OPALESQUE



Opalesque Round Table Series '13

CONNECTICUT

Opalesque Roundtable Series Sponsor:

eurex

Editor's Note

Hedge funds enter new phase of marketing, potentially addressing roughly $50tln investible capital

Providers of hedge funds and alternative investments are experiencing a massing market expansion. With greater diversification of business lines, new product mixes, and expanded channels of distribution, the sector's greatest opportunities for growth are within reach, right now.

One driver is of course the renewed push for increased presence of alternative strategies in the retail markets, with the hope that retail will be the next big source of growth for many strategies.

If we accept the fall of LTCM (1998) as the start of the institutionalization of hedge funds, we are now half way through of what is usually a 30 year maturation process. But it is not only the retail sector that will be increasingly embracing alternative investment strategies. This Roundtable also discusses how hedge funds and alternative investment managers can access reinsurance assets and so potentially address roughly $50tln of worldwide investible capital, not just the current $2tln of fund capital.

Part of the hedge funds' mission is to bring effective risk management to these new investor groups. It is fair to say that risk awareness isn't fully developed yet in the retail space, but also individual investors have started to understand that you shouldn't just chase returns, but risk-adjusted returns. It is in this context where hedge funds and alternative investments have earned their stripes.

The Opalesque 2013 Connecticut Roundtable, sponsored by Investor Analytics, Eurex and Taussig Capital, took place in June 2013 in the Stamford office of Federal Street Partners with:

1. **Brian Lasher, Federal Street Partners**
2. **Art Vinokur, K2 Advisors**
3. **Eli Combs, Meehan Combs**
4. **Jeff Haas, The Patriot Group**
5. **Damien Zinck, Eurex**
6. **Jim Robinson, Middlebury Securities**
7. **Damian Handzy, Investor Analytics**

The group also discussed:

- **How to actively generate alpha with risk management tools: two examples**
- **How smaller funds outsmart and take advantage of the larger funds**
- **The upcoming standardization of OTC transactions: are you prepared?**
- **How hedge funds can become a bond surrogate**
- **The Board who can actually fire a manager: New models for corporate governance**
- **Why Basel III will be extended beyond 2018 and QE may end mid 2014.**
- **Opportunities in direct lending, activism, CTAs, structured credit, European long/short corporate credit.**

Enjoy!

Matthias Knab
knab@opalesque.com

Cover Photo: Connecticut River -Photo by William H. Johnson, courtesy of National Scenic Byways Online (www.byways.org).

Participant Profiles



(LEFT TO RIGHT)

Damian Handzy, Jim Robinson, Eli Combs, Art Vinokur, Jeff Haas, Damien Zinck, Brian Lasher, Greg de Spoelberch

Introduction

Eli Combs
Meehan Combs

My name is Eli Combs. I am the Founder and President of Meehan Combs. We are a long/short credit hedge fund based in Greenwich, Connecticut.

Jim Robinson
Middlebury Securities

I am Jim Robinson of Middlebury Securities. I am here representing Taussig Capital. We are in the business of structuring reinsurance companies as permanent capital vehicles for hedge fund managers. We then raise substantial additional capital for these entities as Reg. D offerings.

Damian Handzy
Investor Analytics

I'm Damian Handzy, Chief Executive of Investor Analytics, which helps financial professionals make better risk decisions. We provide risk management and risk aggregation services for hedge funds and alternative investors including stress tests, Monte Carlo, scenario analysis, and a suite of regulatory risk services like UCITS, Form PF, AIFMD and OPERA. We have 35 people in the US and the UK and service over $380 Billion of Assets Under Analysis.

Art Vinokur
K2 Advisors

My name is Art Vinokur, and I am a Managing Director at K2 Advisors overseeing allocations in event driven, credit, and relative value strategies. K2 Advisors is a global provider of hedge fund investment advisory products and solutions. We are a subsidiary of Franklin Templeton Investments.

Jeff Haas
The Patriot Group

I am Jeff Haas, the COO for The Patriot Group. The Patriot Group is located in Darien Connecticut, employs 15 people, and has been in existence since 2002. We are a multi-strategy asset management firm with the current focus on direct lending, secondary purchases of hedge funds, and an absolute return strategy. In direct lending, with traditional banks not lending we focus on providing senior secured debt secured by assets, including real estate. Our direct lending efforts allow us to generate transactions that have contractual interest rate coupons ranging from 8% to greater than 15% in an environment where most investors are faced with extremely low rates on most other credit products. We leveraged off our asset and real-estate lending expertise to create a hedge fund recovery fund that focuses on purchasing hedge fund limited partnership interests on a secondary basis where the underlying investment focus was either asset-based or real-estate lending. We also have an absolute return strategy, which is different than the first two in that it is liquid. This strategy uses a quantitative model that incorporates a number of factors to generate buy and sell signals to enter and exit the market. This is not a high frequency trading strategy, in that on average the model will enter and exit the market approximately four times during a year. The strategy has a long-term track record and has historically been a good capital preservation tool.

Damien Zinck
Eurex

My name is Damien Zinck. I am in charge of the Buy Side Business Development for Eurex, covering CTAs, hedge funds, institutional investors, and traditional money managers in the U.S., Canada, and Latin America. Eurex is one of the leading derivatives exchanges in the world, with offices throughout the world and, in the U.S., in Chicago and New York.

Brian Lasher
Federal Street Partners

My name is Brian Lasher, and I am from Federal Street Partners. We are a fund of hedge funds boutique located in Stamford, Connecticut. Our focus is generally on smaller and more entrepreneurial firms, and we favor firms that are lift-outs or teams. We value co-investment from the managers that we invest with.

New: MSCI Europe and MSCI World derivatives

When it comes to equity-based derivatives, we have a greater share.



Eurex Exchange is home to the most heavily traded European equity index derivatives. On average, 1.8 million futures contracts and 2.6 million options contracts change hands every day.

