price moves.

All that's changed.

Remember my friend who helps manage CalPERS?

There are only two advantages – having more information than your competitors, or a better way to analyze the information.

Unless you're working at a multi-billion dollar Wall St. investment bank, you are not going to have an edge by having access to more information that your competitors. Make no mistake, you're competitors are traders from Goldman Sachs, UBS, JPMorgan, and every other investment bank on planet earth.

Trust me, they have more information than we do.

They also have access to hundred million dollar trading algorithms and platforms to analyze the information. A friend of mine rented office space to two former systems developers from Goldman Sachs. They developed a trading platform that analyzed news stories online that mentioned stocks. The platform watched how the price moved in relation to the story, then automatically put orders in to fade the move. In other words, the system waited to see if

the news story moved the price, then put a trade in the opposite direction of the price move. They automated the ago old axiom, "Buy on the rumor and sell on the news."

It's very difficult to compete with this type of money, technology, and talent.

That's not to say it's impossible.

The advantage we have over large firms is we don't have to trade billions of dollars. CalPERS manages around $250 billion dollars. There most recent PDF of their holding is 293 pages long. They own stocks, options, derivatives, real estate, bonds, and every other publicly traded security imaginable. Their return for fiscal year 2011 was a measly 1%.

It's definitely possibly to find an edge, a small pocket of market inefficiency, and exploit it. People do it all the time.

But if you don't know what your edge is right now, it means you don't have one. If you want to be successful at protecting your assets and growing them exponentially you better get one.

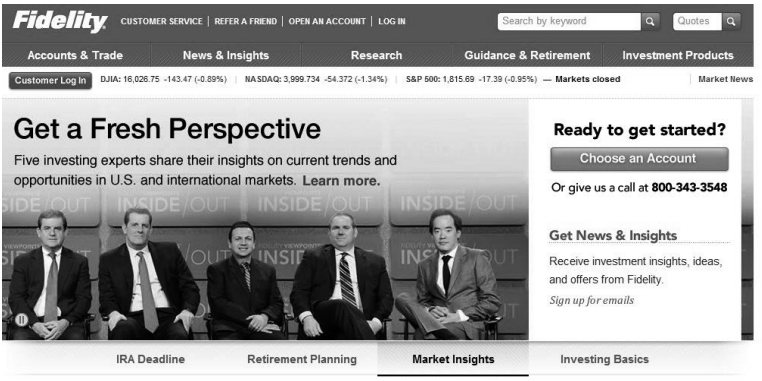
Problem 3: Believing the King Has Clothes

Look at this picture below from Fidelity's website.

Get a fresh perspective.

Five investing experts share their insights on current trends and opportunities in the U.S. and international markets.

They all look legit, don't they? They probably all went to prestigious business schools, living in multi-million dollar houses, and drive $100,000 cars.



But this reminds me of a friend I had who had his heart broken last year. He fell head over heals in love with a married woman. They carried on an affair for several months. My friend didn't tell anybody about it. He was embarrassed that he was having an affair with a married woman, but he was so smitten he couldn't help himself.

She was beautiful. She was sexy. She made him feel important.

He sent her texts messages all day long telling her how much he loved her. He said he would die for her. He said his consciousness would forever be intertwined with hers, and that they were soul mates.

Her reply?

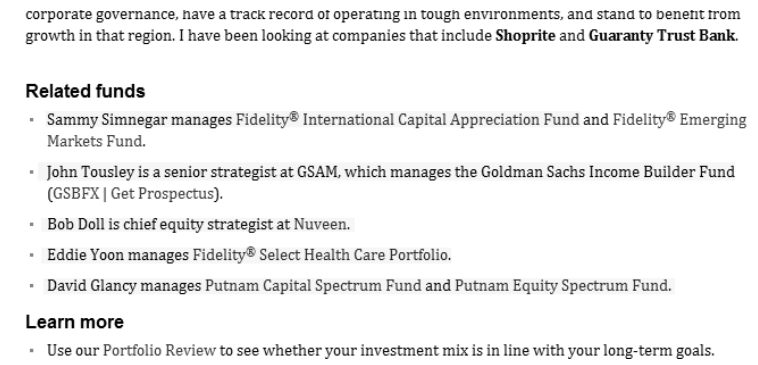
"Work on monetizing that."

Seriously. No joke.

The reason it reminds me of this picture on Fidelity's website is because these 5 guys have the look, the credentials, the titles, and the prestige.

All they need to do now is work on monetizing that.

The article about their "insights" ends with (big surprise) links to the funds the reader can buy from Fidelity.



corporate governance, have a track record of operating in tough environments, and stand to benefit from growth in that region. I have been looking at companies that include **Shoprite** and **Guaranty Trust Bank**.

Related funds

- Sammy Simnegar manages Fidelity® International Capital Appreciation Fund and Fidelity® Emerging Markets Fund.
- John Tousley is a senior strategist at GSAM, which manages the Goldman Sachs Income Builder Fund (GSBFX | Get Prospectus).
- Bob Doll is chief equity strategist at Nuveen.
- Eddie Yoon manages Fidelity® Select Health Care Portfolio.
- David Glancy manages Putnam Capital Spectrum Fund and Putnam Equity Spectrum Fund.

Learn more

- Use our Portfolio Review to see whether your investment mix is in line with your long-term goals.

The links after the story on Fidelity's site take you directly to the overview page for each mutual fund.

These funds substantiate Burton Malkiel's efficient market thesis.

When you look at the returns of the funds these "experts" manage they almost shadow the returns of the major stock indices. When I say almost shadow, what I mean is that they move in parallel, but often underperform the stock indices from which they're modeled.

Obviously, these fund managers have no edge.

If they did, their funds wouldn't be underperforming the major stock indices. And even if they had some very small edge, they're obviously not exploiting it. There's no way their funds' performance could mirror the stock indices returns so closely unless their core strategy was to emulate the indices.

And if that's their core strategy, what are they getting paid for?

It's a trick question.

My first response is that they're not getting paid for anything, but that's incorrect.

They're getting paid because of that picture Fidelity put on their homepage. They're getting paid because they can be marketed.

Because of their credentials, prestige, education, and yes, how they look, Fidelity can market them.

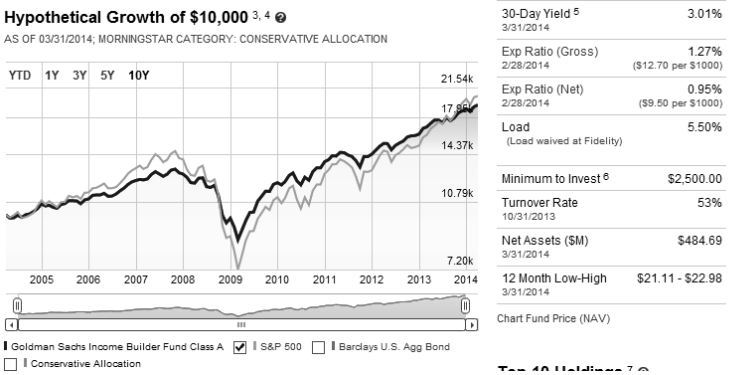
Remember what emotion Fidelity wants you to feel about investing in your retirement?

Confidence.

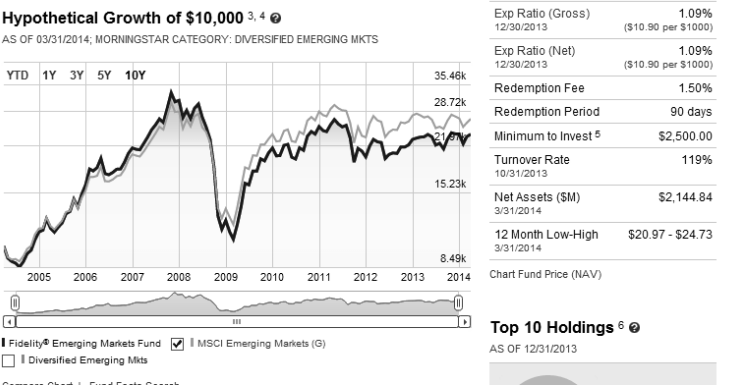
Fidelity can market their funds using these guys, not because they have some edge, but because they can be used to induce a state of confidence in the investors who have to send Fidelity their money in order for Fidelity to stay in business.

Don't believe me?

Just look at the returns these guys generated in their funds:



This manager is getting paid very well to run a mutual fund that mirrors the S & P 500. Note that the fund returns are in blue, and the S & P 500 is in yellow. The variation between the fund and the S & P 500 is within a small random variance. It has nothing to do with what decisions the fund manager is making.



The chart above is the Fidelity emerging market fund compared to the MSCI Emerging Market Index. The mutual fund is in dark blue, and the index is in yellow.

Notice anything?

The fund almost mirrors the index, move for move, and then underperforms from the bottom in 2009.

Not good. At least not good for the investors who have less the 70% of the money in their accounts in 2014 than they did in 2008.

Keep in mind that these same fund managers who sit on chairs in front of television cameras giving their "insights" were giving the same "insights" at the beginning of 2008. And if they weren't, and they claimed they knew that their funds were going to drop 75% in value in less than a year, then they're truly just figureheads who add no value.

Why pay somebody to oversee your money dropping 75%? On your worst day you could do better than losing 75% in a year.

Does it look like these experts have any "edge?"

Of course they don't.

This is the ultimate example of the story about the king having no clothes. The problem is nobody in the media dare point out the king has no clothes because the king is paying their salaries.

Problem 4: Not Leveraging Time or Money

The concept of leveraging money is very simple.

You can use the money you have to control a larger amount of money. For example, you can buy a $5 million dollar house with a $2 million down payment. Your money out of pocket that you invested is only $2 million, but you get the benefit of the potential appreciation of a $5 million asset.

If the value of the house increased to $6 million, and you sell the house and pay off your $3 million loan, you now have $3 million in the bank. You started with a $2 million investment, so you made a 50% profit on your investment. You were able to make this 50% return on investment even though the asset you bought only appreciated 20%, going from $5 million to $6 million.

The problem is that leverage works in reverse as well.

If the value of the house drops from $5 million to $4 million, and you sell the house, you still have to pay off the $3 million loan. Your left with $1 million in the bank when you started with $2 million. You lost 50% of your investment even though the asset only dropped 20%.

So what did we learn from this example of the house?

The most important thing to consider when using leverage is your downside risk.

If you can manage your downside risk, then you can use more leverage to produce larger investment returns.

Let's look at another example.

Suppose you could invest in something that is guaranteed to never drop more than 5% in value. If you put $1 million into this investment, the worst you could ever lose is $50,000. At the very worst you could sell your investment after it lost 5% for $950,000.

Now suppose in this scenario that this hypothetical investment had an upside potential of 25%. If you invested the same $1 million and made 25%, you would have $1.25 million, or a profit of $250,000.

Now here's where the power of strategic leverage comes into play.

What if you were comfortable, in the worst case scenario, with losing $200,000 on this investment?

What that means is you could invest $1 million of your own money, and borrow $3 million, for a total investment of $4 million. Now if the investment lost 5% it would be 5% of the $4 million, or a $200,000 loss which is in your parameters of acceptable risk.

So far so good, right?

Now remember that the investment can also go up 25%.

If your $4 million investment goes up 25%, your total profit will be $1 million. But your personal investment was only $1 million, and you used $3 million in leverage.

This means you made a 100% return on your investment.

This is the difference between fund managers who run hedge funds and mutual fund managers. Typically, mutual fund mangers do not use leverage of any sort. If they invest in the stock market, and the market drops 50%, they will lose 50% of the money in their account. If they were leveraged at an even 2:1 ratio and the market dropped 50% they would be wipe out the entire account.

Hedge fund managers often use leverage. This is why their top concern is managing risk. If a hedge fund manager can keep his maximum investment drawdown to no more than 5% that means even if he leverages his fund at a 4:1 ratio his maximum loss will only be 20%.

Now think about the upside of that situation.

If the hedge fund manager can keep his trading drawdown to 5%, and still generate a 10% annual return, his 4:1 leverage will be the equivalent of a 40% return. In other words, he's able to use borrowed money to generate profits because he can manage his downside risk.

Mutual fund managers typically cannot do this.

This is a huge problem for you if you're money is invested in mutual funds. What this means is that you're not only 100% vulnerable to market risk, you're also missing a chance to strategically leverage your holdings to make more money.

This is why the super wealthy invest their money in hedge funds and private partnerships. Hedge funds have the advantage of being able to "hedge" their investments, which lowers the downside risk. And because the downside risk is lowered, the hedge fund can, at it's discretion, borrow money at a low interest rate and invest that same many in ways to generate much higher returns than the interest charges.

This is especially important in the current economic environment where interest rates are so low. If a hedge fund manager can mitigate downside risk by hedging his investments he can simply borrow money to amplify his returns.

This has the added benefit of leveraging time.

The most fundamentally powerful tool in investing is compounding. If you can generate 10% returns a year and reinvest your profits you can double your money in roughly 7 years. If you can use leverage to generate a 20% annual return then you will double your money in less than 4 years.

If you don't understand this principle of leverage you're not only leaving potentially millions of dollars on the table, you're running the risk of losing years of time that can't be recovered.

If you do understand this concept of risk management and leverage, you can both minimize your risk while at the same time growing your wealth faster.

Now let's add one more element.

Not only can hedge funds mitigate market risks and leverage returns, the fund managers get to participate in

the upside profits of the money they manage. A typical performance fee might be 20% of the profits.

This means that hedge fund managers can leverage the money of their investors to make money for themselves. In other words, if a hedge fund manager has $100 million in money under management, it's the equivalent of getting the benefit of using $20 million of his clients' money for the fund manager's benefit.

This is why the wealthiest people in the world all either invest in hedge funds and/or run their own funds. They've realized the structure of a hedge fund allows them to minimize risks, leverage assets effectively, and accelerate the rate of return.

Problem 5: Illusion of Diversity

The illusion of diversity is one of the most common problems I see that people have with how they manage their own money.

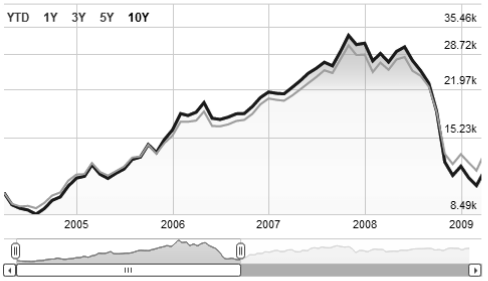
Diversity does not mean owning a dozen or so stocks or mutual funds that are correlated. Does your broker or investment advisor ever run a back-tested, historical report showing you the correlation between all the different mutual funds or stocks that you own?

I didn't think so.

That's why I did a sample for you with the charts on the following pages. They show the returns of a typical "diversified" portfolio that is very common.

Hypothetical Growth of $10,000 [3, 4]

AS OF 03/31/2014; MORNINGSTAR CATEGORY: DIVERSIFIED EMERGING MKTS



Fidelity® Emerging Markets Fund ☑ MSCI Emerging Markets (G)

☐ Diversified Emerging Mkts

4/11/2014	
Exp Ratio (Gross) 12/30/2013	1.09% ($10.90 per $1000)
Exp Ratio (Net) 12/30/2013	1.09% ($10.90 per $1000)
Redemption Fee	1.50%
Redemption Period	90 days
Minimum to Invest [5]	$2,500.00
Turnover Rate 10/31/2013	119%
Net Assets ($M) 3/31/2014	$2,144.84
12 Month Low-High 3/31/2014	$20.97 - $24.73

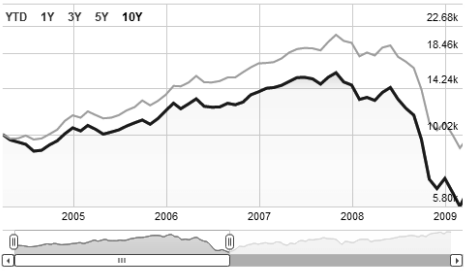
Chart Fund Price (NAV)

Top 10 Holdings [6]

AS OF 12/31/2013

Hypothetical Growth of $10,000 [3, 4]

AS OF 03/31/2014; MORNINGSTAR CATEGORY: FOREIGN LARGE GROWTH



Fidelity® International Capital Appreciation Fund ☑ MSCI AC Wld xUS (Net MA)

☐ Foreign Large Growth

Compare Chart | Fund Facts Search

The performance data featured represents past performance, which is no guarantee of future

4/11/2014	
Exp Ratio (Gross) 12/30/2013	1.17% ($11.70 per $1000)
Exp Ratio (Net) 12/30/2013	1.17% ($11.70 per $1000)
Redemption Fee	1.00%
Redemption Period	30 days
Minimum to Invest [5]	$2,500.00
Turnover Rate 10/31/2013	136%
Net Assets ($M) 3/31/2014	$990.07
12 Month Low-High 3/31/2014	$13.79 - $17.05

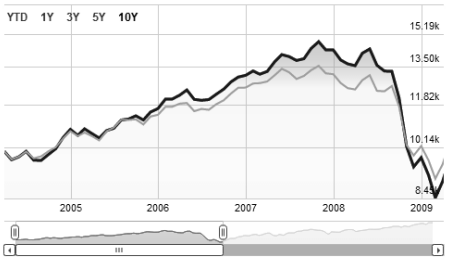
Chart Fund Price (NAV)

Top 10 Holdings [6]

AS OF 12/31/2013

Hypothetical Growth of $10,000 [3, 4]

AS OF 03/31/2014; MORNINGSTAR CATEGORY: MODERATE ALLOCATION



4/11/2014	
30-Day Yield [5] 2/28/2014	1.21%
Weighted Avg Maturity 2/28/2014	13.45 years
Duration 2/28/2014	6.97 years
Exp Ratio (Gross) 12/31/2013	1.44% ($14.40 per $1000)
Exp Ratio (Net) 12/31/2013	1.35% ($13.50 per $1000)
Load (Load waived at Fidelity)	5.75%
Minimum to Invest [6]	$3,000.00
Turnover Rate 8/31/2013	15%
Net Assets ($M) 3/31/2014	$95.77
12 Month Low-High 3/31/2014	$11.63 - $13.17

Hypothetical Growth of $10,000 [3, 4]

AS OF 03/31/2014; MORNINGSTAR CATEGORY: DIVERSIFIED EMERGING MKTS



Exp Ratio (Gross) 12/30/2013	1.09% ($10.90 per $1000)
Exp Ratio (Net) 12/30/2013	1.09% ($10.90 per $1000)
Redemption Fee	1.50%
Redemption Period	90 days
Minimum to Invest [5]	$2,500.00
Turnover Rate 10/31/2013	119%
Net Assets ($M) 3/31/2014	$2,144.84
12 Month Low-High 3/31/2014	$20.97 - $24.73

Chart Fund Price (NAV)

Top 10 Holdings [6]

AS OF 12/31/2013

What's interesting is that these charts show several different "diverse" investments, and that they all got totally crushed starting in 2008.

What's also interesting is that 2008 was a record year for some hedge fund managers. The top 25 hedge fund managers made over $11 billion in 2008. Here's a list of the top 10:

1.	James Simons	$2.5 billion
2.	John Paulson	$2.0 billion
3.	John Arnold	$1.5 billion
4.	George Soros	$1.1 billion
5.	Raymond Dalio	$780 million
6.	Bruce Kovner	$640 million
7.	David Shaw	$275 million
8.	Stanley Druckenmiller	$260 million
9.	David Harding	$250 million
10.	Alan Howard	$250 million

The reasons these guys make money year after year isn't because they have crystal balls and can see into the future. It's because they have high-level investment and trading strategies that will make money, while protecting their money, not matter what happens in the future.

Their funds are portfolios of non-correlated, positive expectancy strategies.

From now on I want you to forget you ever heard the word "diversity." You can have diversity and still be very highly correlated.

Instead, from now on, think in terms of having your assets allocated between different strategies that produce non-correlated, positive expectancy, results.

What?

You mean your investment advisor never told you this is how hedge funds make money? Your stock broker never say down with you and explained how to create a long-short portfolio to totally take the market out of play?

That's because they get paid a lot of money in commissions when you buy mutual funds. In my experience, I've never met a stock broker who recommended shorting a stock.

Why?

Because eventually no matter how many stocks you own, it's hard to convince you to buy a mutual fund that's long-only while you're telling a client to short stocks.

This leads to the next step almost everybody who's become successful has taken after they realize they have a problem.

They seek advice from experts to help them solve their problem.

Step 2:
Seek Advice From Experts?

Hmmm…. this is interesting.

We learned in the previous chapter that those who position themselves as experts in the investing world ARE the reason you have a problem.

In the real world, if you have a problem you go to people who can fix the problem. If you have a medical problem you go to a doctor who spent 8 years in college and 3 years doing a residency at a hospital, then spent 20 years healing patients.

You have confidence a doctor knows what he or she is doing because they have education, experience, and have helped thousands of people fix their problems.

If you go to an investment advisor or stock broker, you're going to somebody who had to pass a government issued test to become licensed. There is not one question on those tests about how to make money, or how to create non-correlated, positive expectancy portfolios.

And if you're using an investment advisor who advised his or her clients in 2008 hold funds that lost 65% that year, then you know the investment "experts" that you at one point thought might be useful don't know any more than you do about protecting and making money.

Think back to the beginning of 2008. Do you remember how all the talking heads on CNBC, and the experts they interviewed all day long were warning you about the upcoming financial collapse that was about to happen?

Of course you don't remember this because it never happened.

In 2008 I was in meetings with some high-level people and learned about how there were trillions in worthless collateralized debt securities on the books of major investment banks and how the market was likely going to get crushed at some point.

I asked my investment advisor friend if he knew anything about it and he had never heard of a CDS, or why I cared. All he kept talking about was what the interest rates were going to do, and how it would be great for the markets.

Just step into what I call your "common sense corner" for 30 seconds.

Did you ever have an investment advisor or stock broker tell you that it was a bad time to be holding your long-only mutual funds?

Question deuce, have there ever been bad times to be holding mutual funds where you lost tons of money?

Obviously, no strategy works in every type of market. A buy and hold strategy gets crushed in a bear market. Your investment advisor will tell you not to worry, the market comes back.

But when?

It's 2014 as I'm writing this and the NASDAQ Composite Index is still lower than in was in the year 2000.

There have been several decades where the U.S. stock market was down. The market was lower in 1941 than it was in 1917.

Japan's Nikkei 225 Index is trading at 16,880 today in 2014. In 1987 it was trading at 38,916. It's still down over 56% over 27 years later!

But wait… that couldn't happen in the United States, right? Japan's market was over-valued because of the crazy real estate prices and government subsidizing the markets with cheap money…

Oh. Nevermnind.

I hope you get my point.

If you do, you've made it through the first two steps to be well on your way to becoming a successfully independent investor.

First, you realize you have a problem that you need to solve when it comes to your investments. You did the smart thing and sought out advice of experts.

That leads to the next step… you realized you can do better than "experts" who have no track record of success, and who have a proven track record of recommending clients do things that lead to 50% losses (or more) of their investments.

Step 3:
I Can Do This Better Than The "Experts"

In 1914 my great-grandfather, Charles Henry Allen, started a manufacturing business in Pittsburgh, Pennsylvania. Just 18 years earlier Henry Ford created the first prototype of the modern car. Pittsburgh is about an hour south of Oil City, PA. Oil City is where oil was first discovered in the United States.

