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Daniel Gladiš on the Importance and the Process of Attracting the Right Clients

John Mihaljevic, The Manual of Ideas: It's always a great pleasure for me to have an opportunity to speak with Daniel Gladiš, Director of Vltava Fund. Those of you who are members of our community will know Daniel quite well by now. He has given us insightful interviews as well as presented at several Value Conferences in the past, and his ideas have just been incredible – not just from a performance standpoint but also from the way that Daniel puts together his investment thesis.

Daniel, I'm very much looking forward to having you with us at the Zurich Project. What I thought we could discuss now is the importance of having the right type of investors, something that I feel like is often overlooked but may in fact be a necessity for long-term survival and success. So, I look forward to your thoughts on the topic and then I'll just mention, obviously, we can continue this discussion in Zurich as well with those who are interested. So, tell me why you thought we should discuss this particular topic.

Daniel Gladiš: Well, first of all, thank you for the invitation, John. It's always a pleasure for me to be a host or a guest at one of your events. I really enjoy it very much. When you came up with this suggestion to do a podcast and I thought about what we should talk about, I think one of the topics I've been thinking about for years now – and it's not very often covered – is how important it is to have the right sort of investors for your fund to achieve success, so I suggested this topic and I'll be happy to share with you my thoughts. It's not a rocket science. There is a lot of subjective input into it, but I think this is something that is very important.

MOI: Absolutely, and I think, you know, I've also come across some scepticism when you mentioned the topic because a lot of folks are really struggling to get money in the door and this notion that you should actually pick and choose your clients seems almost a little arrogant, but why do you think it's actually a necessity over the long term?

Gladiš: Well, let me explain. I think at the end you should probably reject some clients, but let me get to that point step by step. I think when people start a business like a fund or a hedge fund, they may have different motivations. Of course, a financial motivation is important for everyone, but there are other motivations as well. Sometimes, people just want to start a fund because they like that kind of activity. They just like doing it, and also I know a lot of fund managers that feel good about the fact that they are helping others by offering them investment services. So, there could be various motivations. And I think when you start you should realize what your main motivation is, and then, when you look back at your own business, there are a number of criteria that you can use to evaluate whether you are successful or not.

Of course, the investment performance is important, but, if we set the performance aside – because running a fund is not only simply about managing money, but it's also operating a business – so there are other criteria for success evaluation. It could be size of your fund or the size of the business. It could be the stability – the stability of your business, the stability of your investor core. It could be the recognition you receive from not only your investors but from the wider public, and it certainly could be a pleasure from the work that you're doing and also from the relationships that you have with people that you serve - your clients. So, there are a number of evaluation criteria, and they do have a common denominator. That is that it is really very important and critical that you have the right type of investors to be successful, because, if you don't, then you may not be large enough, your business will not be stable, you will not have the satisfaction from working with pleasant people or people that share your investment philosophy, etc.

When you look at what kind of investors you may have, of course, there are various types of investors. When most people start a fund, they start with partners and friends and family and then they move along to high net worth individuals and they may also work with seeders. Then they can work with funds of funds, and, if they get some track record and they are bigger, they can work with family offices, they can use third-party marketers, target foundations, endowments, pension funds and even sovereign wealth funds. So, there really are various types of investors – not only individual and institutional, small and large, but really different types. There are investors that are direct investors, and then there are investors which are not direct and they are represented by an agent or by a middle man or by another fund. And this is all important.

So, when you think about what type of investors is good for you, it should be such that fulfils the following criteria: I think the right customer, or right investor, should understand your philosophy. That means they should be willing and able to understand it. They should understand the approach you have, your goals, your investment horizons, how you define risk, etc. Well, it sounds nice, but from our experience, this is very difficult to achieve in practice, because investors must be not only willing, but also able to listen, learn, and understand what you're doing. We've been trying to educate investors for 13 years now, or 14 years, and very often what happens is that, if you ask them, they say, "Yes, we understand what you're doing. We share your thoughts, we agree with it." And then when you ask them to actually formulate what they think you are doing, very often they are not able to, so there's always some misunderstanding. There's often a misreading in perceptions and expectations, etc.