Our equity-based offering includes well-known indexes like EURO STOXX 50®, MSCI Europe, DAX® and SMI®. We also trade a broad range of equity index and single equity derivatives as well as the most liquid market in global sector derivatives.

And on Eurex Exchange you have direct access to some of the most popular products of emerging markets exchanges – including SENSEX, MSCI, and the Korea Exchange's KOSPI 200 Options – the world's most liquid options contract.

You get the flexibility and global reach from a variety of derivatives on single underlyings – with more than 920 Single Stock Futures and 500 options on equities from Europe, Brazil, Canada and the U.S.

And many of these international products have tighter spreads and better order book liquidity on Eurex Exchange than in their home markets.

We also offer products that let you trade and hedge against the changing nature of today's equity landscape – including dividend derivatives based on our core indexes and their components as well as volatility index derivatives based on VSTOXX®.

And with EurexOTC you can enter large volume bilateral trades – because everything on Eurex Exchange is handled through Eurex Clearing, one of the world's leading clearing houses and an innovator in risk management.

Greater liquidity, global opportunities, multiple ways to make the most of the equity markets.

Discover more on Eurex Exchange.

www.eurexchange.com

eurex

The information published in this publication is for general information purposes only. It is not intended to constitute investment advice nor is it intended for solicitation purposes. Eurex is not responsible for any errors or omissions contained in this publication. Before trading, persons should consider the risks involved and the legal requirements of the relevant jurisdiction.

Greg de Spoelberch What are you seeing in your industry and what excites you as far as industry trends and innovation?

Jim Robinson At Taussig Capital we come at things from a structural perspective, and one of the upshots of the last five years since the break or crisis is the fact that many of the managers that are surviving and actually growing in the last couple of years are diversifying their product mix - they are not solely reliant on a single structure and single channel to raise capital.

So in addition to the natural processes of consolidation and professionalization, we are seeing structural changes that are very positive for a lot of the managers out there.

Eli Combs I can add to that from personal experience. When we created Meehan Combs, we created a firm with a unique fee structure and a unique governance structure, which has been fairly well received by the markets.

I think that on a general level, and maybe this is tying into the point that you just made Jim, after the credit crisis it seems like there is more flexibility in the industry to think outside the box in terms of different structures and ways to express hedge fund strategies. That includes in our case governance and fees, but also includes funds that are getting into permanent capital vehicles or 40 Act vehicles, and so on. It seems momentum in those areas has developed significantly over the course of the last three years.

Jeff Haas: I would second what Jim was saying. The Patriot Group historically had its roots in direct lending. Post-2008 we have tried to use The Patriot Group as a platform to look at the credit space in a unique way, focusing on some unique and niche opportunities, as opposed to the more mainstream credit activities.

With that approach in mind, we continue to engage in direct lending and we see a great opportunity in the U.S. with the continued challenges in the traditional banking environment. With banks really not lending to small businesses, we have stepped in and are able to generate transactions with yields exceeding more mainstream credit opportunities. Additionally, in an effort to add a more liquid investment opportunity we have added the absolute return strategy that I mentioned, for investors looking for an interesting liquid trading strategy, further expanding our asset management platform.



Finally, we also added an investment opportunity that leverages off The Patriot Group's expertise in asset-backed and real-estate lending and created a fund which purchases hedge fund limited partnership interests on a secondary basis. The emphasis of this fund is to identify opportunities to purchase interests that have underlying activities in either asset-backed or real-estate lending, which are areas where we have an expertise. So we are trying to give investors a broader base by offering different opportunities across our asset management platform.



Art Vinokur: We see a very similar trend as it relates to greater diversification of business lines, product mixes, and channels of distribution. However, this is not a new development, but rather a continuation of what has been going on for many years now. Both we and our clients are focused on distilling what is the value of a traditional fund of funds for the end investor. Finding different answers to that question leads both to a proliferation of the structuring solutions that you all mentioned, and to the increased focus on different parts of the market for sourcing investment opportunities.

For example, our investors generally don't need our help in finding the largest

hedge funds, so the historical value of a traditional fund of funds as an access vehicle is less pronounced now. However, many of our clients do need our help in finding smaller managers, emerging strategies, designing actively managed portfolios, risk management, outsourced legal or operational due diligence, negotiating advantageous terms, or co-investment opportunities, to name just a few areas. To meet those needs, a lot of our growth in the past several years has been through advisory relationships, customized mandates, or investment structuring solutions such as managed accounts, liquid alternatives, and so on.

Brian Lasher: Expanding on what Art mentioned, an interesting new phase of the industry transition on the investor side is that we are entering an advisor pickers market, much like a stock pickers market.

Except for those exceptional advisors, fees for institutions generally have been reset to similar lower levels such that the cost of accessing the hedge fund market for a large institution is similar whether doing it directly and developing an internal staff, or using consultants or outsource CIOs, or using commingled products offered by funds of funds.

Accordingly, investors can now really compare advisors based upon their quality and level of returns and their service capabilities. The challenge is getting an accurate return comparison. Going forward, institutions should demand that advisors disclose on a no-names basis the returns and benchmarks for all the various programs and accounts that they run for clients. As a fund of funds, we disclose every month what our commingled products do, and given our history of significant transparency we would clearly do the same on a no-names basis for all our managed accounts.



Then, institutions can ask, is this advisor producing risk-adjusted returns over and above the desired benchmark taking into account the fee reduction that they could potentially negotiate themselves? Are experienced, senior professionals doing the investing for you or a cadre of newly minted MBAs? Does the firm have the level of service and responsiveness of a boutique or a large, mega organization? Institutions can be highly selective now.

Damian Handzy

We started Investor Analytics 14 years ago when hedge funds had not yet exploded on the scene, funds of funds were just starting to gain traction and pension funds wouldn't go anywhere near a hedge fund.