My great-grandfather made gauges that oil companies used to measure the threads in oil pipes. He was in the right place at the right time, and did the right things to turn his experience and skills as a watch maker into a lucrative business.

In 1984, exactly 70 years after my great-grandfather started our family business I graduated from Carnegie-Mellon University with degrees in Electrical and Biomedical Engineering. I worked as a software engineer for the U.S. Navy and Department of Energy for 3 years before I started working in our family business in 1987. I was the first in the fourth generation of family members to go into the business.

By the time I started working in my family business my grandfather was the President. In 1987, at the age of 73, my grandfather was worth millions of dollars. He was the prototypical millionaire next door. He didn't live a lavish lifestyle. He grew up during the Depression. He was frugal. He saved money. He was a businessman. He also

knew nothing about investing. He trusted a stock broker to help him with his investment decisions.

My father, who managed the business for 40 years, was very much like my grandfather. He was an accountant by trade, and he dabbled in investments. He bought Walmart stock and Apple stock when they stocks went public. That was the good news. The bad news? He sold them a few weeks later, very happy to make a few dollars a share in profit. His total net worth in 1987 was about $400,000. Almost all of that net worth was invested in his company retirement account.

By the time you finish this report, you're going to see how I was able to make my father over $720,000 in one-quarter. When I started working for the family business the total investments held by the company were only $400,000. In one year I more than doubled that, doing exactly what you're about to learn in this report.

When I started working for our family business I helped my father run the company. The manufacturing part of the business ran on auto-pilot. We had systems in place for everything. The systems had been created before I was even born.

What we didn't have was any experience in what to do with the money the company was generating. Our family knew how to manage our own business. We knew nothing about the financial markets or investing.

One of the first problems I began helping my father with was the estate planning for my grandparents. They didn't realize until their accountant told them that they had a major problem. Their estate was worth millions of dollars. A large part of their estate was the value of the company. If

they would have died in 1987 the family would have had to sell the company just to pay the inheritance tax.

Not good.

Our stock broker and accountants came up with a solution. It was something called a "vanishing premium" life insurance policy. The plan was to set up a trust to buy a life insurance policy that would pay out enough money to pay the estate taxes when my grandparents died.

We paid a huge insurance premium for several years. We were told the premium would "vanish" when we bought the policy. That was a lie. The insurance company sold these policies based on inflated projections for the investments held by the policy. Instead of the premiums vanishing, we received a notice from the insurance company that we would be required to pay the premiums indefinitely.

Helping my father deal with this problem was one of the first things I did at our company. Luckily, my father kept every scrap of paper that ever crossed his desk. He found a letter from the stock broker who sold us the policy that guaranteed the premiums would stop after 8 years. I was able to drive to Toronto and meet with the CFO of the insurance company, Manulife Financial. We negotiated a settlement that was worth several million dollars.

That was my first experience dealing with anything in the investment world. It was then that I learned that the stock broker who sold us the policy made 8% commission on the sale. That's $80,000 income for every million dollars invested. No wonder he lied about the terms of the contract.

I also learned how cut throat people could be in the investment world. Manulife's CFO at the time was a

woman in her 50's. She was brutally unaccommodating until I showed her the letter from the stock broker promising the premiums would vanish. She just read the letter, said, "Shit…" almost under her breath, and then asked how much money I wanted.

Next I had to deal with the stock broker and his brokerage company, Paine Webber.

We met at our company office with the broker and the Senior Vice-President of the Pittsburgh office. We had him dead to rights. The broker didn't care. He showed no remorse and didn't apologize. Once we discovered he lied about the insurance policy, I started looking into other things he did. I found at least a half-dozen unethical and misleading things he did to people in our family and in our company. The Senior VP met with my father and me at our office and just asked how much money we wanted. He wasn't the least bit upset. He said Paine-Webber had a special account just to pay people who got screwed over. The broker told us it was a numbers game. As long as he made more commissions than the company had to pay out, everybody was happy.

I asked him about all the people he screwed over who didn't figure out they were being screwed over. He didn't care. He said that was their problem.

That's when I thought about my grandparents, and how they devoted their entire lives around the family business. My grandmother was the kindest person in the world. The broker had no problem ripping her off. My grandfather was the most dedicated, hard-working person I had ever met. He spent his life on the business. The broker had no problem ripping him off.

By this time we hired a new stock broker. The new broker was a nice guy from a smaller firm. He spent hours with us going over past performance reports of mutual fund companies. I'm an engineer. I designed software systems for the U.S. Navy's nuclear fleet. I asked him what I thought was an obvious question. He looked at me like I was from outer space.

"Is there a correlation between past performance and future results?"

He didn't know what to say, so he just stammered along for about 3 minutes talking about fund managers, the quality of one company compared to another company, and how stocks had a long-term return of 10% a year.

That's when I had my first "aha" moment.

These stock brokers don't know any more about what's going to happen with investments than I did. It wasn't like knowing all the statistics and financial data made any difference at all.

The ultimate truth is that past performance of mutual funds has nothing to do with future investment results.

That's when I realized I could do at least as well as my stock broker and investment advisors. I couldn't do much worse.

That leads to the next step everybody who's ever succeeded in the investment world must take once they realize they can do better than the so-called "experts."

I began to create a plan for researching my own investment ideas. The first thing I realized was that the best

investment I could make was investing in my own education.

I decided I would open my own brokerage account and learn how to make money trading and actively investing in the markets.

Step 4:

Research and Education

The next day I opened up an E*Trade account.

I was lucky in many ways. I grew up when home computers were invented. When I was in college I was helping my father keep track of his stocks using a model and one of the original Apple II computers. We had one of the first E*Trade accounts before anybody even heard of the internet. The interface was white ASCII text on a black background. The screen updated the stock portfolio daily. It became like a game watching the daily balance go up and down.

At the time my father's total account was around $50,000. He owned about 12 stocks.



By time I opened up my own E*Trade account technology had changed considerably. Everything was done through the internet. Trades could be made in a matter of seconds. There was no need for a stock broker or investment advisor.

This also came with risks.

Because it was so easy to buy and sell mutual funds, stocks, and options, it was also easy to lose money very quickly. Lots of money.

Before I became proactively involved in my own investments, my biggest sin was not looking at my investment statements. I would just through them in a drawer. Every time the market would go down I remembered back to when I was in Las Vegas with my father in October 1987. We were staying at Caesar's Palace. I remember the look on my father's face that night. He looked sick, like he was literally going to throw up. That was October 19. The U.S. stock market dropped 25% that day. My father lost a ton of money.

He didn't try to convince himself it was ok to lose so much money because it was only on paper, or that he was in it for the long-term.

He was sick because he knew that he had lost over 25% of the money that was in his account when we left for Las Vegas on the previous Friday.

I didn't realize it at the time, but that was my first real education when it came to learning how to make money in the stock market. The first lesson is don't act foolishly or allow your money to be at unnecessary risk.

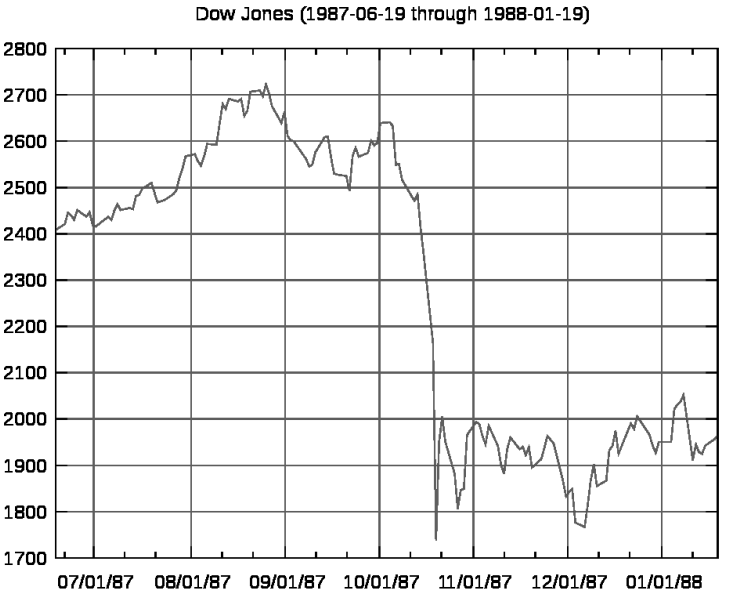


The Philadelphia Inquirer

Dow Dives 508.32 Points In Panic on Wall Street

Navy blasts Iran oil site in retaliation

Billions lost in trading



If you don't want to lose 25% to 50% of your money then don't be invested in long-only mutual funds or hold a long-only portfolio of stocks.

The common thought is that two emotions drive the markets – fear and greed.

Did you ever stop to think about how the entire financial media industry ignores these two emotions when it comes to telling people to buy and hold forever?

A buy-and-hold portfolio is the epitome of a fear/greed portfolio. You can never go into cash because the media has conditioned you to fear missing the next up move after the bear market. And the only reason you're in the buy-and-hold positions in the first place is because the media tells you that the U.S. stock markets have averaged a 10% return over the last 100 years. They tell you that at a 10% ROI you'll double your money every seven years.

Maybe an investment advisor will get out a little calendar or chart, usually with a calculator, and tell you that at your current portfolio value you will have $243,432 by the time you're 72. He'll then get a concerned look on his face and tell you that you better "save" more money by putting cash into mutual funds. Here's a news flash: buying equities that trade on the open market, and that have a history of dropping 25% in a day, is not "saving" money.

The greed is thinking that all you need to do is mindlessly throw investment darts at the U.S. equity markets and you will lazily receive 10% more money at the end of every year just because you are you and you're entitled to it for living in this amazing world of free money.

Sigh.

It really doesn't work that way. I wish it were that easy to double your money every seven years.

This is where investing in your own education makes all the difference in the world. At some point every successful investor realized that all the "information" they're given by the financial media is a mixture of actual facts and marketing propaganda designed to get you to buy mutual funds so the financial institutions can get rich.

This is when people who are serious about their financial future always make a choice. Like my friend, the legendary Van Tharp likes to say, they choose between the red pill and the blue pill. The reference is from the movie, *The Matrix*:

"This is your last chance. After this, there is no turning back. You take the blue pill - the story ends, you wake up in your bed and believe whatever you want to believe. You take the red pill - you stay in Wonderland and I show you how deep the rabbit-hole goes. "

When it comes to investments and taking control of your own finances, this is your last chance.

You either educate yourself so you can know the difference between what's real and what's nonsense when it comes to making money, or you take the blue pill and go back to investing in buy-and-hold mutual fund portfolio, hoping that we don't see a 75%, twenty-five year bear market like what's happened in Japan.



This leads to the next step

You have two choices.

You can carelessly disregard the real risks in the market and accept you're going to lose 50% of your money at some point.

Or you can do what the smartest, and wealthiest people in the world do. You can create a strategic plan that anticipates the fact that the markets will change, and that makes money no matter what happens in the markets.

It's beyond the scope of this book to cover all the technology, all the ideas, and all the software that's available right now, much of it free or very low cost, that you can use to do research.

Just know that what used to be available only to large, multi-million dollar trading operations at an exorbitant cost is now available to be downloaded to your laptop in the next 15 minutes. All the tools that were once custom

designed and hidden away on Wall St. are on every trader's laptop. Many are even web based.

Nothing in the world has become easier for traders and active investors than doing the research. What used to be difficult is now very simple.

You still must have ideas, and a basic understanding of how to use the testing platforms. And most importantly, you need to have common sense and understand basic mathematical and statistical principles.

Seeing pretty green and red arrows on charts telling you where a strategy got you into and out of trades means zero if there is no solid principle backing it. And know that many system vendors will create pretty charts that look like the next Holy Grail trading system. But what you don't see is how they curve fit their systems to make the pretty charts.

Here's the example I like to use to demonstrate this.

Suppose somebody dropped a quarter from an airplane. You see the quarter land in a parking lot. You run over and draw use a piece of chalk to draw a circle around the quarter. You then say, "Look, the quarter is exactly inside the circle! Isn't that amazing!"

Not.

That's what's called "curve fitting," and it's very common among people trying to sell their latest and greatest trading systems. Unfortunately, it's also very common among amateur traders who are working on their "Holy Grail" trading systems. They do things like over-optimize variables, like moving averages for example, until their trading systems look like they make money.

The only problem with this is the systems have been "curve fit" to make all the right trades on the left side of the chart. Anybody can program a system that back-tests well if they curve-fit the variables.

The principle to keep in mind is that the less variables you have in a trading strategy, the more likely it will continue to work in the future the way it's worked in the past. The number of variables is called "degrees of freedom" The less degrees of freedom the better because each degree of freedom is another opportunity for the system to break.

In other words, if you create a nice algorithm that trades the left side of the chart to perfection, but uses 27 variables, all perfectly balances to achieve some miraculously looking result, you probably have nothing.

Even 3 or 4 variables becomes sketchy.

Also keep in mind that the validity of your testing only statistically applies to the same time sample period that you have run your tests. For example, if buy-and-hold enthusiasts claim the U.S. stock market has averaged 10% return over the last 100 years, the sample period is 100 years. For this to have any statistical significance, you'd have to apply the result over the next 100 years into the future. In other words, your test has one sample period of 100 years, and you could project that you might expect similar results over the next 100 year period.

Of course it's completely idiotic to extrapolate any meaning from one single, unique sample set. That would be like flipping a coin and having it come up heads, then concluding that the coin has a 100% chance of coming up heads on the next flip.

Conversely, if you flip a coin for 100 years it would probably turn out that heads and tails came up equally. You could then extrapolate that if you flipped the coin for another 100 years, with all things being equal, there would be a good chance the coin would come up half heads and half tails at the end of the next 100 year period.

The coin only has one variable – heads or tails.

The markets have a virtually infinite number of interrelated variables. The global economies and technologies, the political climate, wars, famines, droughts, and any number of variables affect the markets. To claim that you can look at the last 100 years of the market and extrapolate what's going to happen in the next 100 years, next 10 years, or even next 12 months is dumb.

What happened in 1939 has zero bearing on what's happening next week or next year. And there's probably a good chance that what happened 6 months ago isn't going to affect what happens next week either.

The general principle that has proven to have statistical, and real world validity is that prices tend to be slightly self-correlated. Of course don't take my word for it. That's why you need to do the research and testing yourself.

Just make sure your research and testing are based on 1) sound real world principles of cause and effect, and 2) sound mathematical and statistical principles. This is not an area to take lightly, or to skimp on. If you never have taken a course in statistics take one online at Khan Academy. Take a course at a community college.

Unless you understand how to statistically validate your trading ideas, you might as well not go any further.

This doesn't necessarily mean you need software, although with all the software available today it would be really dumb not to use it.

If you're purely a discretionary trader, just make about 200 trades and then start looking at your results. Measure and quantify your own abilities by looking at your real trading results. Measure a few simple key performance indicators:

1) Number of trades
2) Total wins
3) Total losses
4) Money you made on wins
5) Money you lost on losses
6) Biggest drawdown
7) Time between peaks in your equity curve.
8) Time between drawdowns in your equity curve.

That's should be enough to get you started. To begin with, try to at minimum turn all your results, or potential results, into a simple binomial probability function, like a coin flip. If you can know what percentage of trades you win, and how much you expect to win when you win, and lose when you lose, you'll be ahead of 99.98% of all the traders and active investors in the world.

Step 5:

You Must Have A System That Makes Money No Matter What Happens In The Market

We can thank Alfred Winslow Jones for being the first person to come up with this idea. My guess is that he wasn't the first person to think of this, just like Columbus didn't discover America. When we were in Iceland at our first Destiny Partnership mastermind event, we saw a huge statue outside the main church in Reykjavik, with the inscription, "Leif Ericson, discoverer or America."

So like Columbus, Alfred Winslow Jones gets all the credit for "discovering" the most simple and effective idea that spawned the entire multi-trillion dollar hedge fund industry.

The idea is simple. Instead of holding a portfolio of stocks that are going to get crushed when the market gets crushed, you hold a portfolio that's ½ long the stocks you think are good, and ½ short the stock you think are bad.

This takes the market totally out of the equation and turns the game into one about picking companies, not worrying or predicting what's going to happen in the market.

What this does is create a portfolio of non-correlated assets, each with a positive expectancy. In simple terms, this means who consistently make money no matter what's going on in the market because your long positions will do

good when the market goes up, and your short positions will do well when the market goes down.

The net return you generate will be based on how well you pick stocks. What this also means is that you will minimize your losses. Instead of getting hit with 50% drawdowns if the market crashes, since you have a long-short portfolio, you'll have losses under 10% if you do a good job at picking the stocks for your portfolio.

So instead of having a Reward/Risk ratio of 10% average return with 50% expected risk like the U.S. stock market, you reverse it. You might have an expected return of 15% a year with a risk of only a 5% drawdown.

Instead of the risk reward being 5:1 against you, it's flipped to be 3:1 in your favor.

Here's why this is huge, and why hedge funds make billions of dollars.

Suppose you had a portfolio where you expected gain is only 12% a year, and your expected loss is 3%. Now think what happens if you borrow money to invest in this portfolio.

If you borrow an equal amount of money at 4% interest as you already have invested, your return is now 20% and your risk is only 6%. If you borrow that 3:1 your return is 32% and your risk is 9%.

This is why your entire goal should be to create an investment strategy that has a positive expectancy, with a 2:1 or 3:1 expected reward for every unit of risk.

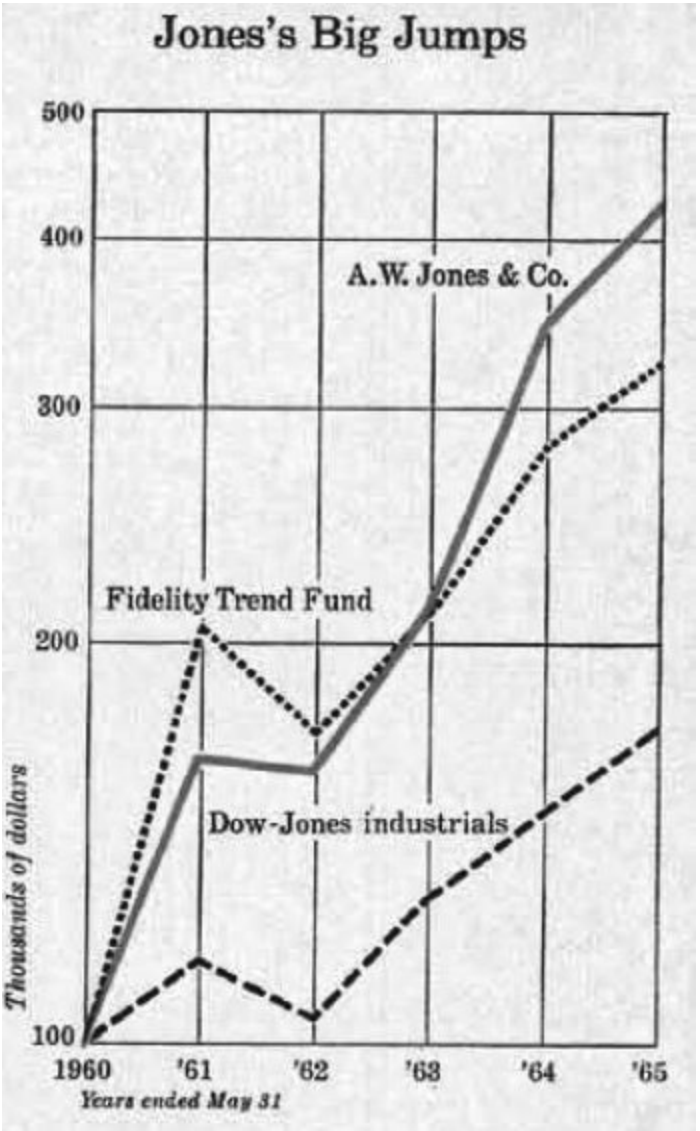
Simply diversifying between mutual funds or stocks doesn't do this for you. This is why you must have non-correlated strategies, each with a positive expectancy.

Alfred Jones did quite well using this strategy. So did Warren Buffet and George Soros. In fact, over a 5 year period Jones beat the best performing mutual fund by 44$. Over a 10-year period Jones' fund beat the top performing Dreyfus Fund by 87%. And that's with his 20% annual performance fee.

This business model and investing strategy is sound, both in theory and in the proven results. This strategy for investing IS the Holy Grail of investing or trading.

That leads to the next problem that every successful investor has overcome.

If you're bad at picking stocks, then this strategy is useless. What you need to do next is find an edge.


Jones's Big Jumps
500
400
300
200
100
A.W. Jones & Co.
Fidelity Trend Fund
Dow-Jones industrials
Thousands of dollars
1960
'61
'62
'63
'64
'65
Years ended May 31

Step 6:
Find Your Edge

Let's review the big picture before we talk about how to find a trading or investing edge.

The goal is to protect your money and grow it. It's a simple goal. What makes it complicated is the brainwashing of the financial media that has perpetuated the myth that to get better returns, you must take on bigger risks.

That's demonstrably false.

The way to get better returns is to lower your risk. I guess if your investment universe consisted of simply buying and holding stocks or mutual funds, then yes, you will need to take on more potential losses in order to get bigger gains. If you're deciding how much money to allocate between a stock portfolio and money under your mattress, then yes, you'll want to keep more money safely under your mattress in order to reduce your risks.

But think about the presupposition with this entire premise. If you compare putting money under your mattress and investing money in the stock market, the presupposition is that the money in the market will somehow magically grow on autopilot. The money under your mattress will be the same tomorrow, assuming nobody breaks in your house and steals it. So the growth in the safe money under your bed is 0%. That's low risk.

Say you put ½ of your money in the stock market. That's money in the "high" risk bucket. The theory is that having only ½ of your money in the market and the other ½ safely under your bed gives you less risk and less reward.

But that only works if the market goes up. Remember, there are two types of investment objectives – monetary return (money in your bank) and investment return, measured by ROI. If the market happens to go down, the money under your bed was the safe investment, AND it was the investment that turned out to be greater at the end of the year. We don't care so much about growth as we do money in the bank. $50,000 in the bank is always better than $25,000 in the bank. It doesn't matter how it got there, or how much you started with. $50,000 is always better than $25,000.

Now let's keep going with this example. If your market investment dropped 50% down to $25,000, then you're going to need a 100% return on that money just to get back to having the same amount of money in the market as you do under your bed. How long will that take? How long will it take to double your money in the markets after the predictable 50% loss?

There's a reason people are willing to needlessly lose 50% of their money in the market. It's is because they want more money in their bank accounts. They would rather spin the wheel and hope for big winners because an 8% ROI on $100,000 only gives them $8000 more in their bank account. That doesn't' help much when you want to buy a new $74,000 car. A 74% ROI on a $100,000 account will get you the money to buy the car PLUS leave you with your initial $100,000 capital.

Of course, we want to use money to make more money. We don't want to keep trading hours for money our entire lives. That's eventually a losing proposition. You can only trade so many hours for money until you run out of hours. What we want to do is turn the money we have now into an asset that puts more money into our bank accounts

systematically. That's one of the biggest benefits of owning your own business rather than just being self-employed. If you own a business that systematically puts money into your bank account, and you don't have to be there for the money to keep going into the account, you have a positive expectancy system. If we can find a way to do that consistently, we have what is known as an "edge."

Casinos have edges. Every slot machine, roulette wheel, crap table and poker machine have an edge. Players put money on the tables or into the machines. The game is played. The casinos keep more money than they pay back to the players.