Another thing to consider is should I offer what the people want or should I do what I think is right and then try to find investors that fit into this? These are two different approaches, but I think the right steps for achieving the right type of investors are the following: First of all, we should focus on the right types of investors in general. As I said, there are individuals, there are institutions and they have different expectations, different horizons, different criteria. If you focus on the wrong groups, then the probability of your success is lower. It's the same like in investing, you know, if you focus on sectors or industries where there is a high probability of success, then you'll probably find good investments. If you focus on the wrong industries, on the wrong countries, on the wrong types of companies, then you'll probably not succeed. It's the same in working with investors.

If you want to find the right types of investors, you have to realize first who they are and then to target them – and do not target other types of investors. You should do all you can before they become investors in order so that they understand your business. This is important, this is absolutely critical because if you accept a client or an investor that does not understand what you are doing or does not agree with what you are doing and is joining you only because he likes your performance or only because someone has recommended it to him or someone even just sold it to him, this is not good, because, sooner or later, this will result in dissatisfaction on both sides – on your side and the side of the investor. So you have to make sure that you do everything you can before someone becomes an investor so that he understands what you're doing, which means also that you should absolutely not take everyone that offers you money.

Now, there's a conflict between size and quality of your business. If you make size of your business the #1 priority – which is fine; I'm not telling what people should do – but then you should realize that you have to make sacrifices on the qualities of your business. On the other hand, if you put priority on the quality of the business, which means the quality and stability of your investors, then you should sacrifice probably something on the side of the size of the fund and you probably cannot do both at the same time. Then, when time goes on, and even if you do everything you can to accept only the right clients, then it's inevitable that, over time, you will realize that some of your investors are not the right ones. So, what can you do?

Well, I think the best way, actually, is to discourage them from further investments in your fund. It sounds crazy, but I think it's better for both you and them, because if there's people in your fund that shouldn't be there in the first place because they expected something else or they had different horizons, they never actually accepted what your investment philosophy is, they're unhappy and you're also unhappy. I think a relationship like that lowers the quality of the business, and I think you should, in some way – I don't know in what way, there might be different ways for different funds – basically discourage them from at least further investments, but maybe from staying in your fund at all.

It is also very important that you control the selling process of your fund, because if you enable third parties to distribute your fund, it means that you give up a lot of control over who becomes your investor. You don't know what your new investors are being told, what they're being promised, what expectations they create before they become investors and this is very dangerous because there's a conflict, of course. There's a conflict between you as a principal of your business and your desires, there's a conflict between someone who sells your fund because their motivation is probably very different from yours. So, I think the best way to achieve the highest quality is to absolutely control the process over who becomes your investor. But I understand that for some fund managers or for many fund managers, this is either too restraining or too difficult or might be even too costly, and therefore they want other people to sell their funds. But then they have to realize the dangers that they're getting with it.

Then, as the fund goes on, as the business goes on, you must make the communication with investors your top priority, because as the fund gets bigger and your client base grows, it becomes more time-consuming and more costly to constantly communicate on a one-to-one basis with everyone, so you have to design ways of communications for communicating with investors all the time, because even if you think that they understand what you're doing, that they accept it and they like it, don't get too complacent. You have to repeat the same things over and over and over, because people tend to forget. They tend to deviate from their original understandings and, very often, they just get distracted and basically they say they understand what you're doing, but they don't. So you have to repeat the same thing over and over and over all the time. Communicating with investors during their investments is very important. Last but not least, I think you have to be very patient and consistent. If you're in a hurry to grow your business, you'll probably get a lot of undesired investors in your fund, so being patient and working slowly I think pays well in the end. So, those are my thoughts. I have some other thoughts, but maybe you want to jump in with your comments now, John.