Investor Analytics has focused solely on risk management for hedge funds, funds of funds, pension funds, money market funds, endowments, foundations, prime brokers and managed accounts. We have witnessed the maturation of risk analysis from simply protecting your own money – where it all started – to protecting your investors' money.

Damian Handzy: It's fair to say that in the mid-2000s there was a good deal of lip service given to the concept of risk management. The accepted convention at the time was, "we do have a system because our investors require us to have one, but don't ask me to necessarily turn it on or produce a report from it."



That has all changed post-crisis. One of the first things we had to do at Investor Analytics was expand our knowledgeable client service staff to answer the tough, meaty questions from hedge funds, funds of funds and pension funds who were all learning a lot more about risk and caring a lot more about risk

From an overall financial industry perspective, that risk wave hasn't hit the retail space yet, but asset management investors are starting to understand that you shouldn't just chase returns, you should chase risk-adjusted returns. Our industry has made great advances there, and I am hoping that the retail space catches up, because none of us want our parents or family members to be at risk.

RISK
IS ALWAYS
ON

Risk. It's no longer a 4-letter word. It's a reality.
And with increasing client demands for transparency,
unpredictable market volatility and new regulatory
requirements, it's also an imperative.

And when it comes to managing that risk,
Investor Analytics covers everything.
We provide end-to-end aggregation, processing
and delivery of customized risk analyses.
All on the industry's most intuitve platform.

Try it and see for yourself at:

www.InvestorAnalytics.com/RiskOn

INVESTOR ANALYTICS

RISK TRANSPARENCY

Jim Robinson Damian, are you seeing any of your clients actually looking at risk as potential value-add in terms of incremental returns?

Damian Handzy Absolutely. Earlier this year, we hosted a risk summit that was widely attended by our clients and industry participants. Our panel of hedge funds experts agreed that the biggest change in risk management post-crisis is that it has migrated from the back office to the front office. The risk manager is now co-piloting with the portfolio manager regarding the actual risk analysis techniques used to garner returns.

Jim Robinson Is anyone actually generating ideas using risk? Has risk migrated to the point where in the more enlightened organizations they are using it for actual stock selection or idea generation?

Damian Handzy: Yes, companies are actively generating alpha with risk management tools, and I'll give you two examples. One is that risk concentrates on the left tail, and we all know that the left tail is asymmetric with the right tail. However, the techniques of analyzing the left tail lend themselves to analyzing the right tail. The result is that firms are now looking at the causal relationships that make the tail fat – and on the flip side examining the causal relationships between the securities that will make the right tail, the gain tail, as fat as it could be.



The second example is a hedge fund using risk analysis techniques to identify the characteristics of trades that generate the most profit. Their intention, naturally, is to do more of the trades that increase profitability and less of the trades that do not. And while that's pretty obvious when you think about it, the mathematical techniques of actually teasing that out come from the methods used to understand risk drivers.

Art Vinokur K2 has been around since 1994, and since the early days we have been focused on institutional-quality risk management as one of the key areas of value for our clients. That focus has not wavered either before or after the crisis both as it relates to our own process, and as it applies to our underlying hedge fund manager investments. Risk management is one of several value-adds that arise from aggregating pools of capital, with investors benefiting from economies of scale of a larger firm such as ours, as opposed to trying to do everything in-house or with the help of a consultant.

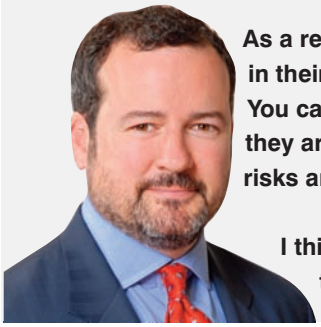
Brian Lasher What Damian had to say a minute ago is very encouraging, primarily because the emphasis on trying to tease out the right tail is as important as teasing out the left tail from the data that we all receive and run through our risk models.

The last couple of years, the industry has been so focused on risk that it has become more "return-adjusted risk" avoiding as opposed to the risk-adjusted return seeking mode.

At Federal Street, we invest our own money alongside with our clients, and we are very much focused on generating risk-adjusted returns as opposed to just taking on some level of risk and hoping for some return on the back side. An emphasis on the right tail suggests a better return generation for our industry going forward.

Eli Combs Tying in the earlier question about trends in the industry with your discussion about risk, what we are seeing from the standpoint of a newish manager is that to the extent that you can quantify your risks and returns and make it very clear where they are coming from, what seems to be happening is that firms are becoming repositories of talent and ways to generate returns and less a way to access a specific structure, like a two and 20 structure.

Eli Combs: As an example, there is a firm that we know very well which has been around about a year longer than ours, and they have six different products which are permutations of what they do. But they were able to have those six different products and grow them as individual business lines, because they were able to deconstruct where the risks in all their portfolios are and where the returns have come from.



As a result, they are able to go to the end investor and say, if you believe in our core skill set, which in their case is long/short credit, like ours, then here are different ways that you can express that. You can take the riskier type of portfolio or the less risky portfolio, and that's only possible because they are able to disaggregate in a very specific way where they generate returns and where their risks are.

I think that being able to quantify that gives creative or opportunistic firms different ways to grow their business and to actually represent what the end investor wants.

Damien Zinck As an exchange we see that data is available and is plentiful, but the key is to know what to do with that data, and that's where risk comes into play. Based on feedback from our clients, I would agree about the rising importance of risk now in investment strategies and for investors in selecting the right managers.

I see also the emergence of or the continuing success of some hedge fund platforms which provide transparency. That is a huge theme that we are seeing with our clients. I welcome all these trends, especially if they allow investors to gain more comfort with managers that are smaller or medium sized. Here I echo what Brian and Art said about looking at smaller managers, because unfortunately, as we all know since the crisis, the trend has been to go with the larger hedge funds. The larger ones have become even larger, and there is a lot of talent out there which is not benefitting because they are in the $100-500 million area.