This is what you need to create with your investment strategies. You must have systematic and quantifiable edges that have a high probability of putting more money into your bank account that you spend on investments.

Yes, I used the term "spend" because it's a useful way to look at the money that you take out of your pocket to buy a security. You spend the money to own a security. Your desire is that somebody will come along and pay your more money for the security that you now own than the amount of money you just spent.

The amount of money you spent is your risk. If you have the ability and liquidity to sell your security at a pre-determined lower price than you bought it, then that's your risk.

You have an edge when you can systematically buy securities with a known and manageable cost, or risk, and consistently sell them for more than you paid for them.

If you don't have this ability, or if you don't know what your edge is, then it means you don't have an edge. You're

like the player in a casino who thinks that since red came up 8 times in a row on the roulette wheel, he has a better chance to make money by betting on black.

Not having an edge means you're consistently giving away your money to the players in the market who DO have an edge. Just like card counters at the blackjack tables, players in the markets who know their edge increase their bet sizes when the odds are in their favor. If you don't know your edge, you don't have an edge, and you have no idea how to manage your risk. Worse, if you think you have an edge, and you haven't quantified it, you're going to not only lose money, you're going to be stressed out while you're losing your money. This is the same money that you traded hours of your life to earn.

Do you really want to piss it away because some guy on television told you he believes you should, or your investment advisor who makes less money than you tells you she thinks the market looks good for next year?

Seriously?

Now is the moment successful investors and active traders, people who decide they are going to get out of the mindless world of investing myths, put on their big boy and big girl pants and make money. You have a chance, just like everybody else who has an edge, to find an edge and run your edge day and night.

It's not that hard finding an edge once you know how, and once you know one key distinction. The way to do find an edge is simple, but not necessarily easy. You just start with an idea and quantitatively and accurately test your idea. This means you have to know a little math so you don't do something stupid like believe 8 blacks in a row on a

roulette wheel mean that red is more likely to come up. That's ridiculous and childlike. You need to understand concepts called self-correlation, and independent results. These are simple concepts. If you have a math phobia get over it.

In fact, now would be a great time to look at the five major steps you need to take to become a successful trader or active investor. I call these the 5 Steps to Becoming A Super Trader.

Step One : Treat Trading Like A Business

How do you treat trading like a business? Simple. You do the following.

- You know how you're going to make money.
- You manage your expenses.
- You stop making stupid, random decisions.
- You have key performance indicators that you measure.

Step Two: Find Your Edge

The second step to becoming a Super Trader, aka a consistently successful active investor who manages to make a lot more money than you risk, is having an edge.

This is NOT difficult, even though people seem to make it difficult. The key distinction is that no trading edge works in every type of market. We'll cover that more in Step 4. Just know that this is doable, and it takes time, research, and thorough, intelligent quantification of your ideas.

The best part is they don't even have to be your ideas. The internet is filled with hundreds, if not thousands, of trading edges that work –just not in all markets at all times. Once

you have a systematic way to evaluate if an edge is valid, and when it will work, you have a core way to make money in your trading "business."

Step Three: Manage Your Risk

The next step is you must totally own the concept of how to manage your risk, and how much to risk each and every time you buy a security, or short a security.

Understand risk, and how much to buy or sell, is predicated on having an edge. You can't know how much until you understand your own edge.

For example, suppose we had a coin flip game where heads comes up 60% of the time, and tails only 40% of the time. Each result is independent of the previous flip, and you get paid even money if you win your bet.

Now suppose I gave you $100 to bet, and told you that you could bet any amount you want, from 1 penny to your entire account, on each flip of the coin.

How much would you bet?

This question stumps everybody, including guys I'm friends with who fancy themselves as hedge fund managers. They often have a deer in the headlights look on their faces.

Truth is they have no idea how much to bet on each flip. Eventually they mumble something like, "It depends…"

Of course it depends. How much you risk is entirely dependent on your financial objectives. If your goal is to make $100 so you can go out to dinner in 5 minutes, you would bet $100 on the first flip.

If your goal was to save to have enough money to pay for your kids' college tuition, and your kids are 2 and 3 years old, you would never bet $100 on one flip of a coin. You'd bet much less.

If you were industrious you would get out a spreadsheet and actually run some projected numbers. You'd figure out that with a 60/40 edge, an even money bet, and 1000 flips of a coin over the next 16 years, you could bet 0.3% of your account and likely have enough money to send your kids to Harvard.

Now think about your buy and hold portfolio and the advice your investment advisor gave you about time in the market vs. timing the market.

It's stupid to count on 10% returns over the next 10 years if you have actual real world goals, which if you're reading this right now you do. Your investment advisor's life isn't going to be affected if you don't have enough money to pay for your kids' college in 16 years. Your investment advisor's life will be affected greatly if he or she doesn't make the commissions this month on selling you whatever he or she wants to sell you.

You need to totally own this area of your financial life. And when I say "this area" I mean understand the math behind risk and rewards.

Step Four: Combine Strategies

Combining strategies is simple –once you have at least strategies that are based on a quantifiable edge. The idea is you want strategies with a positive expectancy that have non-correlated, or inversely correlated results.

Why is this important?

Because if you have two strategies with an expected 10% annual return and 5% max drawdown, and if there drawdowns are 100% inversely correlated, then your overall portfolio will have an expected 10% return with an expected 0% drawdown.

This is how you get a large return not just *while* reducing risk, but *by* reducing your risk.

When I started my first hedge fund I only traded two non-correlated strategies. One strategy was applied to U.S. securities, and another to Asian and European securities. The strategies were design from the start to have little correlation between them because they were each based on different underlying ideas about how to make money. They each had a different edge, and their edges were not correlated.

I made millions of dollars for myself, my family, my friends, and my clients with just two edges. More importantly, I protected my assets by having edges that were not correlated, meaning when one strategy had a drawdown, the other strategy was typically making money.

You can do this too. In fact, if you're reading this now you have no excuse not to. You investment goal should be to create non-correlated, positive expectancy strategies and combine them in an overall portfolio, not just seeing what stock or fund might give you the best return. That's a foolish, amateurish way to invest. That's how mutual fund companies advertise and appeal to the masses of "low information" investors.

You don't want to be a "low information" investor. Worse, you don't want to be a "false information" investor. That's worse than a low information investor. In fact, if you only

traded on very limited information and excluded making any decisions based on beliefs or false information, you'd be ahead of 99.9995% of all traders and active investors.

Step Five: Psychology

Everybody talks about emotions and psychology, but usually only superficially. Even the financial media talks about fear and greed. Usually they talk about fear when the market is crashing by telling us how we should be smart and buy stocks and funds instead of selling them like all the scaredy cats who are panicking.

They rarely talk about greed in terms of convincing you that it's wrong, or a mistake to be greedy.

See the problem with that?

The reason the financial media and your neighborhood investment advisor don't tell you it's bad to make decisions based on greed is because that's how they get paid. If they mentioned risk management, and showed you how your real estate holdings were actually already very much correlated to your investment portfolio, they'd never be able to sell you any of their mutual funds.

To reach the next level of success, and leave behind the false premises of the retail investing and trading world, you're going to need an "aha" shift in your psychology. All your psychology really is when it comes to investing is a collection of your beliefs along with your emotional conditioning.

Everything we've discussed so far has all been related to the psychology of investing and trading. It's really simple.

You have to take on the psychology of a casino owner. You must own games that are quantifiably likely to pay you money just for playing the game. Just like a casino owner, you know you're going to have winning and losing bets.

But if you own a game that will pay you more money the more you play it, how dumb would it be not to play it as often as possible? How stupid would it be for a casino owner to ever jump across the table and decide to bet on a number on his own roulette wheel?

As a trader or active investor, this is the only psychology you need to master. You must own winning games, and you must play them every time.

My friend, Van Tharp, is one of the top experts in the area of trading psychology. He calls this trading efficiency. Trading efficiency is simply the percent of the time you follow your own trading plan. If you have a sound plan to make money, there's no reason not to follow the plan 100% of the time.

When I started trading my own accounts, and started running my hedge funds, it was a given that I would trade my plan 100% of the time. That's my business. That's what I told investors. I gave them my exact plan, and how I used that plan to make money. To not follow the plan would not just be stupid, it would be really stupid. This is why we start with treating your own trading and investing like a business.

Have a proven plan on how you're going to make money, then simply follow your plan.

This leads to the next problem, and the solution.

Now how do you scale up?

There's a huge difference between being a Super Trader and becoming super wealthy.

Let's go back to the example of you having $100,000 in a trading or investment account. You are a real person with real financial desires. The only reason to have money is to spend it or invest it on something else. If you want money just for the sake of having money, then you're probably going to lose interest and quit.

In the real world you might want $50,000 to buy a new car. That means you need a 50% return on your $100,000 investment account.

If you figured out a way to consistently make 12% a year with 2% drawdown, you'd have a world-class trading strategy. That's a 6:1 ratio of reward to risk. Compare that to the stock market's 1:5 ratio in the wrong direction.

Problem is your 12% annual return strategy with 2% drawdown is only going to make you $12,000 a year. That's less the one fourth what you need to buy your $50,000 car.

What most people, meaning most amateurs do, is look for bigger returns. They look for ways to make 50% on their money, and don't consider the reality of the math. They might put 10% stops in on a buy-and-hold portfolio using William O'Neal's famous CANSLIM strategy. That's great in a non-volatile, bull market. In a volatile market, even if it's a bull market, you're going to get stopped out of every position, every time.

You might even do what my one friend did and "average down" your cost basis in losing trades, hoping that if the price just goes back up to some fantasy number you think it must hit, then you'll make money.

If I had pink unicorns pooping diamonds in my back yard I'd make money too.

It's probably not going to happen.

Worse, if you do get lucky and double down and the price actually comes back and you make money, you've just conditioned yourself for failure. You've associated pleasure with a strategy that's guaranteed to make you lose all your money.

It's the equivalent of the little old ladies sitting in front of slot machine all day because they bet 25 cents and they hit "winners" all day long for 15 cents. The bells and whistles go off, and it shows YOU WON 15 CREDITS on the screen. Of course that's after you bet 25 credits.

Averaging down is the same thing. Even when you win, you lose. The worse is when the price comes back, but only to about 90% of your average price. Then you exit the trade and feel good about only losing 10%. Now you're exactly like the little old ladies and men playing the slot machines all day.

You're conditioned to feel good about losing money. Instead, you need to feel good about making the right trades, and executing your positive expectancy plan.

But here's the problem.

Your financial result of making $12,000 a year isn't exciting, even though a 12% ROI with 2% drawdown is an incredible trading result.

Here's the answer.

You scale up your financial results, the actual money in your bank, not by increasing your risk, but by implementing the single most powerful risk/reward strategy ever devised.

We'll cover that in the next chapter.

For now, just know that you must have a quantifiable edge that's based on real world cause and effect relationships. Once you have this you've found your way to make money.

Step 7:
Scale Your Edge And Make Millions Of Dollars

By now you've gone through the entire transformation of being an erratic, retail trader or active investor, to being able to produce world-class results. You realize it's not your absolute returns that matter. It's having a systematic way to consistently make money while making protecting your money the top priority.

But you still have a major problem to overcome.

Your financial result of making $12,000 a year isn't exciting, even though a 12% ROI with 2% drawdown is an incredible trading result.

Here's the answer.

You scale up your financial results, the actual money in your bank, not by increasing your risk, but by implementing the single most powerful risk/reward strategy ever devised.

We'll cover that in the next chapter.

You scale up by trading other people's money, and getting paid a percent of the profits you generate, while having zero downside risk on the money you're trading for your clients.

Let's look how this works with the same example.

Suppose you're trading your own $100,000 account, and you generate a 12% return with 2% drawdown. That puts $12,000 in your bank at the end of the year.

Now suppose you have some friends or family members who would love to have a 12% return on the money they have sitting in the bank getting 1%. So you tell them you'll trade your same strategy for them. You created the strategy, and you'll implement it for them. All you want is a measly 20% of the profits you make for them.

There are limitless examples of business partnerships where the investor and the implementer split the money at rates more like 50/50. The implementer does all the work. In this case, the implementer also has the idea and the strategy how to make money for the investor.

The implementer (you) will keep only 20% of the money you make for the investor. The investor keeps 80%. Add in another 1% of the total money you're trading to cover your administrative fees, and the results are staggering.

Suppose you traded just $1 million of outside investors' money. This can be your friends and family members who you truly can help.

You would get paid 1% of that $1 million, or $10,000 a year just for your administrative fees. This means just on the administrative fees alone, you've nearly doubled your financial reward, i.e., money in your bank account, from your trading. Remember, the example is that you make 12% on your $100,000 account. This means you would have made $12,000 from trading your own money. Even without the performance fee, you make $10,000 from the admin fee for trading other people's money.

Your income is now $22,000 instead of $12,000. You've just increased your income by 66% without increasing your investment returns, or by taking on more risk.

Now let's look at the performance fee. If you make 12% return on $1 million that means you generated $120,000 in trading profits for your investors. You get 20% of that for your performance fee.

This means your performance fee for the same 12% return applied to other people's money is $24,000. This brings your total income from trading your exact same strategy up to $46,000. That's almost a 5x increase in income using the exact same strategy you were using with your own money.

This means you've increase your financial results by nearly 500% without increasing your risk even by $1.

Keep in mind raising $1 million to trade is very easy. If you're not sure how you're going to do that, or if you have the right psychology to do that, don't worry. Everybody goes through that same process. It's just a simple process. You tell people how you're trading, tell them what it's done for you, and then offer to do the same for them.

If you're producing solid results with a solid methodology, you'll quickly have people wanting you to trade a portion of their money.

Remember, they have investment advisors and stock brokers who suck too. They're probably not doing well with their buy-and-hold positions, and they figure they might as well give you a shot because you can't do any worse than losing 74% like they just did on an IPO their broker got them in on.

What's super cool about this is when you look at the big picture, all the steps you've taken to get to this point in your trading/investing evolution.

Remember step 1 that everybody goes through? Facing the reality that there's a problem? Then step 2, looking for experts to help solve the problem?

If you've followed the steps, figured out an edge, learned to manage risk to meet your trading objectives, and created a non-correlated portfolio of strategies, then YOU ARE THE EXPERT!

Get this!

You know more about how to protect somebody's money, and make money for them, than 99.99999% of all the registered investment advisors and stock brokers in the world.

It would be doing your friends and family a disservice NOT to help them if you have the skills and ability to do so. If they're taking the advice of investment "experts" who rely on superstition and false premises they are not only losing money in the markets, they're paying the false experts for the privilege of taking their bad advice.

This is what business is all about. There is a huge need, and a huge demand for people who can help other people protect and grow their money.

This is why hedge fund managers make so much money. They don't have some secret business model. They use the same business model I just showed you.

Then they scale it up.

It's easy to trade somebody else's account. I'm not a lawyer, so I won't give legal advice. I will tell you what I did when I first started.

I told people about my investment strategy. Some of those people simply gave me trading authorization on their brokerage accounts. I could trade their money, but I couldn't withdraw it.

We had a separate, 1 page contract that said I would get 1% of the total money in the account, paid ¼ percent each quarter, and 20% of the profits I generated from trading the account.

The first account I traded was a $20 million account. That meant I made over $200,000 a year just trading this account no matter what returns I produced.

I made my client nearly $5 million in less than a year. My first check was nearly $1 million. All from trading the exact same strategy I had been trading in my personal account.

Keep in mind something else that's significant.

Some people think that it's unfair to make money on profits, but not lose anything if my clients lose money in their accounts.

There is a side of this that most people don't recognize until they actually do it in real life.

If the market is down 25%, and the account I'm trading for my client breaks even, then I only get the 1% administrative fee. I saved my client $5 million compared to what he would have lost if his money would have been in the market. I get paid no "performance" fee for protecting

a client's money on the downside, even though that is an incredibly valuable service.

Likewise, often managed accounts will have a hurdle rate. This is often around 5%. This means that the performance fee doesn't kick in until the returns are greater than some minimum return. Plus, there is often a high-water mark. This means that if the account drops in value, it has to make all the losses back the next year before the performance fee kicks in. In other words, I can't lose 10% in year one, and make 10% back in year two and get paid a performance fee for year two.

While managed accounts are a great way to scale up your financial results, there pros and cons you must consider.

The advantage of managing other people's money using managed accounts is that it's quick and simple to set up. You can be up and running in 24 hours. You only need the trading authorization at the brokerage company, and a private contract between you and the person whose account your managing.

You can immediately begin to scale up the real money hitting your bank account when you're getting 20% of the profits you're generating in somebody else's account.

That said, there are several disadvantages of using managed accounts to scale up your results.

The first is that even if you're making more money, a managed account isn't a business. You're basically acting in the role of a consultant. The person who owns the account can see all your trades, and probably reverse engineer your strategy very easily. They will realize they can add another 20% to their returns by removing you from the account and trading the account themselves.

The second disadvantage of a managed account is that it isn't build a track record or a business that you can use to raise money from other investors. This is a huge disadvantage. Even if you happen to show somebody the actual results of a managed account, or even your personal account, that won't mean much to potential investors who aren't related to you, or who don't know you personally.

Why?

Because anybody can manage multiple accounts. If somebody had an account that did well, they can show that account's results to prospective investors. They wouldn't have to show the account where they lost 43%.

The solution to this is simple, and inexpensive.

The solution is to set up your own hedge fund.

A hedge fund is a private Limited Partnership. The investors are the limited partners. Each partner has their own capital account that's valued proportionally based on their percent ownership of the fund.

You own the management company that's the General Partner of the Limited Partnership. You have an Agreement of Limited Partnership that spells out the business relationship between the General Partner and the Limited Partners.

All the monies from investors are pooled into an account titled in the name of the Limited Partnership. The General Partner makes all investment and trading decisions.

The money is deposited with a Prime Broker, and there is a 3rd-party fund administrator that does all the accounting

for the fund, and allocates all the profits and losses according to each partner's percent ownership in the fund.

The fund administrator also calculates all performance and management fees. At the end of each year, the General Partner (you) hires a 3rd-party reputable accounting firm (not the fund administrator) to do a complete audit of the fund's results. This audit is provided to the investors.

In the pre-Madoff days, con artists posing as fund managers were able to steal money from investors by simply running Ponzi schemes. They would bring in new money to pay out money to existing investors.

This risk of a fund manager being able to pull off any scheme like this now is almost nil. There are reputable 3rd-party brokers, auditors, banks, and the fund administrator who all would have to be conspirators in any scheme to defraud investors. Accounts are often set up with dual pin numbers that require a 3rd-party other than the fund manager to move money between accounts. In other words, having your own hedge fund does not give you unfettered access to clients' monies.

What having your own hedge fund does give you is your own business. And just like any other business, you will succeed or fail based on the results you produce for your clients.

The difference is that compared to just about any other business, the amount of money you can make is almost infinitely scalable without a corresponding increase in work on your part. You can trade $10 million or $100 million by putting in the same orders and just adjusting the number of shares you buy. Of course once you start managing over a billion dollars it might not be as easy to

get in and out trades. Once you get to $150 million under management you also have to comply with a different set of SEC regulations if your fund is in the U.S.

Most people think setting up a fund is expensive.

Usually it is. When I set up my first funds my lawyer told me it would cost nearly $100,000 in legal and accounting fees.

Here's a shameless plug.

My fund administrator has in-house attorneys he uses to set up hedge funds for his clients. We can get a fund set up at a fraction of the cost you can do it anywhere else.

I know. I checked.

Better yet, is you can allocate the cost of setting up your fund and charge it to the fund instead of having the entire set up cost come out of your own pocket. Better still, the cost of setting up the fund is an expense that can be amortized over 5 years. This means the actual cost of setting up your fund is less than how much I spend at Starbucks every month.

It's easier to explain with an example:

Suppose the legal fee to set up a fund is $40,000. You send a check to the lawyer, and in a few weeks you now are the sole owner of a corporation that's the General Partner of a Limited Partnership that was set up in conjunction with the corporation.

While the lawyer was writing up the documents for your fund and registering the business entities, you were getting some outside investors to agree to put some money in your

fund. Say for this example you were able to get a few friends and family members to agree to put in a total of $450,000 into your fund.

Now here's where the magic happens. Pay close attention.

When you launch your fund, you have $450,000 of outside money in your fund. You also have some of your own money. To make the math easy, let's say you have $50,000 of your own money in the fund. That means you own 10% of the fund's assets.

When the fund opens, you immediately are cut a check from the Limited Partnership for the $40,000 payment you made to the lawyer to set up your fund. That $40,000 is a fund expense, not your personal expense.

Since you own 10% of the initial investment in the fund, your share of that expense is 10%, or $4000.

Here's where it gets even better.

That $4000 is amortized over 60 months, and your share of that expense is credited against your capital account inside the partnership. That means you only pay $800 per year for 5 years to launch your fund. Your monthly charge against your account would be $67.

And that monthly charge would drop as you raise more and more money for the fund. As investors put in more money, and your percent ownership of the fund decreases, your amortized monthly charge for the start-up cost would also decrease proportionally.

I easily spend $100 month at Starbucks. For less than that, you could be managing your own hedge fund in next 6 weeks.

When I tell people this they usually are in a state of disbelief. They think there must be some catch, or that it can't be real.

It's real.

It's also the simplest way to increase your expected trading/investment reward without a corresponding increase in risk.

If you have a trading or investment strategy that you expect will bring in 2 units of reward, for every 1 unit of risk, your actual financial results will be double your actual financial risk. In other words, you'll risk $10,000 over the course of the year to make a $20,000 profit.

When you have a hedge fund, and you're making 20% of the profits you generate on outside investors' money, you effective increase your trading return, and your income by 20% for each dollar of investments that matches your own trading account.

For example, if you have a $100,000 trading account, and raise just $100,000 in outside money, your financial return increases by 20%. If you raise $500,000 in outside money, your financial return doubles. You get 20% of the profits you generate on the $500,000. If you produce a 10% return, that means you made $10,000 on your own money, and $50,000 for your investors. You get to keep 20% of that $50,000, which is $10,000 – the same amount that you made trading your own personal account.

These numbers we're using for this example are incredibly small. When I set up my first fund, I was amazed at how quickly I was able to get up to $2 million under management just from friends and families. And we're not

talking about mega-rich friends and family, or even wealthy friends and family.

I was able to get $2 million under management very quickly with about 15 investors, most of whom put in somewhere between $100,000 and $300,000.

Now let's run some example numbers using $2 million under management.

If you can generate a 20% return on $2 million under management, that's $400,000 in profits generated for your clients. You get 20% of that, or $80,000. Add in the 1% administrative fee, and that's $100,000 in income from just a tiny, $2 million hedge fund.

Here's where it gets more inspiring, and where you can easily see yourself making million dollar profits.

Most small hedge funds manage somewhere between $25 million to $50 million in outside money. If you were on the very low end of that scale, with just $20 million under management, you would just add a zero to the previous example.

A 20% return on $20 million under management would give you a yearly income of $1 million.

The next question that invariably comes up when I explain this to people is this:

"What if I'm not sure about my trading strategy? I don't think I have it perfected yet, so I want to wait before I would open up a fund."

Now you're back to step 1. You know you have a problem, and you're facing the reality of your problem. If you're not

sure about your strategy that can only mean a couple of things. You either don't have an edge, or you only have one edge that works in a limited environment. Or maybe you have no idea yet how to figure out position sizing strategies to apply to your edge.