MOI: Yes, thank you so much for laying it out so clearly. Maybe on the investor communications part I'd like to go a little bit deeper in terms of how often you might want to communicate, what you actually want to put in those letters. I know you don't discuss live ideas in your letters, so just tell us why you decided on the modalities that you did.

Gladiš: Well, they've evolved over time. We have various frequencies of various types of communication. We have a monthly fact sheet, which gives you monthly NAV, but also gives you a set of basic data, including top investments, basic statistics and allocations, etc. But then we have quarterly letters, which are basically designed for both existing and potential investors. We try to explain what we do and what our thoughts are on various actual topics. We discuss only investments that we have closed in these letters, because it's been widely read and we don't want to give up our ideas publicly too soon. Then we have various presentations and annual gatherings for investors where we are more open and we discuss everything in detail. These are the standard ways of communications. Then, too, we do meet with investors throughout the year on a one-on-one basis, but this is very time-consuming, so we have certain dedicated people just to do that.

This is very efficient and brings nice new business, but it is also very time-consuming. And then we organize various other events. We organize conferences, we organize seminars – so we try to do a lot of communication, and I think it's very, very important. I think one mistake that I see very often in other funds that come and go is that they usually just start a fund with an idea, "Yes, I'm going to start a fund and start managing money and then people will come," but people never come. If you don't try to get them very actively, they will not come on their own. It doesn't work like that, so I think you should make marketing and communication and business development – whatever you call it – a top priority right from the beginning. And it's a very different function from running money. It's inevitable that the fund manager himself or herself gets involved because he is the one that is the source of the ideas, but he cannot do it alone. You have to have other people that are basically designated and dedicated to the marketing activity.

You should also realize that you will never achieve the perfect or ideal setup, but if you know what you want to achieve, then you might get close. Basically, I see this as a trade-off between the quality of your business and the size of your business. I think if you prefer quality, then your business will grow anyway, your satisfaction will be higher, and money, even if it might not be your #1 priority, will follow in the end anyway. So, these are the criteria that we use and I think that they work well. Another thing that I think is important is that, as the time progresses, you may want to – or you may have to – target different types of investors at various phases of your business. Of course, when you start a fund, there is no track record, it's a small size, you could hardly get a sovereign wealth fund as your seed investor, right, so typically people start with their family and friends and partners when they start a fund. Then they can move along as the fund gets a track record and gets bigger in size to other types of investors and eventually they might end up with large institutions, and this is fine, but doing it the other way around is probably not a good idea. So, yes, you may have different preferences at different phases of your business.

MOI: I assume to date you've had mainly individual investors in the fund. In terms of communication between individual investors versus institutions, do you think there are any major differences there to be aware of, and how do you actually pick the institutions? That seems even more difficult than picking the right individual investors.

Gladiš: Yes, the communication is very different. Individual investors, even if they are very rich, they don't really care about, you know, tracking errors and Sortino ratios and drawdowns, and stuff like that. They basically use more common sense than hard finance, and you should also communicate with them in this way. It doesn't mean at all that they are less advanced or so, they just view things differently, but I think they are probably a better, more stable source of investors for smaller funds. We market our funds primarily to individuals from various European countries, and we find this to be the best source of money, because, first of all, they are end-investors, so they have no one to report to. They don't have any supervisors or bosses or boards or their own clients. They are end-investors, which means that they are making their own decisions. They usually are very long-term oriented, and they do not succumb to herd behaviour. They are not hot money. They make their own decisions, and they usually are more stable. They're also a good source of references for other clients, so I find this to be a very stable client base.

I realize that our fund could be bigger if we were more aggressive and if we were using third-party marketers and if we were more after institutional money, but I think the client base would not be as stable as it is right now because our client turnover is something like 2% a year. It's usually very low – and some of that comes from people divorcing and people dying, unfortunately, as well. So, there are natural causes for client turnover, but otherwise it is a very, very stable client base.