Greg de Spoelberch Does anyone have anything else to add in that regard as far as transparency for investors, are investors becoming more granular with their demands for transparency?

Jeff Haas: On the transparency side, one of the things that has dramatically changed for us is that we have shifted the direct lending activity from a traditional hedge fund format, to a managed account or customized portfolio format.

For investors who are looking for yield, we see a great deal of opportunity right now because of regulatory constraints being placed on the banking structure in the United States. This results in the inability of small- to medium-sized companies being able to access capital. We see a tremendous amount of deal flow where we can generate collateralized lending transactions with returns between 8% and more than 15%.



We are now executing our direct lending activities in customized portfolios. Customized portfolios or managed accounts lend themselves to increased transparency. Additionally, by approaching direct lending in a customized portfolio, investors will have some input in the construction of the portfolio and the types of deals that we source for them.

We have a couple of investors that are specifically oriented toward aircraft finance transactions and that's all they want in their portfolio; our team will source only these transactions for them. It's the same thing with the more liquid opportunity that we manage, our absolute return strategy is being executed exclusively in the managed account format, again providing greater investor transparency.

Damian Handzy Damien mentioned that post-2008 most of the flows went to the big firms. I think that is largely interpreted as investors fleeing to safety as a risk management technique.

Transparency and managed accounts emerged from the financial crisis for much the same reason, which is the appetite for safety and fact that investors feel safer if they can see everything in their portfolio. That being said, investors might not necessarily know what to do with that information

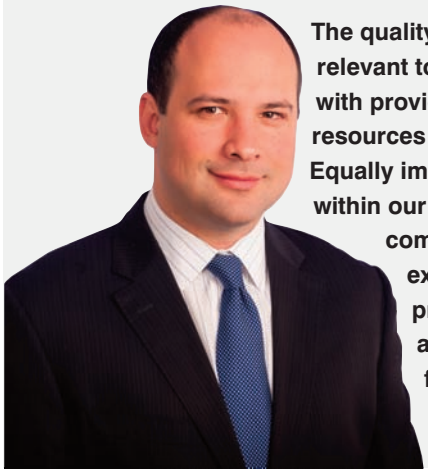
and may need advice and help to properly interpret the analytics – but there is a very strong desire to see that transparency.

The industry is itself proactively responding to investors and regulators through initiatives such as OPERA and AIFMD. It is attempting to find a balancing act between the degree of transparency to provide and the type of information investors need to feel safe.

What I am seeing is the trend of smaller-sized managers who are looking to attract investors. They do that first and foremost by generating good returns, but they are also treating transparency as almost equally important. Most flows we are seeing in the industry are definitely going to firms who provide transparency, because institutional investors are now demanding it. If you are not doing that, you are not in the game.

Art Vinokur: The value of transparency became very clear to everybody post-2008 crisis. However, what people were mostly focused on was a component of transparency relating to independent asset verification – the need to see every single line item in the portfolio, and having those holdings verified through an independent party.

That being said, there is a huge difference between seeing the data and understanding what it is. Aside from asset verification, the value of full transparency is very limited if you do nothing with that data, or don't have the tools to analyze it and obtain meaningful information. Seeing what you have and understanding what it is are two very different things. A listing of "Position A" in the portfolio is meaningless if an investor does not have the tools or the time to understand the risk factors relevant to that position, its liquidity, how it relates to other positions within the aggregate portfolio, etc.



The quality of analysis that you can perform on the data you receive from managers is more relevant to us than the mere fact that they provide transparency at all. All managers we invest with provide us with very good transparency. Our firm, in return, has spent extensive resources by investing in technology and people across our research, risk, and IT groups. Equally importantly, we have developed a culture of risk management and risk understanding within our firm, with a focus on quality of analysis rather than just quantity. Some of this value comes from the fact that most investment professionals at K2 had direct investing experience of their own as traders, analysts, or portfolio managers. As a result, our process is focused on understanding what the drivers of the manager's returns are, as well as what are the true sources of risk both on the downside and the upside. We feel that is a key to a high quality risk management program, rather than just having transparency that one doesn't know what to do with.

Jim Robinson: I think transparency is demanded in a lot of the new products that have been evolved. 40 Act funds, for example, and ETFs. There is a whole different level of information. To your point, I don't know that there is true incremental knowledge, or understanding or meaning, I think that generally follows – but more transparency can actually lead to greater complexity and result in greater confusion

I do think that one of the greatest opportunities is expanding markets, and I think Eli was saying it in our pre-talk that he is seeing demand from non-traditional hedge fund investors. Part of that is a changing landscape, part of that is an awareness of the inherent risk in the credit markets relative to very long-term trends. But it's also transparency, alternative products, liquidity, and massive market expansion, because through a 40 Act or through a reinsurance company, the way we operate, you are addressing roughly $50tln of worldwide investible capital, not $2tln of fund capital.



So your opportunity set is much larger when you go after other buckets of investors, and with that quite often there is the requirement of transparency, which I think managers are pretty comfortable with offering.

Greg de Spoelberch What opportunities do you see in the markets right now, where you can make the biggest impact, and what are the best opportunities you see right now?