Here's another shameless plug. My partner who owns the fund administration firm does the accounting for nearly 200 hedge funds every month. Do you think he knows which fund managers are consistently producing high returns with limited risk, year after year? He sees every one of their trades so he knows if they're drifting away from their stated strategies. And because he sees all their holdings he knows if there is any risk-overlap between funds.

If you had access to the monthly statements of nearly 200 hedge fund managers, and you know who was consistently making money year after year, and were able to make sure their results and styles were not correlated, what would you do?

Chances are you'd want to cherry pick the best fund managers and invest in their funds.

There's only one problem with that.

Even if you knew the best fund managers, and you decided you wanted to invest in their funds, most of these funds have a high minimum investment amount to even get into their funds. Often the minimum investment is $500,000. Some funds are at $1 million. Plus, these funds only have spots for 99 total partners, and many are closed, or nearly filled.

That's why my partner and I decided to set up our own fund of funds to invest in the fund mangers we know are

doing well. We only invest in funds where we have access to the actual their actual monthly trading statements, and who accounts are audited by a reputable 3rd-party auditor.

So if you're reading this now, and the idea of having your own fund seems like a no-brainer, but you're not 100% sure that your strategy is perfected yet, you might consider investing in our fund of funds right away.

This gives you the potential benefit of having some proven hedge fund managers make money for you while you're building up a track record for your own fund. And even if you're already producing great results with your own methodology, that doesn't mean you can't allocate assets to other traders who have their own, non-correlated, positive expectancy strategies.

And when it comes time to raise money for your own fund, we've found when people hear about our unique access to so many successful fund managers, they want to know how they can access those same managers too. You can tell your potential investors the truth. You're investing some of your money into a fund of funds that has direct access close to 200 fund managers' actual brokerage account statements. You'd be adding massive value to your potential investors by giving them a way they could access the results these fund managers are producing.

That said, our fund of funds is set up for a maximum of 99 limited partners. The space is very limited. If you're serious about setting up your own fund, and accessing our traders and fund managers through our fund of funds, we can get you set up quickly, and for pennies on the dollar. If you can get $500,000 in outside money, and invest $50,000 of your own money, your portion of the set up fee is only 10% of the overall fee, amortized over 5 years.

Family Offices

You've probably heard of the term "Family Office." A family office is a generic term for when a family's wealth, usually from a family business, gets so large that they set up an office just to manage their money.

At least that's the public perception.

I never heard of a "family office" when I set up my first partnership accounts. What I was able to accomplish with very little expense was set up a family partnership that allowed me to manage my family's money in one account.

I then put all the money from the family partnership into my hedge funds. I originally did this just for the convenience of having one trading account instead of a different account for me, my joint account with my wife, my wife's account, my retirement account, my children's account, my business account, and my father's account.

That's a lot of accounts to be dealing with every day.

Instead I consolidated all of these accounts under one family partnership account, which later turned into my first hedge fund.

Not only did this make my life much easier, it also allowed me to structure my investments to give me maximum asset protection for both me, and my family. I went through a divorce that lasted 5 years, and at the end of the process, the asset protection worked as planned. My father went through a nasty lawsuit that lasted several years, and once again, the asset protection plan worked.

It's not complicated. It doesn't require offshore accounts, or doing anything unscrupulous. Everything is out in the

open. When assets are held inside a family partnership, and the partnership's assets are held inside a hedge fund, all that a somebody suing you can possibly get awarded are shares in one of the partnerships.

With shares in the partnerships also comes the corresponding income allocation and tax liabilities, without necessarily the ability to liquidate those shares for real money. Usually when lawyers see this they realize it will be an uphill battle for them to milk legal fees from the situation. They often suggest a reasonable and fair solution to the dispute as a wise alternative to a drawn out and costly legal dispute.

There's no reason for you not to enjoy these same benefits. Again, I'm not a lawyer, so don't take any of this as legal advice. That said, my personal lawyer told me I was crazy to set up a hedge fund. He also told me I could never make any money trading, and that I would be better off investing in mutual funds.

Be prepared for similar resistance from your personal lawyers and accountants. Your lawyer has no upside in you setting up your own fund. Neither does your investment advisor, stock broker, or CPA.

In the interest of full disclosure, I personally have an upside in you setting up your own fund because if you know how to make money, we can allocate money from our fund of funds for you to trade. Our business is to find people who know how to make money, and then pay them to make money for us and our clients.

That's it, you now know the 7 steps every super successful trader or fund manager went through in order to get to the

point where they were making millions (or billions) of dollars.

To review, the steps are:

1. You face the fact what you're doing now isn't getting you the results you want.
2. You seek outside experts to help you.
3. You realize you can do a better job at managing your own money without their "help."
4. You do research and educate yourself so you can more effectively manage your own investments.
5. You have an "aha" moment when you realize you need a systematic way to make money no matter what's happening in the market. You'll go broke trying to predict the markets. You get rich by have non-correlated strategies and controlling your risk.
6. You work on finding some sort of quantifiable trading or investing edge. Ideally, you find more than one because no strategy works in every type of market.
7. You leverage your actual trading ROI to put more actual money in your bank account by trading other people's money. You create a fund to 5x your income with the same trading results. You invest money from you fund with other traders and fund managers who have their own ways to make money.

That's it. That's how I went from a $60,000 a year job to making millions of dollars. The first time I made over $1 million in one day was in the year 2000, less than 2 years after I started my first hedge fund, when I made over $2,200,000 in ONE DAY.

Think about this. To make $2,200,000 from my $60,000 a year job, I would have to work over 36 years. I started

trading my own accounts in 1997, and set up my first hedge fund in 1998. I was 36 years old when I set up my fund. In less than two years I made as much money in ONE DAY as I would have made in the next 36 years of my life working at my job.

Actually, that's not true.

When my father was diagnosed with cancer, other family members in our family business formed an alliance to throw my father, and me, out of the company. I was fired by my own father at a Board of Directors meeting because that was what the other board members insisted he do or else they were going to fire him too.

Thankfully, I had already made millions of dollars and had trusts set up for my kids. I'm writing this on my laptop, laying back in my hammock in southern California, looking up at a crystal blue sky and palm trees, all because I followed the exact plan I've laid out for you in this book.

SECTION 2

Frequently Asked Questions About Hedge Funds

1. What are hedge funds?

When I first started trading I had no idea what hedge funds were. I never even heard of a hedge fund.

What I did know was that I figured out a systematic way to consistently make positive ROI every month. Or at least almost every month. I knew I had a business system that generated profits consistently with little risk.

The only reason I created this system was because I had been working for my family business. Our million dollar stock broker that our family had hired was a joke. We trusted him. We had a 80 year old manufacturing company. We knew nothing about investments.

My retirement account made a total of 1% gain in seven years. That's not 1% a year, but 1% total gain. The stock market almost doubled in that same time period. I knew I could do better investing my own money. I personally never met a broker or investment advisor that wasn't totally wrong in everything they believed.

I told my friends and family they should use the same strategy I was using. Most of them said they'd rather just have me trade their money for them.

I thought I could just set up a corporation and make them owners, then divide the money based on how much they invested. I called my lawyer and told him that's what I wanted to do.

He laughed and said, "Oh... You want to set up a hedge fund."

He spent ten minutes on the phone telling me why I shouldn't set up a hedge fund. He told me I didn't want the headaches or responsibility. He told me that it was too complicated. He told me that I could never "beat" the market, and that the only way to make money in the long-term was buying and holding stocks and mutual funds.

Fast-forward...

When: March 2, 2000
Where: Sitting at my desk at home
Subject: Net Daily Profit $2,214,726.14

By now I was almost totally emotionally detached from how much money I made or lost in a day. I knew I had an edge, like a casino owner. I didn't care about if I made or lost money on any "bet." I knew all I had to do was keep making the same decisions, everyday, and the money would add up.

I was happy when I knew I had a good day, even if it was only for a minute. I enjoyed the moment and celebrated making the right decisions, not necessarily the outcome of that decision.

That said, I was still a bit surprised when I totaled up my daily net profit on March 2, 2000,

$2,214,726.14

Not a bad day at the office. 3 years before when my lawyer told me that setting up a hedge fund was a bad idea I was making $60,000 a year in salary, before taxes.

It would have taken me 37 years working at my job to make what I made in one day from running my hedge fun. That means if I would have kept working at my family business I would have been 72 years old before I made that much money. My kids would have already graduated from college and maybe had kids of their own.

But I wasn't focused on the $2.2 million I personally made that day. I multiplied the $2.2 million x 4. That's $8.8 million.

Why did I multiple by four?

Because the fee structure of my fund was 1 and 20. This means I made 1% annually on the total money invested by my clients, and 20% of the profits. In other words, for every million dollars profit I generated in my hedge fund for my clients, I would get 20% and they would get 80%.

The day I made $2.2 million my fund made $11 million in profit. My clients made $8.8 million.

I always calculated how much my clients made first. I had a spreadsheet on my computer that had every client's name and daily profit and loss.

I loved seeing that my best friend made $42,632 in one day. His annual pay was $45,000.

I loved seeing that in one quarter I made $762,652 for my dad. My dad's entire retirement account after investing for 40 years was $400,000 when I started managing his money.

I loved the day I sent my aunt a letter showing her total

balance went over a million dollars. She started by investing $300,000 with me.

So the first thing I always thought of when I did my daily accounting was how it impacted the lives of my friends and family. I knew that I created a business where they could invest their money and pay me just 20% of the profits while I did ALL the work to make them money every day.

What business exists in the world where you somebody else does all the work and you keep 80% of the profits? Everybody I know who has their own business works 60 hours or more a week. A hedge fund is a business where the owners (my clients) do zero work and keep 80% of the profits.

And it gets better.

The owners of the business (my clients) have zero liability. The general partner (that's me) has 100% of the liability.

So to me, a hedge fund is a business that allows me to take care of my closest friends and family's money for them. It's a way to protect them from unscrupulous investment advisors and just plain wrong advice that's thrown at them from all directions, mostly by people in the media who have no idea what they're talking about.

Is that the technical definition of a hedge fund?

No, of course not. A hedge fund is a generic term for a private investment partnership. The business entities are typically limited partnerships.

A limited partnership is an entity that has Limited Liability Partners and a General Partner. The limited partnership is called something like Global Hedge Fund, L.P. The limited partnership is managed by the General Partner who has complete authority and autonomy to invest the money held by the limited partnership. The General Partner can make investment within the terms of the Agreement of Limited Partnership.

Typically, the General Partner is also a business entity - either a C corporation or LLC.

The terms of the partnership agreement define how much the General Partner will be paid for managing the assets of the Limited Partnership. Typically the General Partner will get a Management Fee and a Performance Fee. When you hear that a fund charges 1 and 20 it just means the G.P. gets paid 1% annually of all the assets under management, plus 20% of the net profits generated by the investment of the assets.

Usually the General Partner is owned by the fund manager. The owner of the G.P. is typically the President of the corporation or LLC that is the General Partner.

Here's how this works in practice:

John Smith sets up a Limited Partnership called The John Smith Partnership, L.P. He also sets up a corporation called John Smith Management, Inc. which is named in the partnership documents as the General Partner of The John Smith Partnership, L.P.

People who want John Smith to manage their money write a check out to The John Smith Partnership, L.P. Their

money is deposited into the John Smith Partnership, L.P. bank account. John Smith has signature authority on the bank account, and will move the money into investment accounts held in the name of The John Smith Partnership, L.P.

The partnership has an accountant called the Fund Administrator. All the bank statements from the investment accounts are sent to the Fund Administrator. The General Partner tells the Fund Administrator the names and investment amounts of all the limited partners. The Fund Administrator sets up the accounting for the partnership so that each member of the partnership has their own Capital Account.

The amount that's allocated to each partner's capital account is simply the percentage ownership that their investments represents out of the overall assets of the partnership. So if a partnership has $99 million in assets, and a new partner comes in with $1 million, he or she will have a 1% ownership in the partnership.

It's this percentage of ownership in each capital account that determines the amount of profits or losses assigned to each partner. If in the previous example the fund made $5 million in profits, the partner with a 1% ownership would be assigned 1% of those profits, or $50,000.

Usually the 1% management fee is deducted from each capital account at 0.25% per quarter. This is a simple accounting entry in which every capital account has 0.25% deducted from the account and the General Partner has 0.25% added to the G.P.'s capital account.

The performance fee works the same way, except it's often

calculated and assigned at the end of the calendar year. If the partnership had a 30% net gain for the year, each capital account would have 20% of that gain (6%) deducted from their capital account and assigned to the capital account of the General Partner.

So in broad strokes, if John Smith ran a $100 million fund and generated a 30% return, The John Smith Partnership, L.P. would have a $30 million profit. Of that $30 million profit, 20%, or $6 million would be paid to the General Partner, John Smith Management, Inc. The General Partner would also have received the 1% management fee, pro rated over the course of the entire year. This would be somewhere between $1 million and $1.3 million for the entire year.

The metaphor I like to use is that hedge funds are like buying your own business that you pay the fund manager to run for you. You're partnering in the results he's producing for himself. You get the benefit of his lifetime of experience, his full-time management of the money, and the operations of his entire office. The 1% management fee gives you ownership of your share of the business. The fund manager is running your entire business, while you get to keep 80% of the profits he makes for your business, plus have 100% of the original equity you invested in the business.

2. Why invest in hedge funds?

There is only one reason to invest in anything - so you have more money than when you made the investment.

It's not that complicated.

What makes things complicated is that this simple principle has been lost and shoved under the rug by financial service companies and the financial media.

Let's start with this fact. The financial media conglomerates make money one way - by selling advertising.

That's it.

The Wall St. Journal, CNBC, and the Financial Times don't need to have any expertise on the financial markets to make them money. They need to get readers and viewers so they can charge advertisers huge sums of money.

Who buys the advertising?

Huge financial service companies like Vanguard and Fidelity, which each have close to $1 TRILLION dollars under management.

It's the combination of the financial media and the financial service companies who've distorted and buried this one fundamental concept:

The only reason you invest in anything is so that you can sell it for me later.

The mutual fund companies make their money based on the amount of money they have under management, not based on their performance. That's why they say that it's ALWAYS a good time to invest in the markets.

The investment advisors and stock brokers make money by selling the the products mutual fund companies are offering. Again, every day is a good day to buy stocks and mutual funds.

Here's a reality check...

In January 2008 every stock broker, every investment advisor, and every mutual fund company took money from people who trusted their advice. A little over a year later these people lost over half their investments.

Know the craziest part about it?

Not one of the mutual fund companies, stock brokers, or investment advisors, even in hindsight, look back at the beginning of 2008 and think that it was a bad idea for their clients to invest money then -even knowing that many clients lost over 50% of their investments.

Every hedge fund manager I've ever met has his or her own money, their friend's money, and their own family's money invested in their own hedge fund. They would want to shoot themselves at the thought of losing 50% of their own money, their friends' money, or their family's money. They would be physically sick at the thought of losing 20%.

They'd be sick about losing that much money because they're world-class professionals who pride themselves on

be smart, protecting assets, and not doing stupid stuff that amateur investors do. And when I say amateur investors I'm not saying that it a derogatory way. People who don't make a living from their investment decisions are amateur investors. People who make a living selling investments are not professional, world-class investors. They're professional sales people. A broker isn't an investor. A registered investment advisor isn't a professional investor.

The reason you invest in a hedge fund is simple - to have more money in the future.

Here's why a hedge fund will almost always give you much, much, much better odds at having more money in the future.

Let's look at the history of hedge funds. When you see this you'll have an "aha" moment and never want to invest in anything but hedge funds, or at minimum manage your own investments like a hedge fund manager.

The term "hedge" means to bet against your own bet, like when you hear people say they want to "hedge their bet."

Most people who hear this for the first time immediately think that hedging their investment bets is something that might limit risks, but also limit their upside.

Uh-uh.

That's not how it works. The reason people don't understand this, at least in my experience, is because stock brokers and investment advisers either don't understand it or know they aren't going to make as much money from commissions explaining this to people compared to just

dropping an 8% commission into their bank account my selling a $1 million dollar annuity.

When I first had this conversation about hedging with my stock broker he laughed and said, "Why would you want to do that?"

He explained how buying put options to protect against downside losses was stupid because the cost of the options would eat into the upside potential of holding the stock.

He thought buying put options as the way of "hedging" as insurance against big market drops.

That's not how hedge fund managers hedge.

Hedge funds were first created when a stock investor decided he wanted to take the overall market performance out of the equation. He reasoned that he could own the best stocks in the world, but if the market crashed, he would still lose a TON of money.

This is 100% true. The mutual fund companies and financial media want to put their heads in the sand and pretend this isn't true by sugar-coating huge losses with the mantra, "You're investing for the long-term."

Yes, they're right about that.

Now let's step into the common sense corner. If your investing for the long-term, does it ever help you to lose 50% of your money in the short-term?

Nope.

So the guy who invented hedge funds reasoned that the way to totally take the market risk out of his investment portfolio was simple - he would put half his money in the stocks he thought were the most likely to go up in value. He would then go short the other half of his portfolio the stocks he thought were the most likely to go down in value.

This way, the money he would make or lose would be entirely dependent on his ability to pick winners and losers, not the direction of the overall market.

So think about this.

If you have a portfolio of stocks that you're half long, and half short, and the market crashes, what happens?

You lose money on the stocks you're long, and make money on the stocks you're short. If you did a decent job at picking the stocks the stocks you're short will lose more money than the stocks you're long. You actually will make money when the market crashes.

So what happens when the market goes up?

Again, if you did a good job at picking stocks, the strong stocks will go up more than the money you would lose on your short positions. You've effectively take the overall market performance out of the equation and drastically reduced your risk.

This is because you've selected a portfolio that consists of inversely correlated assets. If the assets are perfectly uncorrelated you will have zero risk because when one asset increases in value the other will decrease the same in

value.

At first this made no sense to me. It sounded totally stupid. Then I totally got it. Keep reading...

If both inversely correlated assets had a zero positive expectancy then your account would be flat, no gains or losses, all the time.

But what if each of these inversely correlated assets had a 10% annual positive expectancy?

What this means is that at the end of the year your account would have increased 10% and -ready for this - your account never have lost money.

Why?

Because the assets are both meandering upward at a 10% annual rate, but always moving in opposite directions on the way up. Imagine a zigzag line going up at a 10% slope, then copy that line and flip it upside down. You now have two lines that go up at a 10% rate, but every time the blue line goes up, the red line drops down the exact same amount. In physics terms, the lines are out of phase with each other. It's like how noise canceling headphones work -they short-term meanderings always cancel each other out, while the overall movement is always up.

Imagine two boats that set sail from New York to London, a red boat and a white boat. The boats don't travel in a straight line, they weave back and forth. But every time the blue boat weaves north, the red boat weaves south. At any time the average position of the two boats falls on the line that sets the direct course between New York and

London. If the blue boat goes 100 miles off course too far north, the red boat goes exactly 100 off course to the south.

But both boats end up in London on the same day.

This is why hedge funds were created. To create portfolios of inversely correlated assets that each individually had positive expectancies.

The Investment Act of 1933 made sure that hedge funds would not only be legal, but hidden from the public. Joe Kennedy, the first head of the Securities and Exchange Commission, made sure that the hedge fund structure was written into the Act.

The problem was this strategy was so much better than simply buying stocks and hoping they would go up that the powers that be couldn't advertise it. The U.S. was in the depths of the Great Depression. They couldn't afford to have the masses do anything but have confidence in corporate America. They didn't want people shorting stocks.

So they created caveats regarding hedge funds that guaranteed the super rich would be able to benefit from this strategy. First, hedge fund managers couldn't advertise their hedge funds. Second, the funds were only limited to accredited investors, i.e., people worth over $1 million. Third, they limited the hedge funds so that they could only have 100 investors.

These guys weren't stupid. That's why there's still a huge divide between what the general public knows about hedge funds and what the wealthy know about hedge funds.

(If you don't know what "going short" means, it's simple. When you short a stock you make money when the stock price goes DOWN, not up.)

3. How are hedge funds different than mutual funds?

Know what the biggest difference between hedge funds and mutual funds is?

Simple.

Wealthy mutual fund managers invest their money in hedge funds. The owners of the mutual fund companies have their money invested in hedge funds. Hedge fund managers don't typically have their money invested in mutual funds. They have their money invested in their own hedge funds.

That should tell you something.

Why?

Because there are huge differences between hedge funds and mutual funds! We'll get to those differences in a second. Before we go into the differences, let's start with how hedge funds and mutual funds are alike.

A fund is pooled money from many investors in the name of one business entity. For example, the entity could be Your Fund, L.P.

The fund is managed by a fund manager. Typically, the fund manager is also a business entity, e.g., Your Fund Management, LLC The business entity Your Fund Management, LLC hires an invididual to be the fund manager.

Investors write checks out to the fund company. The fund company gives trading authorization on its investment accounts so the management company can invest the money.

The investors share a proportional ownership of the fund's assets, and therefore receive a proportional allocations of investment gains and losses. The management company hires an accounting firm to keep track of everybody's percent ownership, income, withdrawals, deposits, and tax liabilities.

So far, hedge fund and mutual funds are very similar, almost identical.

Here are some key points where they differ. As you read these points keep the perspective that the U.S. Securities Exchange Commission established the Investment Act of 1933 to define how these entities differ. They created these two types of entities under the premise of "protecting" the public. What the SECOND did was establish different rules for the wealthy. The defined what is called an "accredited investor." An accredited investor is somebody who's wealthy. In 1933 that was defined as having a net worth of over $1 million USD.

In 1933 a million dollar net worth, in the middle of the Great Depression, would have been more than wealthy. The rules for hedge funds were designed for the elite, the super wealthy.

That's why things haven't changed. It's the super wealthy who still are reaping the benefits of investing in hedge funds. And the hedge fund managers make more money than any other profession in the history of planet earth.

That's because the first and most important difference between hedge fund managers and mutual fund managers is this:

Hedge fund managers get paid based on their performance. Mutual fund managers get paid based on how much stock brokers and investment advisers bring into their mutual funds.

Why is this important?

Because hedge fund managers have incentive to both protect their clients' money, and to grow it. That's because along with the performance fees, hedge funds also have what's called a high water mark. What this means if an investor's account value ever drops below their initial investment, the hedge fund manager must get them back into positive territory before he or she can take the performance fee. This high-water mark carries over from year to year.

Mutual fund managers suffer no equivalent consequence to the fees they charge if they lose their clients' money. Of course, the assets under management drop, but that's the same for hedge fund managers. Both mutual fund managers and hedge fund managers get a flat management fee based on total assets under management.

What this performance fee does is create a win-win for the investors and the fund managers. The investors get to buy into a business whose sole purpose is protecting their capital and growing it at the same time. From the outside, investing in a hedge fund is no different than investing in somebody who sells apples on the side of the road. What's

different is that the investor gets to keep 80% of all the profits, and the fund manager, the one whose work and expertise is generating all the profits, only keeps 20% of the profits.

Imagine that same scenario with the apple stand. There's no business in the world where you can invest into the ownership of the business and get paid 80% of the profits. The best dividend paying stocks might pay around 10% of the profits. Hedge funds pay 80% of the profits to the owners. Nothing else compares.

The next difference between hedge funds and mutual funds is that mutual funds are allowed to advertise to the general public. They spend a significant amount on advertising. The last I checked the amount mutual funds spend on advertising was something around $10 billion per year.

