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J. Tomilson Hill

The Wall Street veteran brings an investment banker's perspective to the fund-of-funds business.

As an undergraduate at Harvard College in the late 1960s, J. Tomilson Hill had little interest in Wall Street. A history and literature major, he immersed himself in Japanese studies during his senior year. "If it hadn't been for the Vietnam War, I would have studied Japanese, gone to Japan and had a very different career path," says Hill, who drew a 13 in the draft lottery and likely would have been sent to Vietnam had he not joined the Army Reserves following graduation. During basic training he decided to apply to both Harvard Business School and Harvard Law School, and attend whichever one accepted him first. "When I decided to go to business school, I think I was the only person in my class who didn't know what a balance sheet or an income statement was," he says.

Today, as head of Blackstone Alternative Asset Management, the 66-year-old Hill oversees $62 billion in discretionary assets, making BAAM the largest allocator to hedge funds in the world. Under Hill, who is also vice chairman of Blackstone Group, BAAM has been a pioneer, moving the fund-of-hedge-funds industry from one-size-fits-all products to more-customized investment solutions. The firm's consultative approach to hedge fund investing is a direct reflection of Hill's 20-year career as an investment banker, which started in 1973 when legendary deal maker Joseph Perella hired him out of B-school to help build the mergers and acquisitions business at First Boston Corp. in New York. In 1982, Hill, who by then was running M&A at Smith Barney, was recruited by Lehman Brothers CEO Peter Peterson to join that firm's merger group. Peterson was forced out some 15 months later and went on to start Blackstone with another Lehman refugee, Stephen Schwarzman. Hill thrived at Lehman, eventually becoming co-CEO of the firm with Richard Fuld, but was ousted in 1993 by Harvey Golub, CEO of Lehman parent American Express Co., over compensation issues.

Hill joined Peterson and Schwarzman at Blackstone, which had started investing in hedge funds in 1990 with the $100 million its partners received for selling a minority stake to Japan's Nikko Securities Co. When Hill took over day-to-day responsibility for BAAM in 2000, the fund-of-hedge-funds operation had eight people, $1.2 billion in assets and $8 million in revenue. A year later BAAM won a mandate to advise the then-$170 billion California Public Employees' Retirement System on its new hedge fund portfolio, beating out much larger, more established rivals. That landmark deal led to a series of innovations and new products for BAAM, which now has 250 professionals and is approaching $800 million in annual revenue.

Alpha: How does your experience as an investment banker influence what you do now?

Hill: The lesson of being a banker is that you're in the problem-solving business. You're in the business of listening to what your client has to say, never assuming anything and being prepared. I'll never forget the first meetings I had as an associate at First Boston, where I'd go with the greats of investment banking — Paul Miller, who was the president of First Boston, and Jim Land, who was vice chairman. The first thing is, they had very strong personal relationships with the CEOs. Second, they completely understood the business of their clients. Third, they were never selling anything. They were always listening and then figuring out how to solve the problem.

I think one of the big differentiators in our business model here at BAAM was that early on I said, "We're not going to presume we know what the person sitting opposite us wants. We're going to ask them. We're going to understand what their asset allocation model is; we're going to understand what their return objectives

are, what their risk profile is. We're going to get into a conversation around what do they want."

What makes hedge funds such an attractive alternative?

The best and brightest investment talent wants to end up in the hedge fund space — if they can stand the complications of operating a hedge fund — because there's maximum flexibility around how to invest the money. You can be 200 percent gross. You can be 100 percent in cash. You can be net short. You can do whatever you want within your investment guidelines. Also, the economic model is superior to that of traditional asset management. If you produce the returns, you get to share in them. There's been a talent migration into hedge funds since the '70s and '80s.

How did you get involved in BAAM?

I joined Blackstone in '93. My background was M&A. I sat on both the firm's management committee and private equity investment committee. Because I had invested in hedge funds when I was at Lehman, I was given oversight responsibility for BAAM. But I wasn't running it. Throughout the '90s, BAAM largely was a vehicle for managing our own money. In 2000, when I took it over, it had $1.2 billion in assets under management. We had some outside investors, including some ERISA accounts where I had a particular relationship, but more than half of the assets were firm and partner money.

We saw our competition — Grosvenor, Quellos, Ivy, JPMorgan, Goldman Sachs, Morgan Stanley — all growing significantly. And yet we weren't growing. We were doing a great job with the strategies, managing the money, but we just weren't growing. So the question was, Is this just an in-house vehicle to manage our own money, or is it a business? Before deciding to run BAAM, I needed an answer to that question.

I spent six months talking to big investors, seeing what their potential demand was for marketable alternatives. I concluded that the reason that university endowments had such large exposures to hedge funds was exactly the reason that big pension plans ought to — which is this whole concept of risk-adjusted returns and low correlations to traditional asset classes and capital preservation. So there was the academic theory to back up why the university endowments were doing it. But that hadn't translated into large hedge fund investments, other than selectively in the corporate pension plan market. One of my goals was to actually educate, proselytize and try to get these big pools of money to understand the benefits and merits of investing in alternatives.

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How did BAAM beat out larger, more established funds of funds in 2001 to win the mandate to advise CalPERS on its new hedge fund investment program?