Eli Combs: **Again, we are a long/short corporate credit manager with focus on Europe. We see opportunities right now because Europe is in recession and when economies go into recession, two things happen. Default rates go up and downgrades go up considerably. Both of these cause credit spreads to widen, which they have done historically and are starting to do right now in Europe. This causes companies to restructure, and that's where really we generate our best opportunities.**

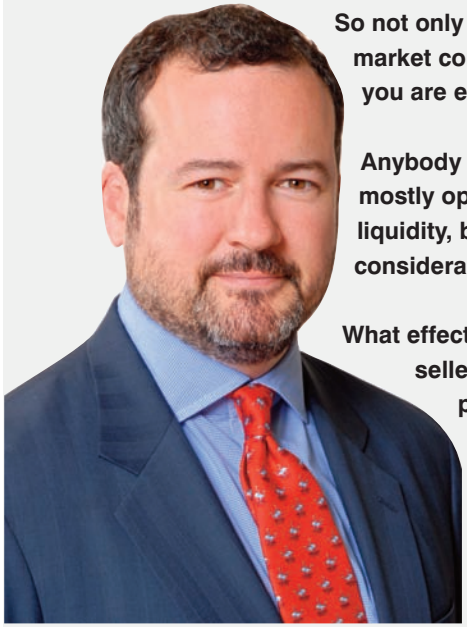
On a high level, to us it's very clear that it is the beginning of a time period of significant opportunities coming out of Europe. The majority of our portfolio right now is in Europe and the portfolio is doing well.

Another area that we are looking at for opportunities is what we call "taking advantage of the large funds". This is tying into the comment from earlier about capital moving to large hedge funds because they are perceived to be safe.

Just to provide some statistics about the market that we trade, which should make people's hair stand up but also illustrate the point. We are trading in the over-the-counter market and so we are always transacting with dealers; the inventory that is held by the dealers in corporate credit is down by about 80% in the U.S. and about 90% in Europe since the credit crisis.

This is both a risk and a challenge that a lot of people aren't talking about. Certainly none of the $5bn plus funds are talking about it, but you feel it every day in the market. In that period of time, the landscape of credit managers has gone from a handful of $3-5bn managers to a handful of $10-20bn managers. Meaning, a lot of the biggest managers have doubled in size, but liquidity has come down by 80%. The month of May was an interesting test of that limited liquidity.

You can see that liquidity dynamic, because the New York Fed lists inventory held by dealers on their website now. Not only do they list inventory by different class of credit, but they list the weekly turnover of that inventory for the prior week and what the change was from the week before that. Most of the problems in May happened in the credit markets in the last week of May. As significant participants in the high yield market, this is an area of focus for us, and if you go on the Fed website right now you can not only see how much high yield inventory is held by the dealers, but most importantly what they did with that inventory. The turnover by the dealers was down 25% in that week of stress.



So not only are they holding less inventory, but they are less willing to use it to make stable market conditions. If you have the privilege of being one of the 21 dealer banks in the U.S., you are expected to be helping to smooth out and make orderly markets.

Anybody that's been a participant in the market for a long time knows that dealers are mostly opportunistic, and you wouldn't expect that they would necessarily provide liquidity, but that is the public's perception. However, in May that turnover was down considerably.

What effect does that have? It means that prices gap out considerably when there are forced sellers. The best headline example of that is Apple. Apple came out with a very high profile bond offering to raise capital to buy back their shares at the beginning of the month of May. It was a close to 3.5% coupon bond, which was heavily oversubscribed. As an aside, it's questionable why anybody would be attracted by 3.5% from any company for that length of time.

Yet during the course of May that bond was down from 100 to 90, so the day one

investors in that bond lost three years of potential return in the first month that they owned it. The question is why such a high profile name was down 10 points during the month? Well, we believe a major reason is that there are no dealers there when people seek to sell.

We look for those kinds of opportunities, and what we are seeing in Europe is that when companies miss earnings or they have to guide down or some other operating metric changes, their bonds are down 15 points on $300-500m issues. This is contrary to past years where they might be down only five points. The challenge or the opportunity is that only five or 10 million will trade. Meaning, if you are opportunistic enough you can come in and you can buy them down 15 points. They may end up down seven points from where they were before, which can make a great gain for an opportunistic buyer. Seven points down might represent the real value, but the point of the difference between 7% and 15% is because of lack of liquidity in the market.

This is going to be tested at some point and all these big funds that are meant to be safe are going to be proven to be a lot more risky then investors expect. If I were someone focused on risk management, I would have a complete sleeve focused on liquidity, because we are in an environment where we know in the credit markets that rates are going one way, it's up, and that's against the interest of long credit investors.

So that risk is going to rear its ugly head, and if there is panic in the market given the current liquidity, things can get a lot worse than people think.

Greg de Spoelberch Damien, what can you add to Eli's insights on the over-the-counter market and his insights, and what opportunities are you seeing for clients from the exchange perspective?

Damien Zinck Regarding the subject of liquidity that Eli pointed out, I just want to mention that from the perspective of an exchange, we are in very liquid markets, so liquidity is not an issue and it is our role to make sure that the markets are efficient and fair.

Damien Zinck: Sometimes we do also see the opportunity to provide tools for investors to translate ideas into trades. Just to give a couple of examples of providing these tools, in the last 18 months we launched a futures contract on French government bonds. We did the same thing for the Italian market, and given what has happened in Europe over the past few years, it was an opportunity for many investors to either hedge their risks on a country by country basis or take advantage of opportunities between those countries. It is very rewarding for an exchange to offer more tools for market participants to implement their ideas. Another example is VSTOXX®, which is the European equivalent of the VIX, which allows also investors to hedge their portfolios more specifically for their European exposure.

From the exchange perspective regarding regulation, what might be a challenge for market participants is the new requirement to clear OTC trades through central clearing counterparties, as a result of Dodd-Frank in the U.S. and EMIR in Europe. For us it is a great opportunity because it allows us to offer our clients the possibility to benefit from cross-margining between futures positions and OTC positions. However, it is a challenge for a lot of buy-side participants who now need to have the setup and infrastructure to handle OTC clearing.



The way we see it is that the impact of that new regulation is likely to be the "futurization" of the market, which means the migration of traditional bi-lateral contracts into standardized futures-style contracts which are exchange traded and centrally cleared.

Another trend is probably going to be the standardization of OTC transactions to satisfy the OTC requirements more easily. This being said, I think that there will continue to be room for tailor-made OTC trades for customer transactions.