What do mutual funds advertise? They used to advertise their previous year's returns. For the most part they stopped doing that after the 2008 devastation of their investments. It was not uncommon to see mutual funds lose between 50% and 75% of their total value in about a year.

So what do they advertise?

Mutual fund advertising is exclusively directed towards one thing - having consumers put their money in mutual funds. They advertise almost nothing except how you need to save now for your retirement. Saving now will make your mother proud. Seriously. That's a real ad by Vanguard.

Where hedge fund managers are mortified by losing their clients', and their own money, mutual fund managers are unapologetic. Every single mutual fund company and mutual fund manager was telling people what a great idea it was to invest in their mutual funds at the beginning of 2008. Nobody apologized for losing more than 50% of their clients' money.

In fact, they did the opposite. They explained how nobody can predict the future, and how everybody should ignore the losses and focus on the long-term.

They're wrong. I can predict the future with 100% certainty. The markets will go up and down. The markets will have periods where they drop significantly. Everybody knows this.

The difference is that 99.9% of mutual funds are not permitted to go short, i.e., bet against the market. That was part of the regulations created by the SEC. The idea was that the powers that be wanted to create a systematic way for the general public to funnel their monies into fund managers that would use their money to buy U.S. stocks. This saved the U.S. banking system from default. History repeated itself in 1971. 1998, and 2008. In 1971 Nixon took the U.S. off the gold standard, in 1998 the Federal Reserve organize the take over of Long Term Capital Management to save the global banking system. In 2008 the U.S. poured hundreds of billions into U.S. corporations to once again save the investment banks.

The reason I mention this is because when these economic debacles happen, which they inevitably will, hedge funds do not lose money across the board. That's because they often have big bets against the markets. Paul Tudor Jones

made over $500 million personally when the U.S. Stock Market crashed on October 19, 1987. George Soros almost bankrupted the entire United Kingdom when he went short against the British Pound. Paul Tudor Jones again made huge profits in his fund when the markets crashed in 2008.

Bottom line? The difference between hedge funds and mutual funds is that mutual funds are limited in how they can invest and protect assets.

Hedge funds aren't.

This means mutual funds are always guaranteed to get crushed.

Hedge funds aren't.

Because hedge funds are less regulated (which the financial media propagandizes as a bad thing) hedge fund manager can protect their investor's money.

Mutual fund manager simply can't protect your money. They've controlled the frame so that the question they ask investors to consider is which of the thousands of mutual funds should you buy.

They've controlled the frame so that the decision becomes a matter of splitting hairs about which fund might slightly outperform or under-perform another mutual fund.

The elephant in the room that nobody in the retail investment business has any inventive to talk about is what happens when the long-only funds all get crushed at the same time? Is it really going to make you feel better that your fund only lost 47% when the average fund lost 56%.

That's the reality.

The biggest difference is that super smart, super wealthy people invest in hedge funds. Think of a Venn diagram. One circle is hedge funds, the other is mutual funds. Yes, there is an overlap. Some super smart, welathy people invest in mutual funds and hedge funds. The average person who relies totally on other people's advice and hopes their investments will grow year after year ALL invest in mutual funds.

4. Are hedge funds just for the wealthy?

No. That's 100% incorrect. I've had dozens of people in my hedge funds who were not super wealthy. Being a partner in my fund helped them get wealthy.

But the average person thinks that hedge funds are just for the wealthy.

Why is this?

There are a number of reasons.

The most likely reason is because the financial media relies 100% on advertising revenues from the retail financial services industry. The retail financial services industry makes billions of dollars a year selling mutual funds.

Here's what's interesting. The Nobel Prize was awarded to the economists who came up with the efficient market theory. Burton Malkiel, author of the classic book "A Random Walk Down Wall St." has always been a key player at Vanguard funds.

Vanguard has $1 trillion under management in their mutual funds. They basically provide one service for investors - they take investors' money and buy pre-defined baskets of stocks and financial instruments that emulate established indices. If you want to invest in the S & P 500, you can easily do that by buying Vanguard's S & P 500 fund instead of buying all 500 stocks that make up the S & P 500.

Vanguard and other mutual fund companies are awesome

for people who want to buy baskets of stocks and hope they'll be worth more later.

The U.S. Government has created key tax legislation to encourage people to invest in these mutual funds. Retirement accounts are not taxed. Neither are 529 college savings plans. Even taxable investments are taxed at the much lower capital gains rate.

If you follow the money, the trillions of dollars invested through mutual fund companies goes into buying stocks and bonds on the open market. The investors hold shares in the funds, which in turn own stocks and bonds.

So where did the actual money go?

Follow the money. Stocks can only be bought from somebody who sells them. There are only two types of sellers -sellers who were once buyers of the stocks and bonds, and sellers who issued the stocks and bonds in the first place.

Let's look at the latter -the sellers who issued the stocks and bonds in the first place.

There are two initial sellers of stocks and bonds. Stocks are sold to the public by people who started their own companies. When somebody starts a company, they form a corporation and issue shares. They sell ownership shares of the company to raise money to grow the company.

This is where investment banks come into play. Investment banks put together the Initial Public Offering (IPO) and sell the shares of stock to the public.

For example, when Facebook went public they sold $100 billion dollars worth of stock.

The investment banks make a percentage of this initial public offering -think somewhere between 5% - 10%.

So the investment banks have huge incentives to promote the stocks to the public. The investment banks essentially become pitch men for the future of the company.

Here's where it gets fun!

The investment banks also manage money for clients. They recommend stocks for clients to put in their portfolios. There's supposed to be a "firewall" between the advisory side of investment business and the IPO side. This is to protect consumers from the obvious conflict of interest that would exist if the same people who were pitching the stocks had their brother out in the world portraying himself as a "neutral" stock analyst and just so happened to recommend that his clients buy stock in his brother's company.

Yes, this is how it works in the real world.

So where do people get the money to buy IPOs?

They usually sell shares they own in something else, like stocks, bonds, or mutual funds. Or else they buy the IPO shares from cash in their bank accounts.

Now here's where it gets really fun.

Imagine a bank with $1 billion dollars of their clients' money in savings accounts. The bank issues an IPO in

partnership with a corporation. The bank makes a 5% commission. Look at what the end result would be if every bank customer put all their money into the IPO.

The corporation would get $950 million in their corporate bank account.

The bank customers would own stock shares.

The bank would have $50 million transferred from their customers' accounts to the banks corporate account.

The retail customers own paper that represents their belief that this paper can be sold later to somebody else.

The bank and the corporation partnered together to transfer $1 billion dollars from the bank's customers' accounts to their own accounts.

Now what do the customers do with the paper? The stock certificates?

The sell them back and forth to each other based on a price that just one seller and one buyer need to agree upon. If the stock sold for $100 a share at IPO and one of the buyers wanted to sell a share for $90, and somebody wanted to buy it, the stock price would now be posted as trading at $90 a share.

This would drop the entire book value of the corporation by 10% overnight. But it wouldn't have one iota of an effect on the $950 million that was already on the corporation's bank account. And it wouldn't have any impact on the $50 million that went into the bank's corporate bank account.

But you know what it would impact?

The psychology and emotions of all the people who transferred real dollars in exchange for pieces of paper that represented their belief that they could sell the paper later for more money.

At this point these "investors" have only three choices:

* Decide they were wrong in their initial belief,

* Insist they were right in their initial belief, or

* Think about something else and ignore that they no longer have money in their accounts, and instead own a sheet of paper that the world thinks is worth only 90% of what they thought it was worth the day they bought it.

So which choice do you think the retail financial conglomerates encourage their customers to make?

That's right.

They tell customers that it's never a bad time to buy mutual funds, and to ignore it when their funds drop in value. Somewhere along the way, putting money into the stock market went from being a high-risk proposition to being called "saving" for retirement.

So what's this have to do with whether or not hedge funds are only for the wealthy?

I'm about to explain that.

Before I do, it's instructive to look at the Investment Act of

1940. This is the law that the U.S. Congress passed that legislated mutual funds and hedge funds into existence. Hedge funds are nothing more than private investment partnerships. The 1940 Act allows for private partnership shares to be offered to accredited investors. Without going into the specifics, accredited investors are wealthy folks and businesses. The Investment Act of 1940 allows partnerships to have 99 investors either accredited or "sophisticated" investors in a partnership.

The act uses the term "sophisticated" investors without defining what it means. Private investment partnerships can have no more than 35 "sophisticated" partners.

What this means from a practical sense is that hedge fund managers have the discretion to allow non-accredited investors be partners in their hedge funds. In practice, this allows the hedge fund managers to manage their friends' and family's money, even if those friends and family are not accredited investors.

What we've learned from all this is simple.

There are two types of people playing by two sets of rules in the investment world. The wealthy, who have been using hedge funds for decades now to protect and grow their wealth. And the average person in the general public who's been told to put their money into mutual funds like the stock market is a savings account.

It's not.

Investing in the stock market with no risk management plan is like playing russian roulette. Getting old and

hoping the market will be higher in 20 years is not a risk management plan.

5. Aren't hedge funds more risky than mutual funds or stocks?

To answer this question we must define risk.

The financial media and the financial services organization have misrepresented risk for some time now. They mistake volatility for risk. Volatility is not risk. Volatility is how far up and down the price of a security has historically moved. Volatility is 100% a backwards-looking variable.

Risk is a forward looking variable.

I was having an investor meeting at my Pittsburgh office with some of my high profile clients. One of them asked me what the risk was in my fund. I told her that if terrorists blew up the stock market tomorrow that the risk would be 100%. She looked at me like I was joking. She asked me again, "No, seriously, what's the risk?"

I told her again, "100%.". She thought I was being facetious or just covering my ass. I wasn't. I was dead serious.

That night she flew from Pittsburgh to New York. I remember this vividly because the meeting was on a Sunday afternoon. The date was September 9, 2001. Tuesday morning two planes flew into the World Trade Centers, just a few blocks from the New York Stock Exchange.

In 1998 I was in Hawaii with some friends. They were all freaking out because their investments were getting crushed. They had lost something around 25% over a few weeks that summer. They didn't realize how close they

came to losing a lot more. That was the summer of the Long Term Capital meltdown.

LTCM was a hedge fund created by Nobel Prize Laureates and a former Governor of the Federal Reserve. These guys were no lightweights. They developed very sophisticated trading algorithms that created arbitraged positions to take small percentage points of profit out of slightly inefficient markets.

They were also leveraged at a 10:1 ratio. They borrow billions of dollars from every major investment bank.

Here's what happened that summer.

Russia declared they were going to devalue the Russian ruble. LTCM was long the Russian ruble. But that was ok, because they hedged their position by going short the Russian ruble in the futures market. In other words, when Russia devalued the ruble, LTCM's long position would have dropped, but their short position in the futures' market would have gone up proportionally. They might have even made money because of the spike in volatility.

Only one problem.

When Russian devalued the ruble, they simultaneously halted all trading in the futures market. LTCM was screwed. Not only were their long position devastated, but since they were leveraged 10:1 their real losses of investors' monies were almost totally wiped out.

Know who else was screwed?

The largest investment banks in the world. Why? Because

it was their money that they loaned to LTCM that vanished. Their assets on their books included these IOUs from LTCM. In other words, when the banks loaned LTCM the money it didn't affect their balance sheets one bit. The money they loaned LTCM just changed from billions in cash to billions in accounts receivable. Those assets are both the same on the balance sheet.

When the LTCM investments blew up, it also blew up the value of those loans. If something was done immediately, the banks would have had to account for those losses in assets. Banks have a capital requirement which basically says they can only lend out so much money in relation to their assets on the books. It's not uncommon for this capital requirement to be a ratio of 10:1. It's called fractional banking.

Remember the movie It's a Wonderful Life, where Jimmy Stewart, playing the character of George Bailey, says, "You're money's not gone! It's in John's house, and Bert's house, and Ernie's house..."

That's an idealistic way of looking at things. When you put your money into a bank, the bank can load out 10 times more money than the amount you deposited. When I was speaking at Harvard I saw a painting in the Harvard Business School that showed a banker handing money to somebody. The caption read, "The Greatest Invention of Mankind - Commercial Credit."

Seriously. I couldn't make this up.

Back to the story...

The U.S. Government helped coordinate a meeting with

the LTCM's principals, the regional Federal Reserve Bank of New York, and a few billionaires who smelled blood. They knew LTCM was screwed, and they piled on. They reached a deal where they bought out LTCM's "distressed assets" for pennies on the dollar. When the dust settled a few weeks later, the LTCM trading positions actually re-balanced, and the people who bought out LTCM actually made a nice profit.

Does the LTCM story sound familiar?

It should. Fast-forward to 2008.

The 2008 financial crisis was a repeat of the LTCM debacle. In the 90's the U.S. government decided to make it easier for people to get loans to buy houses. I have personal experience with this. A very close friend of mine borrowed $350.000 to buy a $340,000 home.

That's right. She got a $340,000 home plus $10,000 cash in spending money.

And she didn't have any assets or a job. She was going through a divorce a got a friend to sign a one-page income verification document that said she was employed, making $8,000 a month.

That was all the mortgage brokers, the real estate agents, and the lending banks needed. They wrote her checks for $350,000.

Why didn't the banks care?

Because they immediately sold the loan paper to another banking institution. This banking institution packaged all

these loan papers and bundled them into one entity that they then sold to another investment bankers. The sales people at these investment banks made a nice commission on the sale.

Let's do some hypothetical math.

Suppose a sales person made a 4% commission on selling one of these debt packages. Say he or she sold a $100 million package to another investment firm. The sales person would make $4 million on that one transaction.

Now suppose that sales person reciprocated the deal, and had his firm buy a $100 million debt securities package. The corresponding sales person at the other investment bank would also make a $4 million commission.

Nice.

It reminds me of an episode of Beavis and Butthead where they had to sell $2 chocolate bars for a school fundraiser. Each of them were give 20 chocolate bars. They went door to door and couldn't sell any. Finally, they sold 1 chocolate bar for $2.

Dejected, they sat on their doorstep wondering what to do. Beavis came up with a great idea!

"Butthead, um.... Can I borrow two dollars?"

Butthead loaned him the $2. Immediately Beavis bought a chocolate bar from Butthead for $2 dollars. Beavis ate his chocolate bar.

Next Butthead asked Beavis, "Hey Beavis! Can you loan me $2 dollars!?"

Sure enoug Beavis loaned Butthead $2 dollars, and Butthead bought a chocolate bar from Beavis.

This went on and on.

The next day Beavis and Butthead showed up for school, faces covered in chocolate, proudly telling their teacher that each sold all 20 chocolate bars!

The teacher wasn't amused.

The episode of Beavis and Butthead sounds ridiculous. It isn't.

Just substitute Lehman Brothers for the school, and the Lehman brokers for Beavis and Butthead. That's why after 170 years in business Lehman Brothers was liquidated and put out of business.

But it gets worse...

At some point the investment bankers ran out of people to sell these packaged debt securities to. They knew they were screwed. The last person holding the bag in any Ponzi scheme is screwed.

So what did they do?

They invented a new, unregulated financial instrument. They gave it a fancy name. Collateralized Debt Securities. These CDS's were nothing more than insurance policies against the underlying assets of the debt

packages dropping in value. In other words, what the bankers were buying and selling were nothing more than loans, IOUs signed by people like my friend who bought real estate without any income to make the mortgage payments. When the bankers realized they were totally screwed the created insurance policies so they could claim the insurance policy was worth the equivalent of what they lost when somebody defaulted on their mortgage.

Let's backtrack one second...

Why would somebody default on a $340,000 mortgage?

Because the home they bought wasn't really worth $340,000. Three years earlier is sold for $210,000. The person buying a $340,000 only bought it because they believed they could sell it for $400,000 a few months later.

I was in Boca Raton back in 2003 when people were buying the air above empty lots where developers were promising to build condos. They would buy the air for $500,000 and sell the air to the next "investor" for $550,000 a few weeks later.

How much money did they have to put up to buy the air?

Almost nothing.

Banks would put the money up for them.

When the entire scheme began to unravel the banks had as collateral empty air 200 feet about an empty lot.

Now back to the insurance policies, the CDS's.

The investment bankers realized they were totally screwed because even if they foreclosed on the properties the assets were worth pennies on the dollar compared to the loan values they showed on their books. Keep in mind everybody along the chain benefited in higher commissions and fees if the original house was sold for a higher amount of money.

The the investment banks convinced everybody it was a good idea to create these insurance policies. They got AIG, the world's largest insurance company, to underwrite these polices. Why not? AIG made hundreds of millions of dollars just for typing up pieces of paper and giving those policies to the bankers. AIG made billions by legally assuming the risk from this giant pyramid scheme.

Then things blew up. The asset values spiraled down. The banks couldn't loan people money anymore to keep pushing up the price of the empty air. This caused people who owned the empty air to drop their price. When nobody would buy the empty air the developer couldn't pay the loan he took out for the empty lot and for buying the giant billboard that said, "GOLD COAST CONDOMINIUMS - Starting at $400,000"

Everything spiraled downward. In an unprecedented event in the history of the United States of America, the sitting President, George W. Bush called an emergency meeting with the Presidential candidates from each party -Barack Obama and John McCain.

The meeting went something like this.

Bush: "We're totally screwed. Every bank in the world is going to collapse."

McCain and Obama: "um... We don't know much about this stuff, Mr. President. We're career politicians."

Bush: "That's ok. I don't either. That's why we always put our buddies from Goldman Sachs in charge of all this money stuff."

McCain and Obama: "That's a relief. We thought we might have to figure this out. This stuff's abobe our pay grade."

Bush: "Mine too. Just make sure whichever of you two wins... Just do what the guys from Goldman tell you to do."

Obama: "Done."

McCain: "I'm too old for this s..."

That meeting happened a couple weeks after the U.S. Government in an unprecedented took over ownership of AIG with an $83 billion dollar buy in.

While all this was going on the U.S stock market dropped a little bit. Many mutual funds lost well over 50% of their value. The U.S. Government increased it's debt obligation to over $17 trillion dollars. The insurance companies and investment banks survived to live another day, financed by the future earning potential and taxing authority of the U.S. Government.

The global financial system survived to live another day.

So what's the moral of these stories? What's the takeaway?

Risk has three components.

The first is the total amount of risk involved. It's almost always 100%. Don't let financial advisers tell you that volatility is risk. It's not. Always ask yourself how much money would you lose if terrorists launched a coordinated attack against the U.S., London, and Tokyo stock exchanges. What would happen if there were a dirty bombs set of in New York, Washington, D.C., London, and Tokyo the same day?

The risk is always 100%.

The second component of risk is the probability that the loss will happen. It's almost 100% certain that the stocks you own now will drop 10% sometime in the future.

It's also a 100% certainty that the markets will rise in over-priced bubbles and fall in staggering crashes. Why? Because all assets prices reflect human psychology, a shared belief system about the agreed upon value of any asset.

The third component of risk is something investment advisers never talk about directly. In fact, they talk about this only from one point of view -not the equally corresponding negative point of view.

The third element of risk is time.

Investment advisers and mutual fund companies, in fact the entire financial media and financial services industry have one mantra - time is your friend.

They talk about how stocks, over the last 100 or so years, have averaged a 10% return a year.

For this statistic to have any worth at all, it means that to reap the benefit of this "fact" one would have to hold the stocks for 100 years. In statistical terms, they quote one sample size of 100 years to "prove" that stocks are a solid, long-term investment. They cite examples of buy-and-hold value investors like Warren Buffet as who you should model.

I agree, if you had a time machine and could start in the 1950's, it would have turned out good to buy and hold stocks in great companies.

How about if you started this advice in 2000 and bought great companies like Microsoft and Intel?

You're assets would still be worth much less than they were worth 14 years ago, and you would have lost 14 years of your life waiting for these stocks to go up.

If you had young kids in 2000 and you were hoping for that 10% a year return to put them through college, it didn't happen. What happened is tuition prices have gone up 10% a year, but asset prices have not.

So the real risk is more than financial. It's practical.

Are you willing to bet your future quality of life for you and your family based on the belief systems of financial professionals who get paid when you buy what they're selling?

I don't.

Hedge fund managers don't make money when you decide

to invest in their hedge fund. Their goal is to protect your money, and grow it. They keep 20% of the profit they make for you.

This is a significant difference between the risk profile of a hedge fund and a mutual fund. Mutual funds rely on order flow. The entire mutual fund industry is set up on funneling money into their funds. Hedge funds are private, and don't spend billions, or even millions, on marketing.

6. Why doesn't my stockbroker tell or investment advisor tell me about hedge funds?

Great question. Here's the short answer, as told to me by a veteran stock broker.

If he recommends a client buy stock in IBM or Ford, and the stock drops, he's covered. Who can fault him for recommending IBM or Ford?

But if he recommends you invest in a hedge fund, and the hedge fund doesn't perform well, everybody will ridicule him. His clients will ask, "Why in the world did you have me invest in that hedge fund? Are you friends with the fund manager? Everybody else is buying mutual funds. None of my friends invest in hedge funds! Why did I let you talk me into deciding to invest money in a hedge fund!?"

Get the picture.

Because of this, very few stock brokers or investment advisers even talk about hedge funds with their clients. There's no upside. A stockbroker or investment adviser make the same money getting you to invest in "safe" investments. Safe for them, that is. Not necessarily safe for you.

Another reason stock brokers and investment advisers don't tell customers about hedge funds is simple - they don't know about hedge funds, or understand them.

Because very few customers are astute enough to want to

invest in hedge funds, it doesn't pay for a stock broker or investment adviser to learn the ins and outs of the various hedge funds that are available. Plus, most hedge funds do not aggressively market themselves to retail, high net worth investors. Most larger hedge funds rely on institutional investments to build up their Assets under Management (AuM).

That said, there are brokers and investment advisers who do recommend hedge funds to retail investors, but they're not common. If you have a brokerage account with a large firm, or even a large bank, you might want to ask about their private wealth management office. "Wealth Management" seems to be the secret code to get beyond typical investment advice.

What's interesting is that over and over we see the same pattern - the world of hedge fund investing is usually only known to financially successful, wealthy people. One of the reasons is that many hedge funds have both minimum investments and lock-up periods. The average investor usually can't afford the $1 million or even $500,000 minimum investment, and probably doesn't feel comfortable with a 1-year lock-up period. Larger funds have even higher minimum investments.

It's understandable that retail brokers and investment advisers aren't knowledgeable when it comes to hedge fund investing because their average customer isn't the type of person who would invest in hedge funds anyway.

7. Who can start a hedge fund?

Anybody can start a hedge fund. A hedge fund is simply a private investment partnership.

What makes a hedge fund different than other investment vehicles is that the fund manager uses specific exemptions as defined by the Investment Act of 1940 that permit the manager to run the fund in different ways than other publicly traded securities.

What this means is that anybody can start a fund without needing any government registration or licensing until the fund grows to $25 million in total assets under management.

What's interesting about this is that the people who the general public see publicly as investment professionals - stock brokers and investment advisers are licensed to sell securities and give investment advice. But typically hedge fund managers, who make multiples more than brokers and investment advisers, are not licensed.

This doesn't mean hedge funds are not regulated. They are. So are the hedge fund managers. They're just under the same regulations as other investment professionals and companies publicly issuing securities.

The average person that doesn't feel comfortable enough to invest in a hedge fund, let alone start their own hedge fund, might be well advised to keep something in mind. There is no evidence that the most prestigious investment advisers in the world, and the largest mutual fund companies in the world, and the managers who run them, have any proven

advantage over amateur investors.