MOI: If you wanted to look to some institutions, what would be your ranking of the types of institutions to go after? Would you look at university endowments or family offices? Where would you get started?

Gladiš: Probably family offices, because they are the closest to what we have right now. And we do have some. Then probably endowments would be a natural extension because, again, their investment horizon is very long and they are more stable than, for example, funds of funds. We have been approached by some of the largest university foundations, but we do still fight certain prejudices, because I live in Eastern Europe, and it's very difficult to attract Western money from here. That's also a reason why we focus on high net worth individuals, because they do not have this barrier as much as do institutions.

MOI: In terms of the structure of the fund, meaning frequency of withdrawals and things of that nature, have you looked into ways to use some of those tools in order to help you discourage the kinds of clients that you would not want in the fund?

Gladiš: Not really. I'll tell you what we have. We have monthly liquidity, so there are no lock-in periods, etc. Anyone can come in and out every month, but what we do have is we have a redemption fee, which is 2.5% of the redeemed amount, except in February when it's zero. This is a funny arrangement, but what we wanted to achieve is to discourage hot money, because we do not want money that comes in in March and goes out in July and gets back in in October, etc. We want investors to be able to think first what pocket of their own money they're giving to us, and we only want long-term money. So, if someone thinks in the short-term, don't come, and the redemption fee is meant to be a discouragement. But then what we found out in practice is actually that this also works to prevent investors from acting emotionally throughout the year.

For example, last year when there was the Brexit and the market crashed after that, a lot of investors around the world started panicking and they were redeeming money from various funds…because emotionally they were scared, they were panicking. When they want to redeem from our fund, the redemption fee is preventing them from overreacting to their emotions, which in retrospect almost always seems a good thing to do. Our redemption fee, even if it's not meant to be such, it was not meant to have this effect in the first place, it actually prevents investors from overreacting to short-term market developments. And over the last 13 years, it's almost always been a good idea not to do anything. So, yes, we have a funny redemption fee structure, but so far it's been working very well.

MOI: You are organized as a SICAV. How much flexibility does that structure give you to tweak things like redemption fees? Could you have a redemption fee that's based on the length (of time) that someone has been in the fund? What are some of the limitations that SICAV puts on you that maybe where you might do something differently if it weren't for the regulations?

Gladiš: Well, the regulation in general in the last several years has gotten tougher and tougher and in many ways, just crazy, but, for the fee structure, especially for the redemption fees, I haven't seen much limitations. You have pretty much full flexibility in how you want to structure it, but we have not explored this subject because our fee structure has been the same for 13 years and we don't want to change it. But I think that there are no real limitations here. You are very flexible.

MOI: Great. Well, I found this very helpful, Daniel. Any other thoughts that you'd like to share on this topic?

Gladiš: No, I think we've covered our thoughts, but if this podcast is especially dedicated for the participants of the Zurich Project, then I would be happy to have discussion with friends and colleagues there about this anytime they want.

MOI: Absolutely. I think this is a topic that's on the minds of many and it's also something that maybe gains in importance over time as you kind of maybe realize that you have some folks in the fund who are really more of a headache than an asset.

Gladiš: Yes, it is inevitable because you're working with people, and you may be getting above average people with regard to their wealth, but you're getting average people regarding their temperament, so it's inevitable that you will have always – always – some people that will love you regardless of what you do, but that you also have people that are complaining regardless of what you do. That's just part of the business, but I'm not complaining. This is what everyone else has to expect.

MOI: Great. Well, certainly an important topic to really give a lot of thought to as a fund manager and I know that different people will come to different conclusions about the types of investors they want to have, but, at the very least, one should really think this through because probably for nobody is it optimal to just accept any money that wants to come in.

Gladiš: There are thousands and thousands of funds, so there might be thousands and thousands of approaches, but at least everyone, I think, should think about this before they start a business.

(Edited transcript of the original podcast.)