The opportunity for us as an exchange, as a clearing house as well, is to help buy-side firms deal with that obligation. As I mentioned earlier, there are benefits. When you clear trades with a clearing house, you do not have counterparty risk. However, there is risk as far as the margin and the collateral that you have to post, and there is a big debate right now in the U.S. as well as in Europe, as to which segregation models should be used in order to ensure that the margin and the collateral that you post are not at risk.

For example, if other market participants fail, is your margin going to be absorbed to pay for their losses, or if the clearing broker goes bankrupt, is that going to absorb your margin and collateral? At Eurex we offer in Europe a full segregation model. That means a physical segregation of the margin and collateral, which protects them from the risk of bankruptcy of fellow participants and bankruptcy of the clearing broker.

Right now the challenge for some buy-side firms, including hedge funds, is to comply with this regulation and to have all necessary setups to clear OTC trades.

Greg de Spoelberch Damian Handzy, from a risk perspective can you add to what the end-game benefits will be in regulating or centralizing OTC trades?

Damien Handzy The counterparty risk is concentrated in the exchange as opposed to being distributed across many other entities, which historically is much, much safer. This is also beneficial from the point of view of modeling risk: exchanges offer standardized information about the securities.

The trader's job is to discover or invent alpha. This is chiefly accomplished through creativity; by coming up with new trades, new ways to package or combine trades, or new things to buy and sell in order to generate alpha ahead of the competition. So by definition, there is an inventive component to hedge funds that fuels the industry's growth.



Damian Handzy: The risk analyst's job in this very simplistic picture is to chase the trader and try to figure out what they just built, invented or created, and how that new model or trade works with the rest of the markets in order to measure the potential risks.

A good example is that there are a thousand versions of every OTC trade, but if you standardize the trades, you'll get down to 10 or 20 versions. That is a much more manageable data set. And it allows you to build models, much more robust models that are far more accurate and believable from a risk perspective.

The resulting transparency cuts the opportunity for mistakes and misinterpretations of the data, and it greatly improves the modeling of the securities.

Damian Zinck In general, in terms of other opportunities, I would raise the following question around the table. It was alluded to earlier that the rising rate environment is a major issue for a lot of investors. I think that the investment managers who are able to articulate that their strategy is likely to resist, if not to take advantage of the upcoming rising rate environment, those managers will capture investors' attention.

Brian Lasher: One of the projects that we have been working on here at Federal Street concerns how hedge funds can become a bond surrogate going forward. As we all know, interest rates have fallen from the high teens to near 0% over the last 30 plus years. Looking back in history, at the end of World War II, in 1946, interest rates were near 0%, as the Federal Government held interest rates artificially low to finance World War II. Subsequently they climbed to approximately 18% in 1982, and this caused investors great principal loss when interest rates rose substantially. Since 1982, bonds have reduced portfolio volatility and delivered attractive real returns for investors at large.

It is difficult to make that case going forward for portfolios, and what we are thinking is that hedge strategies are much more likely to satisfy those two goals, which is reducing portfolio volatility and delivering attractive real returns. In the past, hedge fund of funds have pursued commingled vehicles on a multi-strategy basis to serve as absolute return vehicles. The problem has been how to distinguish oneself in a fairly crowded field and add value to clients on a risk-adjusted basis. In addition, the promise of absolute returns was overstated just as investors are likely to be surprised by the safety of bonds going forward.

What we are considering is how to reinvent this idea in a way such that hedge funds could essentially be the 40% in the traditional 60% stock / 40% bond portfolio that's been a standard in the industry for a number of years. Solving the challenge of bonds that are now adding volatility and negative performance to portfolios would be a tremendous opportunity for hedge funds.

In terms of specific opportunities, Federal Street has always had a bias towards long/short equity and emerging markets. Over the last year certain of our managers have gone more into smaller markets, ranging from the Philippines to Nigeria. We feel as long as the liquidity is still there that the weighting in some of the frontier markets will be increased by our managers or by us seeking funds who will go in those markets. As a group, frontier markets have underperformed from an index standpoint since the crisis, so as value investors we are interested in that area to be able to capture the growing consumerism and also more idiosyncratic situations that are available there, and we do it with smaller hedge funds so they can navigate pretty well.

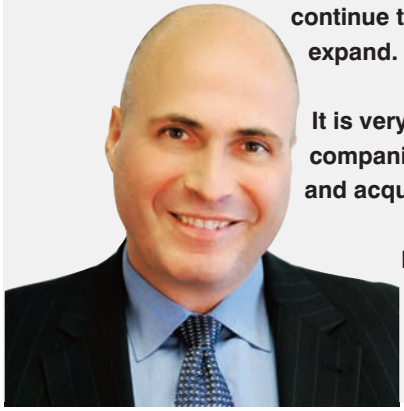


We also continue to believe for a number of reasons, that the U.S. stock market is one of the best risk-adjusted opportunities over the next several years. This is mainly due to systemic forces such as the boom in energy, the depreciation of the Japanese Yen, European fragility that we discussed, as well as basic U.S. household formation. The Economist magazine reported recently that household net worth in the USA is back to all-time highs and stands at $70tln. We have a growing population that is going to buy products and services, and with a strengthening U.S. dollar and repaired balance sheets, it's going to allow people to do that pretty easily.

Greg de Spoelberch Jeff, what can you add as far as opportunities in your field?

Jeff Haas We have a slightly different focus than many of people around the table. We really live in the illiquid world, and we tend to like the space due to the opportunities being presented to us because they allow us to generate superior yield.

Jeff Haas: If anyone follows the shadow banking industry, they know that shadow banking is about four times as big as traditional banking market right now. Over the last 20 years this gap has been expanding as traditional bank lending has shifted away from lending to small business. We at The Patriot Group expect this gap to continue to widen as the non-traditional financing alternatives for companies continue to expand.