Take a look at the recent rise of online brokerage companies the Schwab and E*Trade. Look at the incredible success of Vanguard mutual funds in raising assets.

Not long ago, when I started my first hedge fund, the investment world was much different. High commissioned stock brokers were considered investment experts. They gave their clients professional recommendations about the market, and which stocks to buy and sell.

The performance of stock broker's recommendations would look exactly like a bell curve, a normal distribution of results that could have occurred through random chance. In other words, for the most part stock brokers were taking home huge paychecks from commissions while adding little, if any, value.

The stock broker model jumped the shark when brokers began to swarm towards selling people load mutual funds. There are two type of load funds. The first is a front-end load. The load is the stockbroker's commission he gets paid when he sells the fund. Usually the commision/load is 5%.

So when investors buy loaded funds they're immediately starting 5% behind the market.

Let's do the math on this.

If the fund somehow manages to simply stay even with the overall market, the investor will forever be 5% behind for as long as he or she lives. Every acaedemic study has

shown that the efficient market theory is a fairly robust theory. I.e., it is very difficult for a mutual fund manager to outperform the market because at any moment the market's price is a reflection of all the information known about that market.

For a fund manager to beat the market he must have additional information, or he must have a different way to analyze the information that everybody else has.

The stock broker who gets his 5% commission is making even harder for an investor to beat the market. Here's the math.

If you're starting 5% behind the market, and the market goes up 20%, your investment must go up over 25%. Now look at the normal distribution of mutual fund returns. If the market is up 20%, mutual funds that go up 25% are typically about one standard deviation from the norm.

Bottom line is that because fund managers, on average, don't outperform the market, people began to realize they'd have to be idiots to buy load funds.

The next step of the evolution was the popularity of no-load funds. Anybody could buy a no-load fund directly from the mutual fund company without paying a stock broker a commission.

The rise of no-load funds was a perfect example of the market's efficiency when it came to valuing how much stock brokers added to the equation. Stock brokers, because they added almost no value, were eliminated from the process. I lived through the era where stock brokers would pooh-pooh no load funds like they were some

inferior investment.

When that theory proved demonstrably false, the brokers tried to claim that their value lied in keeping you, the amateur investor, from selling your mutual funds at the wrong time.

When I first started trading my broker scolded me, saying that it was impossible to make money moving in and out of the market. I called him up in the summer of 1998 to ask him how his mutual funds were doing. He scoffed at me and said something about how it didn't matter that his funds were down 25%. I told him to look up my account (which I still held with his firm). He saw my account was up something like 40% for the year.

That's a 65% swing. Funny thing was that since he was still the broker of record on my account he was getting residual fees for doing absolutely nothing except giving me bad advice and buying me lunch at the Burger King down the street from my office.

When I told him I was moving all my money from his company he begged me to reconsider. He pleaded with me, from a personal level. He said I was his biggest client. Maybe one of the only client's he had left.

I felt bad for him but that wasn't my problem. I tried to help him by letting him invest his own money in my hedge fund but he refused. He insisted his ideas were better than mine. He was pushing a stock called CMGI. I think at the time it was trading at some crazy price, like 258 a share. Within two years CMGI was trading at $2 a share before going bankrupt.

So if you're reading this right now, and can relate to any part of these stories, you might want to take a step and do just one thing.

Look at your own thoughts about the market and investing, and instead of asking if what you believe is right or wrong, ask a better question.

Ask this: are these thoughts I have about the market and investing stories, or are they facts?

Anything that can be measured mathematically is a fact. Everything else is a story.

EVERY thought about what's going to happen in the future is a story.

You don't need to be an investment "professional" to start a hedge fund. But to be successful at investing you need to be aware of the difference between stories and facts. The most successful traders and fund managers I know make their money because they buy and sell based on facts. What happens in the future does not invalidate the facts on which they based their investment ideas.

Amateurs make an investment choice and if it turns out well, they believe that their stories were actually facts. They weren't. Results in the present moment don't turn yesterday's stories miraculously into facts. Just because a stock goes up doesn't mean the investor is right when he says, "See! I knew that stock was going to go up!"

That's delusional. He didn't know the stock was going to go up, even if it did go up.

What's funny is there is little, if any, difference between most stock brokers and investment advisers when it comes to having this "see, I knew it was going to happen" mentality.

The biggest qualification that anybody needs to be a hedge fund manager is this:

There is no right or wrong. There's only results.

8. How does the hedge fund keep track of my investments?

Let's review the structure of a typical hedge fund.

The hedge fund is typically a private limited partnership. The limited partners are the investors in the fund. The term "limited" refers to their liability for their investment in the fund, and is always limited to their initial investment.

The General Partner, or GP, is the entity that has complete authority and discretion to invest the money within the parameters defined by the Agreement of Limited Partnership.

The GP is responsible for keeping track of everybody's money.

When somebody invests in the hedge fund there money is accounted for in what's called their capital account. Their capital account is simply an accounting entry within the partnership. It's important to note that the capital account is measured in terms of a percentage within the overall fund. If a fund has $99 million in assets, and an investor puts in a $1 million investment, his capital account will be 1%. The value of the capital account would be worth $1 million.

This is an important distinction for a few reasons, one of which is how ownership of shares of a fund protects the investor in some situation from creditors.

Here's why.

If an investor in a fund is sued, for example in a divorce, the court can order that the shares of the partnership be transferred from one party to the other. But the partner receiving the shares still must abide by the terms of the partnership agreement that the original investor signed.

Most hedge funds have lock-up periods. The partnership agreement defines the terms by which the hedge fund manager and the limited partners abide. Often funds can be set up to give the fund manager discretion over when he will distribute funds to the shareholders.

Here's why this is important!

If you own shares in a limited partnership, while you can still be sued, the person doing the suing will know that being awarded a judgment in the shares does not mean that they'll receive the money -ever. What they will still receive is a K-1 tax allocation at the end of the year for income made by their investment even if they can't take out money to pay the tax bill.

More importantly, the party who is contemplating a lawsuit will undoubtedly have lawyers. The lawyers will see the structure of the investment is a private limited partnership and do one thing - they'll immediately begin to evaluate whether their client will ever see the money from the fund to pay their legal fees.

Think this is far-fetched?

It's not.

It's the exact structure I had set up with another fund

manager when I went through my divorce. Without going into details, the lawyers were desperately trying to get cash out of the hedge fund investments so that they could have their own legal fees paid.

They failed.

The case was settled amicably with me representing myself in court, my kids' mom getting 100% of the cash from the hedge fund investment, and the lawyers and accountants getting roughly 10% of the exorbitant legal fees that they had charged my kids' mom. The lawyers decided to walk away for two reasons -one, they couldn't get the cash, only the shares in the limited partenrship, and two, I sued them for abuse of process for lying about me not turning over 50,000 pages of discovery documents which they had hidden in a closet in their offices.

If you're wealthy, somebody's eventually going to sue you, or consider suing you. If your funds are held in shares of a limited partnership they will be stopped dead in their tracks. Their lawyers understand that hedge funds and the limited partner structure was created to protect the great wealth of the most elite members of society who were still millionaires after the depression.

Back to how your money is accounted for in the hedge fund...

Everybody in the fund, including the General Partner, has a capital account. Typically the capital accounts are recalculated on a monthly basis. This means that if add money during a given month, or withdraw money during a given month, those transactions will not go into effect until the beginning of the next accounting period. This prevents

shady dealings like allowing people to invest or withdraw money in a fund halfway through the month when they already have a good idea if a fund is up or down for the month.

I had one client actually try to do this. She insisted that she be allowed to withdraw money in the middle of the month. I told her repeatedly that if she did this, the accounting wouldn't be reflected until the beginning of the next month. She had a tantrum and threatened to sue me.

I sent her a letter insisting that to get her money, she had to acknowledge that I was giving her the money based on the prior month's value of the account. She signed the agreement and I sent her all of her money.

That month my fund made 4%. Of course this "friend" of mine was livid. She insisted I reimburse her an additional 4% of the money she would have made if she had stayed in the fund the entire month. She claimed that it was all my fault, that I knew we were going to make money, and that somehow I misled her.

I told her to read all the emails that went back and forth, and to look at the document she signed agreeing to the account value at the end of the previous month.

She still argued. Some people are just irrationally greedy. Her husband finally called me to apologize, and thanked me for making him so much money the year before.

At the end of the calendar year the fund issues K-1 forms to all the limited partners. The K-1 forms also get sent to the IRS. The limited partners are responsible for their own

taxes. Each limited partner is allocated profits and losses based entirely on their percent ownership of the fund on a month per month basis. These profits and losses are kept track of my the fund administrator. The fund administrator is just a fancy name for the CPA the GP hires to do all the accounting and produce monthly or quarterly accounting statements for all the investors.

Each year the GP hires an independent auditing firm to audit all the accounting records of the partnership. This audit is very thorough. Every trade is reviewed and reconciled. Once the audit is complete the investors can be sure that every penny of their money was accounted for accurately.

Contrary to popular opinion, and fueled by a few stories of outright fraud, hedge fund accounting is scrutinized to the last penny. Every penny is accounted for because the fund magaer gets paid based on the profits he makes for his investors. He's not going to leave anything to chance. The fund manager also has dozens of sophisticated investors that he or she must answer to. There's no upside in being part of any accounting shenanigans because everything is documented by banks, clearing companies, and brokerage companies.

The most famous case of hedge fund fraud was Bernie Madoff. He ran his scam because he was so big and had so much money that he created his own fake brokerage companies, his own auditing company, and his own clearing company so that he could manufacture totally fabricated accounting records.

And I'm sure there's other cases of hedge fund managers outright stealing money and defrauding investors.

There's also no shortage of stories about brokers, investment advisers, and CTAs defrauding investors.

In fact, my first experience in the investing world came by watching what happened to my dad. You have to understand, my dad was an entrepreneur. He started by selling this thing called a "Big Ear." The Big Ear was a parabolic microphone like you see on the sidelines of sporting events to pick up the sounds of the game. He made a lot of money putting ads in the National Enquirer. Only problem was he couldn't keep up with the orders and got overwhelmed with paperwork.

My dad almost hit it big with several other businesses, always falling just short.

Then he hit it big. Or at least he thought he hit it big.

He dabbled in investing. For some reason he decided to start buying silver in the commodities market. Next thing you know, silver started moving up. I remember stopping in at his broker's office every couple of days to check on the value of his account.

For some reason my dad decided to keep reinvesting the profits he was making. He was pyramiding up like the most seasoned professional traders do. Most amateurs do the opposite. They average down, trying to increase their bet size while decreasing the average price they paid per share.

Not my dad, not this time.

Every time silver moved up, he bought more shares.

Turns out two other guys were doing the same thing. They were simply known as the Hunt brothers. The Hunt brothers cornered the silver market. They drove the price up to incredible levels.

My dad's initial tiny $50,000 account kept growing. At the peak he was worth millions.

On paper.

Then we went to see his broker.

The broker wasn't in his office. The manager of this large, reputable firm said he left for Mexico.

Turns out the broker stole my dad's entire account.

How?

Simple.

He transferred the shares into his own account, sold them, and transferred the cash into a bank account in Bermuda.

Not good.

My dad's one victory in the investing world turned into a total loss.

He hired the top lawyer in Pittsburgh to sue the brokerage company. My dad was suing for millions of dollars in profits that were in his account.

At the end of a three year legal battle the brokerage

company had to give my dad back his initial $50,000 deposit into his account. My dad's lawyers got $15,000 right off the top. He had already paid them $25,000 up front to retain them, plus additional fees for legal services in addition to the retainer.

After three years my dad lost his entire $50,000 investment. The money he got from the brokerage company went to the lawyers.

That's why I say that the risk is always 100%, even when dealing with huge brokerage companies and financial firms.

Managing your own money is the same as running your own business. That's why some people call it running money. You have to have checks and balances, systems in place to protect your money.

Hedge funds are just like any other financial institution. They are required to account for your money just like a bank or brokerage company. Some managers took advantage of their investors' trust and stole money.

That happens in any industry. When it happens with hedge funds it's a big story because of the amount of money involved. In the past, the hedge funds weren't required to be as transparent as they are now.

That's why the U.S. government has changed it approached to how hedge funds are regulated. The entire regulatory approach now is to make the accounting of hedge funds transparent.

The accounting principles for hedge funds haven't

changed. They are still the same as with any pooled investment account like mutual funds or public companies.

It's not complicated in any of these investments. Money is pooled into a business account, and accountants keep track of everybody's investments, whether the investments are held as shares of a mutual fund, shares of a public company, or shares of a hedge fund.

9. Who regulates hedge funds?

There's a complete misconception that hedge funds aren't regulated.

Nothing could be further from the truth.

And who's not telling the truth when they say hedge funds aren't regulated?

Financial service companies and other investment professionals who are selling financial products to wealthy investors.

Why do they mislead people to not understand that hedge funds are regulated?

I don't know. You'd have to ask them.

I started my first fund in 1997. I can assure you that hedge funds are regulated.

In 2001 I was subpoenaed to testify in a case brought by the U.S. Securities and Exchange Commission. There case was against a registered broker dealer, a mutual fund company, a clearing company, and a hedge fund manager.

The attorneys for the SEC had no sense of humor. I flew to from Pittsburgh to Philadelphia for the deposition. My $1200 and hour securities lawyer took a 5:45 am train from New York to Philadelphia.

We met at the SEC offices in downtown Philadelphia. I sat across a long conference table beside my lawyer who was

still wiping crumbs from his bagel and cream cheese off his face when we got started.

Across the table were three attorneys from the SEC. Each had one of those briefcases full of papers that have a handle that pops up like a piece of carry-on luggage. The lawyer on the far left across from me looked like Kelsey Grammer's brother on the show Frasier. Short blonde-hair, tortoise shell glasses, very meticulous in his appearance and speaking.

The lawyer directly across from me was super cool. He was in his late forties, and had been around the block a few times. He reminded me of the guy who played the main detective in The Wolf of Wall St. He's probably working as the Chief Compliance Officer for a billion dollar hedge fund now.

The lawyer to the right was the polar opposite of the lawyer on the far left. She was an unkempt woman in her mid-thirties. Rough around the edges would be a kind way to describe her. Her frizzy brown hair looked like it gets brushed once a day. She had on a blue blazer that looked like she wears it at least 5 or 6 times before she gets it pressed.

The meeting started not with warm and fuzzy hellos, but with a bang.

My lawyer started by asking, "By what authority did you subpoena my client. Is he under investigation? He's not named in any of the complaints your investigating."

The meticulous SEC lawyer on the left answered quickly.

"Your client operates a private investment partnership, commonly known as a hedge fund. As manager of this fund he is under the regulatory authority of the Securities and Exchange Commission of the United States Government."

Whoa...

Nice start.

The cool lawyer in the middle defused the tension and was very cordial. I was thinking "Good cop, bad cop," strategy. The cool guy in the middle said, "As you know were investigating other entities, including mutual fund companies, broker dealers, clearing companies and a hedge fund. Your client may have information about these companies that could be useful in our investigation."

As he was saying this the woman on the right began stacking large piles of papers on the table that she had lugged all the way from Washington, D.C. for our little chat.

The lawyer on the left interrupted again. I'm not sure if he was trying to impress us, impress the other lawyers, impress himself, or if he was just plain dumb.

He said, "As you know, the SEC investigates civil matters. But you should know we're working closely with the Attorney General's office."

That's all my lawyer needed to hear. The SEC had just brought up the specter of this case being a criminal case. If there's any threat of even a possible criminal case ordinary citizens are protected by the U.S. Constitution.

That, and my lawyer didn't want to spend the day in Philadelphia. He was supposed to take his wife out to dinner that night and he had to be back on the train the New York by 3:00 pm.

The cool lawyer in the middle looked over at his colleague like he wanted to slap the back of his head. My lawyer pulled me aside and whispered something in my ear.

I asked him to repeat it, then he whispered it again. My lawyer told the three attorneys from the SEC that he had just advised me to assert my 5th Amendment privilege.

Yes, the was a surrealistic moment in my life. I was kind of annoyed that I had to go to Philadelphia for this meeting. They have an office in Pittsburgh. But I had nothing to hide. Like I said before, in the financial industry everything is documented by both sides of every transaction. There isn't another industry that I know of where everything is documented and accounted for in so much detail. There's no way to ever spin the facts. The facts are in black and white everywhere.

The cool lawyer in the middle asked me to state my name. I did. He asked me on the record if it was my intention to take the 5th.

I replied, "Based on the advice of my attorney I am going to assert my 5th Amendment privilege as granted by the Constitution of the United States of America.

On one hand it was kind of cool, like being in a movie. On the other hand it was scary. I was afraid they were going to take me away and arrest me for not talking to them. My

attorney assured me they wouldn't do that. I wasn't so sure.

The lawyers looked at each other and had no idea what to do. The overzealous blonde guy kept quiet for the most part after that. They had all just taken trains to be in Philadelphia and now they were going to have to go back and report to their supervisor that they totally screwed up.

My lawyer saved them.

He suggested something I've never heard of. He suggested we do an attorney's proffer.

What this means is that the SEC would ask me questions. My lawyer would answer based on his best understanding of the situation. If he didn't know the answer I would whisper something in his ear. Nothing would be on an official record. For all the SEC attorneys knew I was whispering my grocery list into my attorney's ear.

Everything went smoothly after that. The lawyers asked their questions and got their answers, which were already in the documents in their possession. They completed their investigation which they were entitled to conduct because the SEC has regulatory over the entire financial world in the U.S.

Every country in the world has a similar body within their governments to regulate anything to do with the financial industry. Every country has reciprocity arrangements with each other, except for maybe Isreal and Iran, North Korea and South Korea, and the Vatican City. I don't know about those countries.

The take away?

Yes, hedge funds are regulated by the Securities and Exchange Commission of the United States of America.

10. Why do hedge funds always get bad press?

Great question.

Like anything else in the world, it might be useful to follow the money.

Before we talk about hedge funds, let's talk about Hollywood actors. It's a useful comparison that we can relate to hedge funds.

When was the last time you saw a story about how a celebrity's son graduated from high school? Or when a famous actress had a nice, uneventful date with with a real estate attorney?

Never?

So let's follow the money. I just left the grocery store. There were 5 magazines at the checkout line. All five had pictures of either Justin Bieber, Lindsey Lohan, or Miley Cyrus on the covers. All of the stories were about their problems. A woman in front of me in line spent 3 or 4 minutes looking at the magazine before she put it down and paid for her groceries.

Stop there for a second.

Business loves metrics. Accountants can measure sales and expenses. But how do you measure time people in line at stores spend looking at the ads in tabloids?

I'm sure the magazine companies know this down to the

second. The bottom line is the advertisers in these magazines can measure sales. They compare the lifetime value of a customer with the cost of acquiring the customer through advertising. If magazines don't put enough money in their pockets they won't pay as much for the ads.

So do you think the woman in line in front of me at Vonn's would have picked up the magazine to read about how Sigourney Weaver had a quiet evening at home last night after going to yoga class and stopping to have coffee with her sister?

Probably not.

People in line at the grocery store, the masses of statistically average people who make up 80% of the population under the bell curve, will not make as much money in their lifetimes as justin Bieber made by the time he was 21. That's a fact.

The paradox is that on one hand the people who buy magazines would love to strive to be as successful as their idols. But there's part of them that thinks it's impossible. That they don't have some magic, missing ingredient that successful people have. That's why people love looking at the lives of fallen idols. They're not sadists. They don't enjoy the misery of others. They enjoy seeing that those people who have become so successful are really just like they are. That's why the public is always so quick to forgive fallen idols who apologize and repent.

Hedge fund managers are the rock stars of the investment world. Even inside the highest levels of the investment community, fund managers hold a special status. They're like the A-list celebrities walking the red carpet at a movie

premier. Hedge fund managers are the royalty of the financial world.

There are a handful of major financial publications that people read. The Wall St. Journal. Financial Times. Barron's. Those are just a few. There are also dozens of financial websites and television shows. We'll refer to these all under the umbrella called the financial media.

So let's follow the money.

The entire financial media depends on advertising dollars to survive. That's a fact. They don't sell anything else except subscriptions to their publications and advertising space.

The internet has practically destroyed their subscription model. All the information in the world is available for free online. And if it's not available immediately for free, all you need is one friend to share his copy of a newsletter and you income is cut in half.

I have a lot of very successful, very wealthy friends. A lot of them are as cheap as hell. Maybe cheap isn't the right word. Maybe smart is the right word. We share a mutual friend who publishes a $100 newsletter. One of my millionaire friends subscribes to it. As soon as she gets the PDF in her email she immediately forwards it to a group email where all my other friends download the $100 newsletter for free.

So needless to say the financial media is on thin ice. They're not going to survive selling subscriptions. The only way they'll survive is selling advertising.

But who is going to buy advertising in publications and on web sites that appeal to masses of investors, not just the elite?

There's only one answer - financial service companies that are large enough to afford to buy mass advertising and have products they can monetize to the masses.

That would be companies that sell mutual funds.

The last data I saw was mutual fund companies spend $10 billion a year on advertising. Hedge funds spend $0 a year on advertising.

So do you think the financial media, whose entire customer base (when I say customers I mean people that pay them money) is mutual fund advertisers, are going to run stories about successful hedge fund managers?

Of course not.

First of all, the market that consumes the information in the financial media is never going to dream of investing in a hedge fund. It's out of their league.

Second, their like the lady in front of me at the grocery store, they are drawn to stories about their fallen gods -the hedge fund managers.

Remember when the Bernie Madoff story was in the headlines every day? Bernie Madoff was a hedge fund manager who stole a couple billion dollars from his clients. It was a huge deal in the financial media.

Know what what was going on at the exact same time the Madoff story was on the front page every day? Thousands of small banks around the U.S. went under. Thousands of mutual funds lost over 50% of their value.

What do you think the financial media wanted to focus on?

Bernie Madoff and the evil hedge fund industry. There were dozens of stories implying it was the hedge fund managers who caused the financial meltdown in 2008.

It wasn't.

It was average people who couldn't afford to pay back the money they borrowed from banks. Of course the financial media couldn't blame their own readers for causing the meltdown. They blamed banks for being the perpetrators of "predatory lending."

Truth is it was an orgy of excess, an entire industry of inexperienced, not very astute financial wizards turning over homes and paper, making thousands of dollars with each transaction. Mortgage brokers were the new used car salesmen. Home buyers were like gamblers betting on the "sure bet" that real estate will always go up in value.

Back-track to the Holland Tulip bubble... Everybody was buying tulips at exorbitant prices because they could turn them over to the next fool in line. Same thing with the tech stock bubble of the late 90's. Same thing with the real estate dabacle of 2008.

The only difference was that in 2008 the banks were left holding the bag because the dumbasses were greedy and stupid. If not for the U.S government bailing everybody

out the entire credit economy would have come to a stop.

It almost did.

It had to be somebody's fault. The financial media had to report on the 2008 crash like it was The Titanic hitting an unforseen iceberg in the North Atlantic.

It wasn't.

Everybody at the highest levels in the investment banking world knew it was coming. It was inevitable.

Hedge fund managers, like Paul Tudor Jones, positioned themselves to make money when the real estate credit market began to domino downward. I have one friend, a 23-year old stock trader, who made $20 million in the fall of 2008.

But what about the millions of people who watched their mutual fund investments get devastated by this "unforeseen" crash? The financial media never tells the public it's a bad time to be in the market. That's because the financial media gets $10 billion a year from advertisers who sell mutual funds. Mutual funds, which are nothing more than owning shares of stock in publicly traded companies, are now commonly referred to as "saving."