This was a beauty contest. It was just like competing for a piece of M&A business back in my Lehman days. CalPERS sent out an RFP to 100 providers. Then they narrowed the list down to 20. They later narrowed it to five. And then they invited three finalists to make a presentation in Sacramento. An upstart BAAM beat out Goldman Sachs and JPMorgan — in part because we said, "We're going to take a clean slate. We're not coming in with any preconceived ideas of what's right for you." Instead, we took the position that "We will give you what you want." What a lot of our competitors did was assume that because they had built a successful strategy for high-net-worth investors, they could then just repackage it and sell it to big institutions, including CalPERS.

How important was winning the CalPERS's mandate to BAAM's success?

That win put us on the map because CalPERS has always been viewed as a thought leader and cutting-edge in terms of innovation. And then very quickly thereafter, other state plans began to say, "Well, if CalPERS is doing this, we should consider it too," and that opened the door for broader discussions. Our first really major win on a proprietary basis, where we had fiduciary responsibility as opposed to advisory, was the Pennsylvania State Employees' Retirement System [in 2002]. The rest was all about building out our North American presence, then Europe, the Middle East, Asia-Pacific and the rest of the world.

When Alpha *profiled BAAM in March 2006, you were the 15th-largest fund-of-funds firm in the world, with $11 billion in assets. Today you're No. 1, with more than $60 billion. How did you do it?*

I have a great team. I got really, really lucky with the people I hired. But part of it is, I wasn't going to hire anybody from the fund-of-funds industry. I said, "There's nobody I see out there who has the kind of characteristics that I want." Gideon Berger, who heads up our entire investment operation, has a Ph.D. in computer science and applied math, and ran a tech start-up. He's incredibly entrepreneurial. I can't imagine a better risk manager than Gideon.

Brian Gavin was the partner at Arthur Andersen in charge of due diligence on hedge funds. He had ended up putting money into the firm and got wiped out when the Enron situation happened and Arthur Andersen went bankrupt. So, talk about being risk-averse. When he came here, I told him, "I am going to give you absolute veto power to kill any investment in any hedge fund that doesn't meet your criteria around due diligence — on the operational side or on the compliance side or on the risk side." Brian is our first and last line of defense in the event of fraud or incompetence on the investment or business side. He's done an amazing job.

We view our role first and foremost as talent scouts. It's interesting, because some people said, "Oh, we only think of talent in the movie business." "Well, no," I said, "there's also talent in other businesses too." But if you have that definition that you're in the talent business, then what you try to do is see how talent evolves and which organizations grow the best talent. We recently recruited Parag Pande from Ziff Brothers after they decided that they were not going to manage their money internally. Again, we got lucky. Parag could have started his own hedge fund. Instead, he chose to come here.

When did BAAM start seeding hedge fund managers?

We came up with the idea in 2006, and we raised our first fund in 2007. It was $1.2 billion. Our second fund was $2.4 billion.

What was the genesis of the fund?

Again, it was listening to our most important relationships. There's a whole school of academic thought that says that smaller, newer managers produce better returns than older, larger, more seasoned managers who maybe have less to prove, who are maybe in what we would call the asset-gathering business. A number of our big investors said, "We want to participate in younger talent because we think the returns are better, and also we want to be early because we may put a $25 million piece on the table as a limited partner, but we want future capacity where over a period of time we could put a couple hundred million with a manager." So we came up with a completely new model where we have $100 million to $200 million that we can invest as an LP, and we position the new manager into line of sight for big institutional investors. We help them with their operational side, dealing with the risks of starting a business, compliance. We introduce them to LPs, and because we maintain our LP investments in the fund for three years — which is a big deal — they can actually say, "I've got an anchor tenant." If you look across all of our Strategic Alliance Fund managers today, they are managing over $20 billion in total. So the model is working in terms of institutions wanting to put money to work once managers have been vetted.

Doug Silverman and Alex Klabin of Senator were one of the first managers we seeded. They came out of York, where Jamie Dinan not only runs a great business but also really trains his people well. This year we sold our piece in Senator back to Doug and Alex for $150 million; we distributed that to our LPs. Senator was also the first deal in our Strategic Capital Holdings fund, a drawdown fund that is buying minority interests in established hedge fund firms.

What is the impact on the hedge fund industry of what you're doing?

We're giving hedge funds an opportunity to solidify their position as going concerns. One major challenge of hedge funds is generational and continuity of management. Often they started with one person, and there's always the question of the next generation and will this particular franchise sustain itself when the founder is no longer there or doesn't want to do it anymore. For these hedge funds, selling a minority stake enables them to establish a price for their partners to buy in. They also want to have capital to be able to expand their businesses. We invest in 140 hedge funds, so we know what it takes to succeed. We say to managers: "We'll help you. We'll be your kind of anchor to windward so that as you grow you will have a strong partner to help get you through the tough times." And that has enormous value.

What would have happened if you had ended up staying at Lehman, if things had worked out differently there?

Hopefully, I would have been able to help the firm recruit better people in senior management so that the terrible outcome of bankruptcy could have been avoided. The problem was that Dick Fuld was isolated. He surrounded himself with people who were loyal to him but weren't necessarily the smartest, the best and the brightest. Lehman had excellent talent in all of the operating businesses, but the top management did not implement a system of best-in-class risk management. In the end, a successful business in finance is dependent on the talent of the team and its ability to execute a game plan.

Are you glad things worked out the way they did and you ended up at Blackstone?

I tell all of my friends, I got so lucky. It was not what I wanted at the time. In fact, it was a big blow. But sometimes one door closes and another opens.

— Interview by Michael Peltz