It is very clear that in the United States, where we focus on direct lending opportunities, companies need to find other ways of financing their business for working capital, mergers and acquisitions, or whatever need they may have for their business to function.

Right now we are seeing deal flow across a variety of industries. From a risk-adjusted point of view, we feel that investors are being compensated for the illiquidity in the product with yields much higher than traditional liquid credit products. Our loan-to-value ranges from 30 cents on the dollar to as high as 85 cents on the dollar, and

that's really driven by the underlining liquidity of the collateral in the transaction.

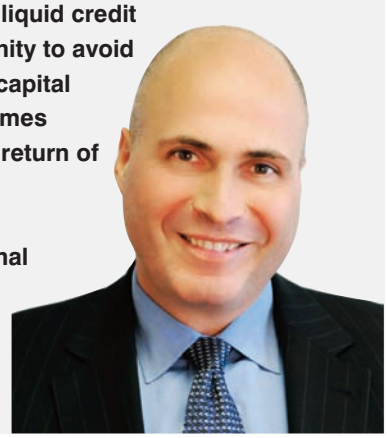
Our typical deals generate interest coupons from the high single digits to mid-teens and we are starting to see more investors interested in investing in direct-lending transactions, actually more so from outside the U.S. Investors are looking at direct lending and saying, for the illiquidity premium, we understand that this is a collateralized transaction and we can obtain significant returns for a senior secured transaction. Why shouldn't we gain some exposure to private direct lending opportunities versus lower-yielding traditional credit investing opportunities?

We are seeing significant interest from investors in Asia and that trend seems to be increasing. More investors like for example family offices and the high net-worth individuals are realizing that they can invest in direct lending opportunities that are paying a relatively healthy cash coupon and with stable returns going forward. So we see direct lending as a good opportunity for investors and it's going to continue for a while, because of the regulatory requirements of Dodd-Frank and some other regulatory hurdles that are creating obstacles for banks to lend to the small to medium-sized companies.

The state banking regulators really drive the lending process. We just got a call not too long ago from a regional bank that had a $50m portfolio of performing loans. There was nothing wrong with the portfolio, but the state banking regulators went in and said that from a capital point of view the bank had to clear them off the balance sheet. The bank basically was forced to move into the market and sell loans that are totally fine. So we would be happy buyers of that portfolio.

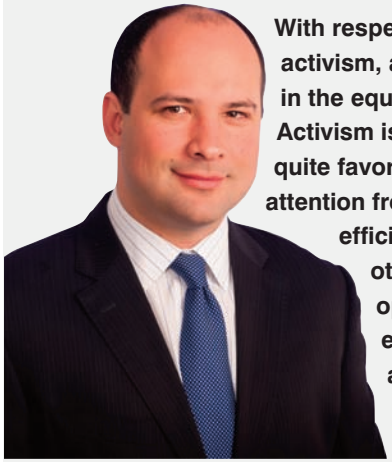
Jim Robinson I think the ABL guys, as I like to call them, like Jeff, are creating non-correlated returns where they are effectively participating in corporate income streams and deconstructing the business model of their clients. This is an income generation strategy, and as I alluded to in our initial comments, packaging is becoming very flexible, so I think it's a packaging question for Jeff and his colleagues. It's about how they access and replace, because I think Brian's comment is right on. There is going to need to be something that shifts and fills the gap, because we have already seen the chase and mad scramble for yield. We are supposed to be seeing a great rotation this year, but we haven't seen it yet. I am not sure it's necessarily going to be as obvious when it's happening, but I do think Jeff would be looking at a lot of different ways to structure his return streams, because they will do a lot of the things you need them to do.

Jeff Haas: I would agree with that a 100%. We at The Patriot Group do not operate in the liquid credit trading world. By operating in the non-traded credit markets we are afforded an opportunity to avoid volatility that may be caused by the very nature of the liquid market. That's because the capital moving around in the market right now is all chasing similar opportunities, which sometimes creates artificial mark-to-market problems for people. We can just focus on the absolute return of what we are trying to put forward for our investors.



I think investors are starting to look at some of the situations considered as non-traditional products, which until now they have shied away from post credit crisis. Investors are looking at this space because of the yield opportunities now and for the foreseeable future. Our direct lending opportunity is in place because of clear inefficiencies in the market, and we plan on taking advantage of that.

Art Vinokur: With respect to areas of growth for the industry, there is now also a renewed push for liquid alternatives which we are very excited about. Investors are trying to integrate the familiar risk, transparency, and regulatory frameworks with the alpha-generating capabilities of hedge fund strategies. With the current developments in technology, operations, investment strategies, and regulatory environment, this is finally possible in the form of liquid alternatives. We do expect that to be an area of significant growth for the industry.



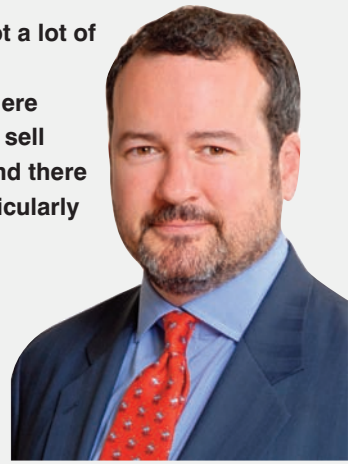
With respect to investment ideas, areas we are generally favorable on include long/short equity, activism, and structured credit. In long/short equity, there is the potential for greater dispersion in the equity markets, and thus better trading and relative value opportunities for managers. Activism is experiencing a lot of structural tailwinds, and drivers of value in that strategy appear quite favorable. In structured credit, we see a very large market that no longer receives a lot of attention from dealer desks because of regulatory changes. This leads to a complex and less efficient market which allows for better alpha-generating opportunities. Hedge funds and other direct investors are now able to serve as a liquidity provider, as well as an opportunistic buyer. We have a large team, and there are a lot of other things we're excited about, like insurance-linked securities, event-driven equity, relative value credit, and so on. There are a lot of things to do, so these are just a few of the areas worth highlighting.