"Save for Retirement by Investing in the Market Will Always Go Up Fund."

Buying stocks is not a savings account. It's owning equity shares of companies with the perspective that at some point somebody else will come along and buy that equity from you. What mutual fund companies don't market is

the fact that the value of your shares in the future is 100% dependent on other people having the money to buy those shares from you.

It was the same with the real estate bubble, the tech bubble, the Holland Tulip bubble, the South Seas Trading Company bubble, the Japanese stock market bubble, and every other market bubble in the history of the world.

The people making money selling the investments now are selling a vision of the investments being worth more later. Much later.

By the time you're ready to retire, if your stock "savings" account is worth 50% less than it's worth now, is it going to make you feel better if your investment adviser or broker says, "Sorry... I really believed the market was going to keep going up 10% a year like my manager told me"?

Of course not.

The entire financial media, funded by the financial services firms, has one core belief:

The future will equal the past.

It won't. It never has.

11. What's the hidden risk of being in a hedge fund?

Back in 2008 the Bernie Madoff scandal was big news. Bernie Madoff stole billions of dollars from investors.

Here's how...

He owned or controlled all the financial institutions involved with running his own fund. He totally faked the records and showed he had assets in accounts when in fact he used the money for his own personal benefit.

He was caught and sentenced to prison. The investors didn't get their money back.

Since then there have been many changes in the hedge fund industry to make it much more difficult for fund managers to steal money.

The reality is that if somebody wants to steal money they'll find a way to do it. Embezzlement has been a crime since the beginning of time.

That said, modern technology has made it much more unlikely that money will be stolen. And if it is stolen, it's almost instantly traceable.

Here's how hedge funds typically handle money.

First, there is an fund administrator who does all the accounting for the fund. The accounting is audited by a different, independent 3rd party accounting firm. The

fund administrator does all the monthly statement for the hedge fund, and the auditor does a compete audit of all the funds' transactions. It would be almost impossible to pull any funny business unless there was some sort of collusion or conspiracy between individuals at the auditing firm and the fund manager. Even then, the accounting firms that do the auditing have their own systems of checks and balances that would make any wrongdoing incredibly difficult to hide.

The actual monies going into and out of a hedge fund are all run through a dual-authorization custodial bank account. Investors deposit money into the custodial bank account. The bank has a secure online system that requires 2-pin numbers to transfer money out -one is controlled by the fund manager and the other by the bank's custodian on the account. This ensures money being moved between financial institutions always goes into the accounts in the name of the fund, not into the fund manager's personal account, or some fake 3rd party account.

All the anti-terrorism and money laundering laws have been significantly tightened. Outright stealing or embezzlement is almost impossible now.

But like I said, fund managers are smart. If they want to steal money they can figure out how to do it. It would have to be an elaborate scheme, and they would know they would be caught fairly quickly. And they know that the Federal and State penalties are substantial, as well as their authority and ability to almost instantly seize back any money that was taken.

The other "hidden" risk in hedge funds is that the fund manager doesn't follow his own described investment

strategy. I've seen a lot of guys claim to have market neutral, long/short funds, who then go almost long only when the market starts going up strongly. This is one step beneath outright defrauding investors. Why? Because the most important part of creating an investment portfolio is managing risk. If fund managers misled investors about the actual risk the investors might as well be invested in mutual funds.

Another "hidden" risk is when fund managers take big bets on market direction, knowing they have huge upside using other people's money. I know fund managers who launched multiple funds and leveraged them at very high levels. The funds held inversely correlated assets. They were sure one fund would be hugely successful, and the other fund would be equally unsuccessful. If you had money in the unsuccessful fund you lost out. The fund manager basically used other people's money to guarantee building a successful track record in one of his funds while knowing the other fund would be closed.

That said, mutual fund companies entire investment business is run the same way. Mutual fund companies will seed a number of funds to be launched. They'll wait 3 years and then publicly advertise the track records of the successful funds while quietly closing down the funds that lost money.

Another risk of investing in hedge funds that not so hidden is the lack of liquidity compared to bank accounts and mutual funds. Typically hedge funds will have a one-year or more lock up period. But this is never hidden. It's made clear before you decide to invest in a hedge fund that there will be a lock up period. This protects the fund manager (and other partners in the fund) from the fund manager

having to liquidate positions at inopportune times. In other words, investors can't typically "time" their investments in and out of hedge funds.

Another hidden risk with hedge funds is a legal risk. Because hedge funds are private partnerships it's possible that somebody will sue the fund manager or the partnership. If the fund manager gets sued it's possible, but not likely, that the funds' assets will be frozen by a court order.

I know this because this is exactly what happened when I got divorced. A judge in Allegheny County was told by my ex-wfe's legal counsel that the money in my hedge fund was my personal money. He lied. It didn't matter. The judge erred on the side of making sure the assets weren't dissipated and issued a court order freezing the assets. The investors in my fund who wanted to redeem shares were forced to hire a lawyer and file a motion to get their money out of the fund, which the judge quickly granted.

The end of the story is that I sued my ex-wife's law firm for abuse of process. Once I filed suit against them they agreed that all the money in the fund was not my personal money and the freeze on the accounts was lifted.

A similar type of risk is what happens if a fund manager is physically incapacitated or dies. There are specific contingencies written into the partnership agreement that deal with this situation. What happens is that investors may go through a short period of time (usually less than 30 days) when they have to wait for their monies to be redeemed from the fund.

Another "hidden" risk with hedge funds or any financial

investment is that the financial institutions where assets are held go bankrupt. Of course this is the hidden risk with mutual funds and banks as well. This is what happened in 1998 and 2008.

Here's why this is problematic, and how the risk has been mitigated. If an institution holds any financial instrument they have to account for the value of that financial instrument on their books. When things like stocks and bonds are publicly traded, the financial institution is required to value the assets based on mark-to-market rules. What this means is that a multi-billion dollar company's book value is entirely based on the last executed trade of their stock, even if it was only 1 share traded between two people.

During a market crash what happens is people stop buying. When people stop buying sellers who really are eager to sell drop their asking price. If buyers still don't want to buy at the lower price, sellers will drop their asking price even more. As the asking price drops, more and more automatic sell stops will be trigger, increasing the supply of stock being offered for sale and dropping the price even more.

This is what happened in the "2010 flash crash" when, on May 6, 2010 at 2:45 pm the market dropped 10% in a matter of minutes. The 1,019 point drop was the second biggest intra-day point drop in the history of the Dow Jones Industrial average. Dow Jones 30 stocks traded at on penny.

There were Congressional hearings about this event. The end result was that there are now "circuit breakers" that halt trading if an S&P 500 stock rises or drops more than

10% in 5 minutes.

The point of all this is that financial institutions like banks and brokerage firms have very specific lending ratios that must be followed. In other words, they can only lend a certain amount of money based on the value of the underlying assets the hold. If they hold assets that crash in value the entire institution is threatened. They would be required to stop lending money and call in outstanding loans.

Any institutions who had accounts with any of these firms would be at risk of having their liquidity vanish. It would be like dominos falling on one institution to another. This is exactly what happened in 2008. All financial institutions would be affected, not just hedge funds.

The advantage hedge funds have is like the name implies, they are able to be hedged against catastrophic market turns.

Currency risk is another "hidden" risk of owning any financial instrument, or even real estate. If your investment is held strictly in dollars, and the dollar is devalued against other currencies, you will lose buying power even if the total on you brokerage statement stays the same. Again, this isn't unique to hedge funds. In fact, hedge funds are typically more flexible and the fund managers are astute enough to mitigate currency risks by hedging their positions.

Finally, one of the biggest "hidden" risks with any investment is opportunity costs. If you're invested in something that drops in value, or even breaks even over a 10 or 20 year period that's 10 or 20 years you could have

been making money in another investment. The same is true for even a 2 or 3 year period.

There's also one more hidden risk in investing in hedge funds that I almost forgot about. It's the risk of being stressed out if you're the type of person who stresses out over not knowing exactly what the fund manager is doing every day with your money. Chances are if you're this type of person the last thing you would want to do is decide to invest money in a hedge fund because I can assure you the fund manager probably isn't going to tell you how the fund is doing every day.

When I started my first fund I didn't know any better and actually did give my investors daily updates. I had no problem with that because I calculated the net profit and loss every day and posted it on my website.

What I didn't anticipate was that some people would become so obsessive about knowing how much their account value went up and down every day. Some people started calling me in the middle of the day to ask how we were doing intraday. They would get stressed out if I skipped posting the update one the website for even one day.

I eventually just sent these people all of their money back to them.

12. What's an accredited investor and why do I need to know this?

This is easy. An accredited investor is defined specifically by the Securities and Exchange Commission of the United States of America as follows:

"An accredited investor, in the context of a natural person, includes anyone who: earned income that exceeded $200,000 (or $300,000 together with a spouse) in each of the prior two years, and reasonably expects the same for the current year, OR has a net worth over $1 million, either alone or together with a spouse (excluding the value of the person's primary residence).

On the income test, the person must satisfy the thresholds for the three years consistently either alone or with a spouse, and cannot, for example, satisfy one year based on individual income and the next two years based on joint income with a spouse.

The only exception is if a person is married within this period, in which case the person may satisfy the threshold on the basis of joint income for the years during which the person was married and on the basis of individual income for the other years.

In addition, entities such as banks, partnerships, corporations, nonprofits and trusts may be accredited investors.

Of the entities that would be considered accredited investors and depending on your circumstances, the following may be relevant to you: any trust, with total

assets in excess of $5 million, not formed to specifically purchase the subject securities, whose purchase is directed by a sophisticated person, or any entity in which all of the equity owners are accredited investors.

In this context, a sophisticated person means the person must have, or the company or private fund offering the securities reasonably believes that this person has, sufficient knowledge and experience in financial and business matters to evaluate the merits and risks of the prospective investment.

How do I calculate my net worth?

To qualify as an accredited investor under the net worth test, you must have a net worth that exceeds $1 million, either alone or with a spouse. If calculating joint net worth with a spouse, it is not necessary that property be held jointly.

Calculating net worth involves adding up all your assets and subtracting all your liabilities. The resulting sum is your net worth. The value of your primary residence is not included in your net worth calculation.

In addition, any mortgage or other loan on the residence does not count as a liability up to the fair market value of the residence. If the loan is for more than the fair market value of the residence (i.e., if your mortgage is underwater), then the loan amount that is over the fair market value counts as a liability under the net worth test.

Further, any increase in the loan amount in the 60 days prior to your purchase of the securities (even if the loan

amount does not exceed the value of the residence) will count as a liability as well. The reason for this is to prevent net worth from being artificially inflated through converting home equity into cash or other assets."

The reason this definition is important depends on who you are, and which side of the transaction you're on.

If you're a hedge fund manager you are regulated by the SEC and the Investment Act of 1940 and the 1933 Act. These acts spelled out how securities could be offered to the public.

The Acts included what's known as the article 506 exemption which described the terms by which you could raise money for your investment pool without having to register your company with the U.S. government. The terms were this:

You could only have a total of 99 partners in your fund.

Of these partners at most only 35 could be non-accredited investors. A non-accredited investor is simply somebody who exactly what it says -not an accredited investor.

So basically what the U.S. government did was pass a law that allowed the richest, most successful investment bankers in the world to continue unimpeded. They could raise money from their circles of friends and acquaintances. What they didn't have to do was register with the Feds.

Sweet deal, right?

What they also didn't have to worry about was bad press. By prohibiting the public advertising of their investment pools, limiting the investment pools to people they knew, and making it so their primary source of funds were millionaires, they were creating a divide between people in the know, and the general public.

The general public would be encouraged to funnel their money into the stock market, providing the much needed capital to get the U.S. economy out of the Great Depression. The rich investment banks would sell the IPO's and help their buddies who owned companies get money and take a piece of the action.

The richest of the rich would pool their monies together, leverage their influence and financial power, and build business empires.

It worked.

The U.S. stock market skyrocketed in the next 20 years. Rich people got even richer. The general public was not being fleeced by unscrupulous stock promoters because now anything to do with the general public was highly regulated. The politicians looked liked heros. Franklin Delano Roosevelt was so popular he was elected President four times and the Constitution had to be amended just because of him.

He broke the game.

He protected his super rich friends and protected the general public from being totally taken advantage of by his super rich friends.

Of course this all was accomplished by creating the world's largest pyramid scheme, funding the entire economic expansion from money printed by the Federal Reserve with only the taxing power of future tax payers (me and you) to pay for it all.

This is where the accredited investors were protected again.

The private investment partnerships were free to invest their money any way they thought would protect their interests. This included betting against the U.S. economy and stock market if they thought that would make them money. It also enabled them to hedge their stock positions by buying put options and selling short stocks.

Selling short is a brilliant idea.

Companies issue shares of stock. They allow people to borrow those shares of stock and immediately sell the shares to somebody else. When they sell the shares they get to keep the money. They only have to pay back the company from whom they borrowed the stock in shares of stock.

This means if the price of the stock drops, the person who sold the borrowed stock can buy it back at a lower price and re-pay the company owner who loaned him the stock.

This allowed private investment partnerships to hedge their long positions in the stock market by being short certain stocks. It was also great because to borrow a stock the investor only had to put up a small amount of collateral.

Keep in mind that the idea of shorting stocks was freely available to private partnerships of accredited investors.

Mutual funds were sold to the general public as a way of investing in the future of America. Mutual funds are under different regulations that typically prevent them from hedging by selling stocks short.

The general public poured money into the stock market, mutual funds grew to gigantic billion dollar pools of money invested in the stock market, rich people didn't have to worry about losing money in the markets because they could be hedged against market downturns, and everybody was happy.

Until they weren't.

In 1963 President John F. Kennedy was shot in Dallas. It was his father, Joseph Kennedy, who was appointed 30 years earlier as the first head of the Security and Exchange Commission back in 1933 when the SEC was created.

I'm not going to speculate on the conspiracy theories involving the assassination. What I will say is that whenever you look at anything, follow the money.

Kennedy's assassination triggered the start of a major economic downturn and stagnation in the U.S. stock market. Eventually, 10 years later President Richard Nixon made it illegal for U.S. citizens to own physical gold.

What made the recovery possible in 1933 was the United States going off the gold standard and going to a fiat money system. Money from nothing but the Federal Reserve creating it. In 1973, 40 years later, the process was

complete.

But that didn't work. Nixon resigned over the Watergate scandal and was immediately given a Presidential pardon by his hand-picked successor, Gerald Ford. Ford replaced billionaire Nelson Rockefeller as Vice-President just before Nixon resigned. Rockefeller didn't want to be President, he was already rich. Owning a president is less expensive than being president. That takes work.

Next Jimmy Carter was elected and he inherited a system in which the U.S. dollar was engineered to drop in value. This was reflected by inflation skyrocketing. Interest rates were somewhere near 20%.

By 1980 Ronald Reagan became President. In 1983 the stock market was at the same level it was in 1963. That plan to save for retirement by investing in the stock market didn't really work out for people who were hoping for 10% returns a year every year.

1983 was the same year the Apple Computer developed the first Mac. IBM had already partnered with Microsoft to create mass produced personal computers.

The U.S. government under Reagan deregulated and lowered tax rates. Interest rates were lower. This, along with the boom in venture cap money going into start-up tech companies led to economic prosperity. Cheap money usually leads to a boom in the economy.

Bill Clinton took over in 1992. The tech implementation in corporate America reached a peak. Every company in the world installed computer systems, hardware, and software. Nobody in the world heard about the internet

back in 1992 when Clinton took office. By 2000 when he left office everybody was using the internet. Everybody had cell phones.

During the Clinton years money was incredibly easy to get for anything. Interest rates were low. Banks had to keep making money by making loans to anybody who could sign their names on an loan agreement. They didn't care if those people could pay the money back because the banks just turned around and sold the paper to another bank. The investment banks packaged these loans and sold the entire package as an investment.

Nobody cared about the underlying problem with all this - the asset values to secure the loans were inflated. A $500,000 loan for a cube of air 200 feet above an empty lot in Florida isn't really worth $500,000 unless you can sell it to somebody else who's willing to pay $500,000.

It was the Holland Tulip Bulb bubble of 1643 all over again, except now the investment bankers were left holding the bag with trillions of dollars of assets on their books that were not really worth trillions of dollars.

The entire house of cards collapsed because banks could loan money. Their capital requirements to loan money didn't drop, but the value of their assets on the books did -considerably.

The U.S. government once again stepped in and used the taxes our kids will be paying to save the entire system -for now.

In the meantime, the hedge fund managers, the accredited investors, not only didn't care much if the economy

crumbled, they actually made a huge amount of money by being invested in financial instruments that bet against the housing industry, the banking industry, and probably even their own banks.

They have to be idiots not to hedge against the value of the stock they owned in their own companies dropping. They've been paid in stock shares an stock options for years. There are no shortage of offshore hedge funds that have no transparency that went up in value when the U.S. market crashed.

You don't have to be Einstein to figure out that the smartest investment bankers in the world knew the financial situation in their own companies and protected themselves from the fallout.

There's a saying on Wall St. that you can tell the state of the economy by looking at the yachts in the harbor. When the market is going great the stock brokers have their own boats. When you look out in the harbor and see that the stock brokers sold their boats, you know the economy is bad.

You know who never sells their yachts?

The investment bankers and hedge fund managers, or the accredited investors who get the benefit of being invested in their funds.

I think you can figure out who's going to get hosed the next time the economy gets crushed -which it will.

There's still $700 trillion in collateralized debt securities listed as assets on the books of corporations.

13. What's a non-accredited investor and why is this important?

Chances are your 80-year old aunt Bernice might be a non-accredited investor.

Why is this important?

Because there are sales professionals in the investment industry who would sell your 80-year old aunt Bernice annuities, insurance, and mutual funds that would pay them the highest commissions possible, or sell policies from a financial company that's offering a trip to Hawaii as an incentive bonus this month for selling the most life insurance policies.

How do I know?

Back in 1996, the year before I opened my first hedge fund, I was helping my grandparents with their estate planning. My grandparents were 82 and 79 at the time.

A few years earlier they were working with a stock broker from Paine-Webber. The guy sold them annuities where he made $80,000 commission. The annuities did nothing for my grandparents except screw up their estate planning because he made my father an annuitant and beneficiary on one of the annuities.

Why?

Because the annuity company had a policy that they couldn't sell an annuity to somebody over 80. My grandmother was only 79 so hers went through the

compliance department of the insurance company that wrote the policy. My grandfather's was a problem because he was over 80 years old. So the broker simply committed fraud. He listed my father as a beneficiary and annuitant. What this meant was that the policy would not pay out until my father died, at which point he would have a difficult time having funds paid to him as a beneficiary.

Of course the broker would have already spent his $80,000 commission check on his kid's college tuition.

Not cool.

In my personal experience, I would estimate that ratio of NOT cool brokers, insurance salesman, and registered investment advisors to good ones is about 10:1.

Here's why.

The entire financial industry is set up for salesmen and sales women to succeed. It's not set up for those who give the best investment advice to succeed. None of the aforementioned professionals makes more money if their investment advice turns out good. In fact they've all been trained to repeat the same mantra, "You're in it for the long term..." as a way of making their clients feel better when they lose a ton of money in the short term.

What none of them has been able to tell me is why it isn't better in the long term if you can avoid losing money in the short term?

They invariable answer me by saying it's impossible not to lose money in the short term. If you try not to lose money in the short term by timing your investments you'll

undoubtedly be wrong and miss big up moves in the stock market.

Maybe, maybe not.

I asked them how they could predict this with any certainty.

They answered that it's impossible to time the market and outsmart the market, etc. Some even mention the "efficient market theory" in defense of not trying to outperform the market.

I then ask them why I need them to help me. Why do I need to have any of my money go to pay for their kids' college tuition if what they say is true.

That's when they get flummoxed and tell me I'm being difficult. They have a very difficult time explaining what value they're adding at that point, especially now that we have the internet and we can look up any data we want about any investments.

Well almost any data.

We can't look up the bonus or compensation plan that the fund companies are paying the brokers.

But we can ask.

Once a broker tried to sell my an annuity that one of my friends was also selling. My friend already told me that the insurance company was running a big promotion to incentivize their agents. The brokers that sold the most would get a trip to Bermuda.

I asked the guy trying to sell me the annuity why I should buy it. He said, "blah blah blah blah" like his script told him to say.

I then asked him if he'd ever been to Bermuda. I told him it's not all it's cracked up to be. It's a stuffy ex-British colony and then men are expected to wear shorts and blazers to dinner. With black knee high socks. I told him I thought he'd look good in black knee highs with white shorts.

It was fun watching his face. It was that moment where he was deciding whether to lie or not. That's how to tell if somebody is lying. Just ask them a question they weren't expecting and watch for the long pause as they consider what story to tell.

He replied with a typical response of somebody stalling for time as he tried to think of what to say.

"Excuse me?"

I didn't say a word. I knew he heard me very clearly.

His face began to turn red. Then he kept going.

"What are you talking about?"

He choose the expected game theory response. If somebody is caught hiding something, game theory indicates that they never admit it until they get exposed from the outside.

Then I told him how my friend was just telling me about

this contest the insurance company was running for its sales people. If they hit a high number they would send them to Bermuda.

At first he tried to act like he didn't know what I was talking about. I confirmed that he was trying to sell me that company's policy, and that the company was offering the Bermuda trip.

When called out he tried to act like he forgot about it.

"Oh that... I forgot about that trip. I don't like to travel."

I think the guy would have said anything. Some people are like that. And that's after he knew what I was a fairly experienced and astute investor.

I then asked him how much money he was going to make if I bought the $1 million policy he was trying to sell me.

He didn't answer. He got indignant and packed up his briefcase, blaming me for not being smart enough to know a good deal when I saw it.

So what does this have to do with hedge funds?

Back in 1642 a guy in Italy named Alfredo Ponzi had a brilliant investment idea. He told his friends that if they gave him $100 pesos on Tuesday, he'd invest their money and give them $110 pesos on Friday.

What Senor Ponzi figured out was that all he had to do was keep getting new people to give him $100 every Tuesday, and he's give the initial investor his $110, using the $100 his new investor just paid him to pay the $10 dividend to

the first investor. Senor Ponzi realized he would soon make lots of money just as long as he brought new people in!

And the best part?

The first investor really did make $10 profit in a week! He went and told his friends how great of an investor Senor Ponzi was!

The problem was that Senor Ponzi got greedy and scaled up. He ran out of people to invest more money with him so he could pay off the previous investors.

The end of the story is that Senor Ponzi's great-great-great-great-great-great grandson was asked to engineer the U.S. financial system.

Now you may be wondering what the difference is between the U.S. financial system and Senor Ponzi's scheme.

Simple.

The U.S. government has the legal authority to tax it's citizens. It will never run out of "new investors" to put money into the system.

Mr. Ponzi didn't have that luxury.

When the U.S. Congress passed the Securities Act of 1933 they wanted to protect the unsophisticated citizens of the United States from being victimized by unscrupulous schemers like Senor Ponzi. But they still wanted to make sure the richest guys in the world could make money without being interfered with much by the newly formed

Securities and Exchange Commission which they entrusted to Joe Kennedy, future billionaire patriarch of the Kennedy family.

So what they did was allow rich people (accredited investors) to run and invest in private offerings without needing to register these offerings with the SEC. They just had a few rules to follow.

