THE SEVEN NEWEST MEMBERS OF THE HEDGE FUND HALL OF FAME — THE FIRST TO BE INDUCTED IN FIVE YEARS — HAVE INDELIBLY SHAPED THE INDUSTRY THEY HELPED TO BUILD.
David Shaw has always considered himself a scientist first and foremost. When he decided in 1986 to leave his position teaching computer science at Columbia University to join the automated proprietary trading group at Morgan Stanley, he was attracted by the opportunity to try something different and the chance to significantly increase his net worth. Two years later Shaw left Wall Street, but he didn’t return to academia. Instead, he hooked up with fellow Hall of Famer S. Donald Sussman, whose firm, Paloma Partners, staked him $28 million to start D.E. Shaw & Co., a quantitative-based hedge fund firm. Known as much for its secretiveness as for its consistently strong risk-adjusted returns (13.6 percent annualized after fees from 1989 through July 2013), D.E. Shaw made it cool to be a quant, recruiting top Ph.D.s in math, physics and other sciences to work on its sophisticated investment models and teaching them finance. Although D.E. Shaw endured its share of adversity, losing $200 million in proprietary capital in 1998 after the near-collapse of hedge fund firm Long-Term Capital Management, it has persevered by adhering to its founder’s core values, putting integrity ahead of profits. Shaw has solved what is arguably the hedge fund industry’s most challenging problem: management succession. By 2001, Shaw had transitioned himself out of the day-to-day management of the firm. Today it is run by a five-person executive committee, which oversees $31 billion in assets across a variety of quantitative and qualitative investment strategies. The 62-year-old Shaw has returned to his first love as chief scientist at D.E. Shaw Research, a 100-person lab he founded that is designing special-purpose supercomputers to simulate the motions of biologically relevant molecules.

**Alpha: How did you persuade investors to give you money to start a quantitatively based hedge fund firm after just two years at Morgan Stanley?**

**Shaw:** I was introduced to Donald Sussman, and he really understood this sort of thing. He believed in the power of quantitative methods, and he was willing to invest in developing techniques rather than just saying: “Here’s money. Start managing it from day one.” He said, “You know, I understand this is a research thing, and if you want to do this, you can have a year to hire people and do the research, and then start trading.”

**How did you know you were ready to start trading?**

Well, we’d done a lot of work with historical data. We were working with a big database, and when we came up with a hypothesis for a model, we were very careful and made sure to test it on different data and not fall into the trap of overfitting the data, thinking that we had something real when it was in fact purely random. We had also done some live trading tests by that point just to make sure that if you placed an order, you’d get it at that price and not move the market too much. Still, we couldn’t be sure until we actually started trading whether our system would work as well as we expected. But it did.
The people are by far the most important thing. The most obvious
What have been the main drivers of the D.E. Shaw group’s success?
least in our case, it really does.

Certainly not in terms of the results we try to produce for our investors.
more than 20 years, and they have a shared vision of what the firm is
all about. They trust each other, and they work really well together.

D.E. Shaw was once deemed one of the most secretive hedge fund
firms. Do you think the firm was somewhat misunderstood because
you didn’t reveal a whole lot about what you did?

In the early days we really were unusually secretive. Back then we
were just a quant shop, and the value was in our computational mod-
els and in the minds of the people who made them. If stuff had leaked
out, that would have been really bad. Even small things could give
people clues in the aggregate if a bunch of things leaked out. So I used to say to our peo-
ple: “This is like you’re in the CIA. You can’t talk about any of this.”

Did you get pressure from investors to give some insight into what you did?

Sometimes. In the early days, though, Donald was our main investor, so we didn’t have to
tell much to anybody else for a while. Some years later, when we started accepting other
investments, there were some investors who were used to getting more information about
how different trading strategies worked than we could share with them. We ultimately fig-
ured out a way to give our investors enough transparency to make them comfortable while
still protecting the integrity of our proprietary sources of alpha. Investors generally under-
stood the reasons we couldn’t tell them everything, and the feedback they gave us helped us
figure out how we could provide them with the sort of information that was most important
to them without killing the geese that were laying their golden eggs. As the firm grew we also added a number
of investment activities that we could say a lot more about, like macro and distressed credit.

Do you miss the investment side of D.E. Shaw’s business?

It was a great experience, but I’m really enjoying what I’m
doing now, and I’m happy leaving the investing to other people. Every once in a while, I’ll stumble on a new math-
ematical or computational technique in the academic
world that seems like it might be applicable to quantitative invest-
ment management, and sometimes I’ll say, “Hey, have you looked into
this general area?” And usually the answer is something like, “We’re
already on it” or “We’re not actively pursuing that for the following
reason,” so I don’t wind up adding much value. But if our quants are
always a step ahead of me, I guess that’s a good sign.

The firm has a lot of cool things that it does, and I enjoy asking ques-
tions about them at our board meetings. But if I wanted to go back into
investment management at this point, it would probably take me a year
or two just to get back up to speed. And I don’t feel any temptation to
do that.

— Interview by Michael Peltz