# A Brave Pep Talk Turns Fear Into Opportunity

*From Star to Founder*

EastRock

# A Seed Investor Who Made a Difference, and Why Founders and Allocators Need to Know About It

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ON SEPTEMBER 19, 2008, I was on the receiving end of an extraordinary pep talk.

It was the early days of East Rock. Graham Duncan and I were running the firm and we started the day feeling awfully smart. Markets were crashing but we were protecting our investors' money by having shorted a variety of financial companies that were falling in the wake of the Lehman Brothers bankruptcy earlier in the week.

Stuart Miller was in our office that day. He and his family are seed investors in East Rock, meaning that they gave us an initial pool of capital to manage in exchange for an ownership stake in our firm.

Stuart had less reason to feel good that day. His family was, and still is, the controlling shareholder of Lennar Corporation, one of the largest homebuilding companies in the United States, and Stuart had long been the company's CEO. The housing market was at the center of the financial storm and Lennar stock had fallen from a high of $56 to a low of $9. The money we managed for the Millers was suddenly a much larger piece of the family pie.

As we sat in a conference room in East Rock's offices, an announcement popped up on our phones. The SEC had announced a ban on short sales of financial stocks. We watched on Bloomberg as the stocks we were short doubled in response.

We no longer felt so smart. In fact, we were shellshocked. Stuart took one look at our faces and knew exactly what he had to do. He pulled us out of the conference room, since others were present, and in the midst of his own company's turmoil gave us a pep talk that will be forever in my memory.

"You two better snap out of it. Wipe that look off of your faces. So we lost some money, big deal, we knew that there was risk in this program. You two are about to see the greatest investment opportunities of your lifetime. You damn well better get out there and figure out how to play offense."

I'll probably never know how much fear Stuart was feeling at that moment. His family legacy was at risk, and yet he found the courage to tell us exactly what we needed to hear while delivering it from the reassuring perspective of someone who had seen more market cycles than we had. We went on to make some opportunistic investments in the 12 months that followed and set our firm on a path to where it is today.

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Why do investment firm founders need to know this story?

Because many founders take, or at least consider, a seed investment to get their firms off the ground, and this story is a powerful reminder that who you choose as your seed investor really matters.

Why do allocators need to know this story?

Because a number of allocators take a negative view of investment firms that have accepted seed investments— a view that seems to ignore the positive side of seeding— and this story is a tangible example of how seed investors can add real value.

Some allocators go so far as to follow a strict version of the "Swensen Rule," named for David Swensen (Yale CIO 1985-2021) who refused to invest with firms that had taken a seed investment or sold a stake in the firm to outsiders. Those that follow the Swensen Rule argue that outside ownership creates an unacceptable misalignment between the investment manager and the non-seed limited partners.

We consider the Swensen Rule to be outdated, at best, for three reasons:

1. Fears of misalignment are a substantial exaggeration of reality. In our experience, the push to grow Assets Under Management (AUM), which most limited partners (LPs) correctly dislike, almost always comes from the manager rather than the seed investor. Regarding team incentives, outside ownership is hardly demotivating since the rewards of investment success remain large.

2. The ability of a good seed investor to de-risk the LP investment of others is underappreciated. More on this below.

3. The population of high quality investment managers that have taken a seed investment or otherwise accepted outside ownership has become too large to ignore.

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At East Rock, we oppose the Swensen Rule whether we are acting as a seeder or regular LP. We have invested multiple times with firms that have taken seed investments from others.

Our views on seeding are guided by a unique perspective, since we are both a seeder of new investment firms, as well as a seedee. Throughout our history, we've aspired to be the same type of high-quality seeder to new firms that the Millers have been for us.

We have made seed investments at a slow pace, only 12 in over 16 years. While we've never had a moment as dramatic as Stuart's pep talk, the small number of seed investments means that we can be there for our managers, with our full attention, whenever they need it. And occasionally, even the best managers do.

The first time we heard that a manager we seeded was rejected by an allocator for the mere fact of having taken a seed, I felt frustrated, confused, and embarrassed. As the seed investor, we had helped the manager build things the right way—the right team, the right LP base, the right infrastructure, and the right pace of growth, while providing stability by investing for the long-term. All of this served as protective support for the LP investment that the allocator would have made.

If Swensen were around today, I wonder if he'd feel that his rule had gone too far. Many of the best managers we know have accepted seed investments or sold outside stakes. It seems an act of self-harm to ignore them all.

Clearly (to us) it makes more sense to drop the binary point of view that says all seeds are bad. Instead, allocators and founders can make better decisions for themselves by correctly identifying those seed investors that help, hurt, or both.

Turning back to our status as seedee, the experience has been incredibly positive. The Millers have been a valuable source of advice, resources, and relationships. Everyone in the East Rock orbit is better off for their role in our firm, and while I think most of them know that, hopefully this writing will leave no doubt. own “ain’t” rule and we are glad we did. It was a contrarian bet with no heroics, just plenty of operating income and a clear path to more.

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NEWSLETTER
**From Star to Founder**
Insights from partnering with exceptional investment managers as they launch and build new firms

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