One of those rules was they couldn't have more than 35 non-accredited investors take part in their private offering.

Why 35?

Probably because they calculated that for a good Ponzi scheme to work somebody would need to double the size of the pyramid at least 5 times, going from 1 to 3 to 7 to 15 to 31 to 6 3 investors. They reasoned that only unsophisticated investors would fall for a Ponzi scheme, and that they wanted to monopoly of having all the unsophisticated average investors paying taxes into the sound fiat money system that they were installing for the U.S.

They were wrong.

Fast-forward, 2008.

Bernie Madoff was one of the richest, most successful hedge fund managers in the world.

He ran a $2 billion Ponzi scheme that was even better than Senor Ponzi's original scheme. He figured out that all he had to do was own his own brokerage company, his own clearing company, his own accounting firms, and have just

a few people "in the know" and he'd be able to just print fake statements showing every investor how their money was always growing at 20% or more a year!

What a genius!

Meanwhile, unlike Senor Ponzi who actually had to give a lot of the money back to his investors to keep people saying what a great investor he was, Mr. Madoff spent all their money on himself and his family and only had to show the investors pieces of paper saying they had nice profits year after year in their investment accounts.

Mr. Madoff is now spending the rest of his life in prison.

When the Securities Act of 1933 was passed the government defined an accredited investor as somebody who had $1 million assets or made $200,000 or more a year. Those numbers were never adjusted for inflation. If they were, they would be roughly equivalent to $100 million in assets and $20 million a year in income.

But they didn't adjust for inflation, so a non-accredited investor is anybody who's not a millionaire or not making low 6-figures from their job.

Of course all the regulations in the world won't stop bad people from stealing money, or unscrupulous investment professionals from taking the money right out of your Aunt Bernice's purse if it means putting money in their own pockets.

14. What's a special partner and why does it matter?

No, this question isn't about your relationship with your spouse.

A special partner is a term given to a limited partner in a hedge fund that is given some special benefit by the General Partner.

For example, when I launched my first fund, I had no idea what I was doing in terms of running a fund. I knew I had an edge in the market, and I could scale that edge. I was making a lot of money by my standards. Actually, my standard back then was that just not losing money would have been a great improvement.

Every month I was making 2, 3, 4, 5% ROI or more. I taught one of my best friends how to trade like I was trading. He traded his 401k retirement account and went from a $50,000 account to a $100,000 account very quickly. He was trading international mutual funds, going in and out of the market based on the the U.S. market did during the day. He was crushing it. So was I.

By the time I opened up my hedge fund we both knew this strategy worked. He put some of his own personal money into my fund. He was not an accredited investor, meaning he was worth less than $1 million.

I turned him into an accredited investor in about three years.

He had a fairly large family. They knew he was crushing

it. Everybody in his family worked their asses off at their jobs. I knew. I grew up with them. They're like my family too. I knew how much time of their lives they put into their jobs to make the money they had in the bank accounts. I also knew it hurt them emotionally when their investment accounts got crushed and they lost $20,000 or $30,000 in a few months. That money represented literally years of work and savings, doing what we're all taught to do from the time we're little kids.

Study hard. Work hard. Save your money.

Only problem is that at some point the financial media and cahoots with the financial service companies hijacked the term "savings." It was a brilliant marketing and branding move. The #1 rule in branding is to "own" a word. The mutual fund companies are all run by Ivy League geniuses. They know this stuff.

They decided they were going to own the word "savings."

Save for retirement.

Save for your kids' college.

How did they tell you to "save?"

They told you buying stocks and bonds was "saving" your money.

It's not. The king has no clothes. Owning equity shares in anything is not savings. It's an educated bet that you're going to be able to sell those equity shares to somebody else later.

So they came up with the idea of splitting your "savings" between stocks and bonds.

Only problem is the bond market can get killed just like the stock market. Watch what happens to the price of bonds when the central banks stop supporting their price. They're going to get crushed. That 1.9% interest you're getting on your bond fund isn't going to seem like much when the NAV of the fund drops 20% in two months.

So when I taught my friend how to trade, and his family saw how he didn't lose money in 1998 during the summer when the markets got killed, they wanted whatever he had. They all wanted to invest in my fund.

So I made a deal with my friend. I told him that I'd help him out by sharing some of my management fees with him that I would have made from his family members' money in my fund.

So what he did was set up his own family partnership. He had all his family put their money into his partnership, which was then an investor in my partnership. Because of the look-through rules they still counted towards the 35 non-accredited investors I was allowed in my fund. It just made it simpler for everybody. He handled all the money for his entire family, and I handled trading the money for their family partnership account.

We more than doubled their money in a couple years. Everybody was happy.

Then the market got crushed for a couple years in a row. The NASDAQ dropped from over 5,000 to under 2,000. Everybody in the world was singing the blues

because their retirement accounts got cut by 50%.

Not my friend and his family. They made over 20% two years in a row while the overall markets were getting killed.

And that was after fees.

I shared the fees with my friend from his family partnership money that was invested in my fund. That's because I had made him a "special" partner. He was special. He's like a brother to me. His family was thrilled. The bottom line is that their investment accounts went up over 40% in 2 years. The money in the 401k accounts that they weren't trading dropped 40%.

So on a $100k account, instead of losing $40,000 they made $40,000. They had $140,000 in an account instead of $60,000.

That's an $80,000 difference. For somebody working 50 hours a week to make $60,000 a year that's huge. That represent 2,500 hours of their life working at a job, being away from their family, being stressed out working to make somebody else rich.

My friend made about an extra $35,000 each year because I shared my fees with him. That money was put directly into his capital account inside my fund, so he was making a return on the money too.

Everybody was happy. That's the way it's supposed to work. Everybody in the process was adding value, and making a fair profit. I made a lot of money for my friends, and got paid 20% of the overall amount I made for them, some of which I shared with my friend. They got 80% of

the overall profits.

My friend's brother-in-law put it best. He said, "What other business can you invest in and get to keep 80% of the profits and the guy you're paying to do all the work and make all the money only gets 20%."

Usually you're lucky if it's the other way around, getting to take 20% of the the profits out of a small business after overhead.

What makes this even better is being able to help people like I did my friend by making him a special partner.

15. What's a lock-up period?

Hedge funds are very special financial instruments. They're offerings of shares in a partnership. The reason very astute, no, the most astute business people in the world decide to invest in hedge funds is because the goal of the hedge fund manager is to protect and grow their money.

Hedge fund managers invariably have their own money in their funds. That's usually how funds start. If you manage your own investments, and you're good at it, you have something a lot of people want.

The average successful business owner is great at making money from their business. They accumulate money and invest it. At some point they figure out the people they've trusted for investment advice don't know anything more about making money than they do.

In fact, they know a lot less.

Here's the best advice one of my friends gave me a long time ago. It holds true today more than ever:

"Don't take advice from somebody who makes less money than you do"

Truer words were never spoken.

If the financial geniuses who call themselves investment advisors really knew what they were talking about they'd be running their own hedge funds. The ones who do know what they're talking about do just that. They have a

separate managed account part of their business.

So why do the smartest financial and business people in the world decide to invest in hedge funds, and even create their own hedge funds?

Simple.

They know the formula for making money, long-term.

Systems.

Processes.

KPI's.

Compare that type of thinking to the masses who simply buy mutual funds and hope the market goes up. No offense, but that's plain foolish. It comes from the social dynamic of when you're not sure what to do, you look around and see what other people are doing and just do that.

That's the fundamental psychological reason why markets will always rise and fall, short-term and long-term. Price only rises when people behind you in line buy what you just bought.

If the supply keeps going up and the demand doesn't go up, the prices will fall. If the demand goes up and the supply stays the same the prices will rise. This is Fundamentals of Economics 101.

So why in the world do smart people think the prices of stocks in the stock market will continue to go up at all, let

alone 10% a year?

They won't. They can't.

It's a mathematical certainty.

The strategy of buying and holding is a system just like anything else. That system goes something like this:

Step 1: Analyze information
Step 2: Make your best decision
Step 3: Hope your decision is right
Step 4: Ignore every KPI and red light when the actual results are substantially different from what you expected.
Step 5: Sell or,
Step 5a: Die and hope your kids appreciate all the work you did so they can spend what's left of your money.

Yes, if you get lucky, you'll have more money in 20 years than you do now.

But as a business owner, or somebody who's already successful at what you do, you intuitively know that's a dumb system. There's no way to protect against being wrong.

Sure, you can put stop orders in place.

What that means is that it's almost 100% certain the stop orders will be hit, especially if they're tight. People put in tight stops all the time to protect their money and all the time the stops are hit.

What we're really seeing with a buy and hold investment is an open-ended system, not a feedback system. By open-

ended I mean we spend all of our time at the beginning deciding where to invest our money. And we spend no time thinking about when we're going to sell.

Sure, some people make pre-determined sell decisions but here's the problem with that. It's almost always based on just one variable -the price of the stock. When the market gets volatile that price will be taken out and you'll sell at a loss.

The other problem is when you make pre-determined, long-term sell criteria you're basing your decision on all the information in the history of the world that you have now.

Tomorrow that information is going to change. You have a new day of data. The mistake people make (especially market technicians, statisticians, and math geeks) is that they have very little in the way of tools to evaluate the weight of the new data. They just put the data into their equations and by default today's data is weighted equally with all the data in the history of the world.

Let's step into the common sense corner for a second.

Does that make sense to you as a business person? Really?

If you're running a business and your sales drop 25% in a month there's a problem. What you sold 6 months ago doesn't matter. There's something new that happened. The world is different for some reason and if you don't figure out why it's different and adjust you'll be out of business.

So how does the buy-and-hold, hope for the best system address this?

It doesn't.

The truth is the masses who think they're "saving" for retirement by putting their money in the stock market are going to be totally screwed at some point.

It's a mathematical certainty.

Why?

Because we all get old and die. The markets go up and down, historically at 50% dips and for periods of time lasting 20 years, roughly the same period of time we use to measure generations. If you haven't read it yet, go out and get the book The Fourth Turning today. Generational economic cycles are very predictable.

So what's this got to do with a lock-up period in a hedge fund?

Hedge fund managers are the smartest financial people on planet earth. They design strategies to exploit market inefficiencies and make money. There strategies are engineered for one thing - to always have more money later than you do now.

Know the best way to do that?

To always make preserving capital the number one priority. If you can preserve your capital, even when you're wrong, you'll make money in the long-run if you have a strategy with an edge.

Think about casinos.

Every table game in a casino has an edge for the casino owner. The casino owner knows that over the long-term the math is guaranteed that he or she will make money.

The only risk is that there may be a short-term loss. If somebody walks into a casino and bets a billion dollars on one hand of blackjack the casino owner could go bankrupt if the guy wins his hand. That's why casinos have table limits.

Hedge fund managers are just like casino owners. They have an edge that if they run it long-term it will make money. That's why they are obsessed with protecting the money in the fund. It's just like a casino owner limiting bet size. Hedge fund managers limit bet size, knowing that they are going to lose a lot of small bets but at the end of the day they're going to make money because they have an edge -it's like they own their own casino.

How do you think I was able to go from being $100k in debt working at a 9 to 5 job to trading over $100 million every day?

I discovered an edge and ran it, Other people wanted me to run their money on this edge too.

Edges are everywhere. You just have to find them.

Hedge fund managers entire lives are spent, usually 16 hours a day minimum, to obsessing over these edges. Pulling money out of the market is their addiction. They hate, hate, hate more than anything in the world losing money. My one billionaire friend would call our broker and chew him out unmercifully because the

broker overcharged him $18 on a ticket for a $300 million dollar trade.

No joke.

It's because the hedge fund managers are running systems to make money that they must know how much money they have to work with at all times. They need this to plan their entries into and exits from positions. They're commitment is to implement the system to make money.

Imagine planning a road trip between San Diego and New York. You know how much gas money you have to start with. Along the way your goal is to stop wherever you see cool roadside attractions and get souvenirs, like a giant scavenger hunt.

If you were halfway across the country and somebody told you that you had less gas money to spend you would have to make different decisions on how you're going to get to New York. If you would have known ahead of time you weren't going to have enough gas money you might not have made that detour from Mt. Rushmore to Devils Tower.

That's the same idea with hedge fund managers. The money invested in their fund is like the fuel in their gas tank. They know how to put the money to use in the best way to take money out of whatever market they're in. If they're forced to unwind a trading position early the entire strategy falls apart.

Why?

Remember how I said they're obsessed with protecting the

money in their fund? That's referred to as risk management. In the buy-and-hold world that term doesn't exist. In the hedge fund world it's everything.

Why?

Because hedge funds rely on getting money in from investors. The investors are rich. They care more about protecting their assets first while at the same time growing them steadily, like a real business plan.

If a hedge fund manager doesn't manage risk and blows up the fund with a 15% down month every investor in the fund will be pissed. They'll pull all their money and the fund will be out of business.

The only way to manage an entire system that's built on the foundation of risk management and protecting assets is to manage the cash flow into and out of investments.

That's why fund managers require lock-ups. In other words, if you want the benefit of using the fund manager's system to make money you need to realize how that system works. It works by strategically allocating money in different positions that cumulatively have an edge. That edge, like the casino owner, will make money long-term.

So what you're doing when you invest in a hedge fund is essentially leasing an entire business system that's taken some guy or gal their whole lives to come up with. You not only get to lease this entire business system, you hire the people to run it. You pay the people who are running it for you a measly 0.08% monthly overhead cost.

And when they run this business system with your money,

you keep 80% of the profits. The people running your business get a 20% bonus for protecting your money and making you more money.

Here's why that's so important!! This is a key point!

Investment advisors scoff at hedge funds a lot of times because hedge fund managers take a 20% performance fee on profits.

Here's the other side you never hear about.

What happens when the market drops 50% and the money in your hedge fund broke even? In other words, your neighbors lost millions of dollars and have to sell their second home in Aspen and they're saying things like, "Don't worry, it's just a loss on paper," or, "Don't worry, the market will come back..."

Yes, all losses are on paper. They're still real losses. Gains are just on paper too but you never hear them talk about that.

While you're neighbors got crushed you broke even. You made no profits. Zero.

Know how much performance fee the hedge fund manager makes for protecting your money?

Zero.

Hedge fund managers only get paid if you have more money later than you did when you started.

That's why they protect your money. That's why they

engineer and implement strategies that are based on risk management, cash flow, and asset protection.

That's why they have lock-up periods -to make sure they can implement these edge-based strategies.

16. How long does it take to get money if I want to withdraw funds?

Before I answer that, let me begin with a case study -my own.

Where: Pittsburgh, Pennsylvania, Allegheny County Courthouse
When: 3 minutes after the start of a motions hearing
Subject: *"Why is that my problem?"*

I was being sued. No need to go into the details. The judge had ordered I transfer a large amount of assets to the plaintiff. I did. That's not why we were in motions court. The reason we were in motions court is because the plaintiff was still not happy.

The plaintiff's lawyer presented their case as I watched silently, representing myself at the hearing.

Here's the summary of the lawyer's argument. I paraphrased for simplicity:

"Your honor, Mr. Allen was ordered to transfer $235 million dollars in assets to my client. He did.

"But the bastard transferred shares of his holdings in a private partnership. Now my client has ownership of these shares, and just got a K-1 form showing she owes $4.7 million in taxes. She has no cash to pay the taxes.

"Then I found out this partnership is owned and operated outside of Pennsylvania. The managing partner of this partnership refused to even talk to me. He sent me a letter

saying per the terms of the partnership agreement my client will have to wait 5 years to get cash out of the account."

"Currently my client owes me $865,921.63 in legal fees. She has no money to pay me to continue having me represent her interest in this matter."

The judge was looking down at papers on her desk the entire time the lawyer was speaking. He was a squirrelly looking guy, about 5' 8, 145 pounds, probably got picked on a lot in school. Being a lawyer leveled the playing field for him. He was used to getting his way now.

That's why with each word he spoke his faced turned more and more bright red. He was spitting by the time he finished.

The judge heard every word he said. At the end of his rant she didn't even lift her head. She simply looked over the top of her reading glasses and said this:

"Why is that my problem?"

Here's the reality.

The amount of time it takes to get your money out of a hedge fund depends on the Agreement of Limited Partnership and the fund manager.

Just like any contract, the person writing the contract usually puts in wording that protects them. Limited Partnership agreements that you sign when you decide to invest money in a hedge fund are no different.

First things first... Hedge funds are not like bank accounts or even mutual funds. There not even like bank CDs with penalties for early withdrawal of funds.

To fully understand this I want you to look at the partnership from the point of view of the fund managers. I'm not going to tell you some blah, blah, blah stupid stuff like a Wikipedia entry. Here's the real deal...

Hedge fund managers are the smartest, most successful, wealthiest people in the world. Some of my friends at Harvard take offense to the smart part, especially the professors, and the A-students who think their Harvard diploma with straight A's behind it means money in their bank. It does. For most of them it means a nice job - working for a hedge fund manager.

Get the big picture yet?

Now, thinking again about life from the point of view of an incredibly wealthy hedge fund manager, what's your biggest problem?

Where to go on vacation? What grades your kids are getting in Philosophy 101 at Yale? Whether or not to sell your chalet in the French Alps?

Seriously, I know a lot of super wealthy fund managers. Those are the things they talk about.

Why?

Because they already solved their biggest problem. Once you're successful and have financial independence, you have only one financial problem. You have a great

lifestyle. But your BAP is simple. BAP is a term they don't teach at Harvard Business School. I know. I checked.

BAP stands for Big Ass Problem.

A super rich hedge fund manager who can live for the rest of his life on the money he or she's already made has only one Big Ass Problem when it comes to their financial life, aka as their lifestyle and the lifestyles of all their descendants for the next 200 years.

Their BAP is losing the money they already have.

They're too smart to lose it in investments or in any trade or market position. They're always hedged and have their assets allocated so no matter what happens, even World War III, they'll make money. That's why they're called hedge funds.

So how could a hedge fund manager lose all his or her money?

Their biggest financial risk is divorce.

No joke. You want real, I'm giving you real. Hedge fund managers lose more money through divorce than any other way. Often it's more than 50% of their money because the courts have this thing called "equitable distribution." In California where I live it's only called community property. That means a divorce is usually a simple, 50/50 split.

In "equitable distribution" states the judge has the discretion to divide assets based on what the judge thinks

is equitable, or fair.

This means the judge can allocate 100% of assets to the non-dependent spouse, i.e., the spouse of the hedge fund manager. The hedge fund manager is the independent spouse. Just note, this is not a gender issue. I have close friends who are female who had. 90% of their assets ordered given to their ex-husbands, plus 5-figure a month child support payments. In the U.S. county courts get what basically amounts to a subsidy from the Federal government based on how much child support the courts assign.

Like I said, hedge fund managers are smart. Their entire lives are about managing risk and grabbing the low hanging fruit in terms of the rewards. They're smart enough to know how to get the low hanging fruit while minimizing their risk.

Enter the Limited Partnership.

A limited partnership is a cool business entity. There's nothing quite like it. A limited partnership was designed as an investment vehicle so smart people could raise money to fund their ideas while protecting the investors from any liability. The "limited" in limited partnership refers to liability.

This means if a guy has an idea for selling rocket trips to Mars he can get money from outside investors to build the rocket ship. If the ship blows up and the guy gets sued, he's the one entirely on the hook. The limited partners can't be touched. Their liability is limited only to the amount of money they invested in the limited partnership. Their assets inside the fund are owned as

shares, just like shares of a corporation.

The guy controlling all the money is the general partner. The general partner has 100% discretion on how to utilize the limited partners' money, within the terms of the partnership agreement. The limited partners reap the rewards of the general partner's business decisions proportionally based on what percentage of the shares they own.

The general partner makes money three ways:

1) He or she gets a management fee, usually 1% a year, for running the business.

2) He or she gets a performance fee, usually, 20%, of the overall profits he makes for the limited partners.

3) He or she has their own personal money held inside a limited partnership capital account within the fund. The bulk of the fund manager's personal wealth is often not held in their own name. It's usually held in the name of another entity, like My Personal Fortune, LLC.

Remember, a super rich person has only one BAP when it comes to money -keeping it. That's why they invented limited partnerships.

Hedge funds are limited partnerships.

The biggest risk to a fund manager's wealth is from external lawsuits. Divorce is the most common legal action fund manager has to consider. People with a lot of money get threatened with lawsuits all the time.

So what happens if a fund manager gets sued?

The first step is discovery. The lawyers love this step because they bill their client at $400 an hour (or more) and have their workers spend weeks organizing thousands of pages of financial records. The discovery phase of a suit is easily a $100,000 profit center for the law firm. Easily.

What the lawyers will notice in this discovery phase is that the person being sued (the hedge fund manager) owns very little in his or her name. It's all inside of business entities. And even then, the business entities own no cash. They just own shares of a partnership.

This is when the lawyers say the word "fuck" silently in their heads.

Why?

Because they've probably worked out a deal with their clients to get paid either on contingency, or on the belief that they'll get money from the defendant in the lawsuit, and that money will go to pay their legal fees.

That's not what's going to happen.

Even if the suit is successful, the plaintiff will only be awarded shares in the partnership because the shares are the only asset on the table. There is no cash. Only holdings in partnership agreements.

The shares entitle the holder of the shares the benefits of a limited partner. This means the limited partner's capital account will get credited with income every year based on the amount of money the fund made, and the limited

partner's percent ownership of the fund.

They will also receive a K-1 form showing their tax liability for the year. If they're limited partnership shares accumulated $100,000 in earnings from short-term trading that's going to show up on their K-1. The limited partner then needs to report this on their tax return and pay about $40,000 in taxes on it.

But they don't get that cash. They only get that amount credited to their capital account.

Oops.

This is where the language of the Agreement of Limited Partnership comes into play. Some hedge funds have 5-year lock-ups. Even after the five years are up they require 90-day notice to send money to investors, and often contain a clause that gives the fund manager special discretion to hold the money in the event of special circumstances.

And often the jurisdiction of the fund is not in the same jurisdiction as the litigants in a lawsuit.

The end result is that having shares held inside of a hedge fund structure makes it an incredibly expensive pain the ass for a litigant to sue. And once the lawyers see this they're going to make their clients pay up front. They're not going to run up a $1 million receivable on their billable hours thinking that even if they win the suit they might get paid in shares of a limited partnership.

Lawyers are smart. They're the ones who invented the limited partnerships to protect their own money and their

clients' money.

This is why the judge in the case I was involved in simply said to the lawyer, "Why is that my problem?"

Guess what?

Judges are lawyers. They get taught this stuff in law school 101. They had to study and pass tests and learn case histories of how limited partnerships protect the assets of the limited partners, and how bullet proof they are when it comes to protecting those assets. The judge dog in this race is not having their decisions appealed. The easy path is to go with hundreds of case precedents, and the law, and tell the lawyer presenting the argument things like, "Why is this my problem?"

The story has a happy ending.

Once the lawyer realized he couldn't keep running up $50,000 a month legal fees the case ended.

As they say in on TV, cased closed.

The reality of the situation is that hedge fund managers are smart, and they're typically good guys. If you need money tomorrow, typically if you just ask they will see if they can make it happen without hurting their fund performance, and send you a check or wire money right away.

Most funds have a year lock-up, and a 30-day or 90-day notice to withdraw money after the year lock up is over.

That's not a disadvantage. The hedge funds are set-up that way for a reason. To protect the money in the fund.

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