Jim Robinson I am just curious, arguably two of the bigger trends globally in terms of the cap markets are the implementation of Basel III and Solvency II. I am curious if anyone here is playing deleveraging expressively or explicitly, specifically some of the investors, whether that's in your playbook or not?

Eli Combs We are very aware of it because it affects European banks. It's not a European only policy, but it clearly affects European banks, because they are more highly levered and they are subject to Basel III.

Eli Combs: Our view is that Basel III will be extended. I think it has been extended to 2018 now and it will be extended past that. There has been a lot of talk about selling distressed portfolios from banks, and that should be a good opportunity for certain kinds of investors to buy those cheaply

A lot of money has been raised for that, I think $80bn or something along those lines, but not a lot of transactions have happened. That is primarily because banks are overinflating the value of distressed assets and if they sell them, the distressed assets have to actually be marked where they really should be marked. In order for investors to buy them, banks have to be willing to sell below where that mark is. Banks can't take that hit without making themselves insolvent, and there are only really three other mechanisms for increasing their solvency, none of which are particularly attractive right now.



Our view is that if it gets to be 2018 and the banks aren't compliant, they are not going to be forced into insolvency to meet the standards of this one regulation, which will just be postponed. The result is just going to be that the Europeans who are driving this are just going to push it out. They will push it to 2020 or beyond.

Eli Combs We don't look at Solvency III as much, which is the insurance regulation. I think that has been a little more under the radar, but again, you are not going to force major insurance companies into insolvency to try to meet the requirements in this. That's our view.

Damian Handzy I just want to put this on the table and see what everyone thinks about it. Going back to what Brian said, we all agree that interest rates are going to start rising, and they don't have to go back to the 18% of the late 70s or early 80s to cause catastrophes. Brian alluded to shoots of green growth in the U.S. economy, but they are largely driven by low interest rates. Housing values are also returning via low rates, but if mortgage rates climb to 6%, 7%, 8%, isn't the growth we've recently experienced going to dry up very quickly?

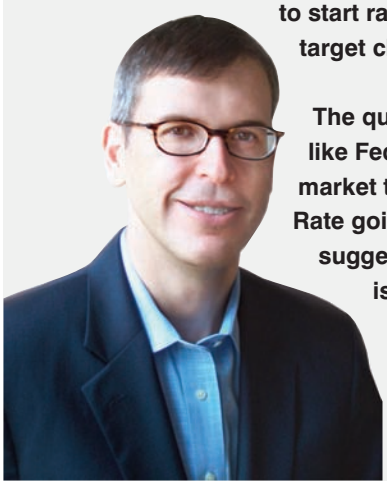
Jim Robinson Didn't we see a blip in the first and second quarter, mortgages directly correlated.

Damian Handzy Yes, we saw a recent blip, which is a direct correlation between interest rates rising and housing

sales suddenly dropping, and then coming right back when the interest rates came back down. Not only that, but now you've got those 60/40 portfolios, the target funds, with the 40% in bond funds sitting in pension books and a lot of baby boomers' retirement accounts.

So my question is: Is this a great opportunity for the hedge fund industry, or is this going to be another credit crisis that's going to hit everybody badly?

Brian Lasher: It is not in the best interest of the Fed to dramatically raise rates tomorrow to cause some of the problems that you mentioned. This is a three act play in my opinion. First, statements by Federal Reserve Chairman Bernanke are interpreted to mean that there is an end to quantitative easing down the road. In the second act, Fed officials actually start talking about a plan to reduce bond buying and whether the labor market data are good enough to start raising rates. Finally in act three, the Fed's bond buying stops and Federal Funds Rate target changes.



The question generally is how to normalize rates to historical averages to a curve that looks like Federal Funds at 3% and a 10-year treasury in the 4-4.5% range. Mid 2015 is when the market thinks 6.5% unemployment will happen which will be the trigger for the Federal Funds Rate going up. In 2017, policy adjustment ends when you look at the forward curve. This suggests an end to QE in mid-2014 and a need to be more neutral before going into reverse. It is possible that "tapering" could occur later this year. This is all normal and the market is moving ahead. This is the inevitable cycle of the business and financial world, seemingly unfolding over time as it has for much of history.

Now that the initial shock has passed, one hopes that markets begin to look past the end of QE, when the good news of improving rates of growth is accepted for what it is.

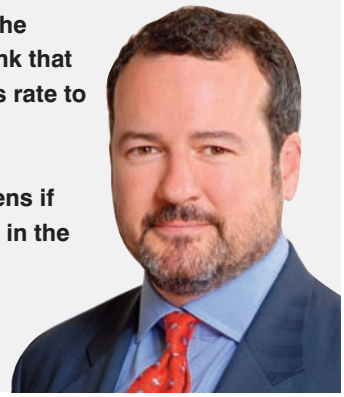
Eli Combs I'd like to look closely at a few periods because these were the last major periods of panic, certainly in the credit markets but also in the equity markets. In the summer of 2011, the 10-year rate was 3%, and that was with the short end where it is right now. In May of 2010, the 10-year was at 4% with short rates are where they are now, so the only difference was that the curve was a lot steeper.

If you want to talk about mortgage rates getting close to 6%, you get there with the 10-year somewhere around 4%. It is our general feeling that what you saw at the end of May was the reality of the Treasury market, the Fed cannot control that specifically.

Getting the 10-year down to 150 basis points was in part the Fed buying the 10-year spot of the curve. But in part people were piggybacking that, assuming it was going to go lower in yield, so there is a big momentum trade there, where the prices are always set by that last marginal buyer.

And so the Fed doesn't have to taper that much; in fact, they may not have to taper at all for the market to reflect a 3% rate again. Now, they might have to increase from 85 billion a month to 150 billion a month, but at some point it becomes a pointless exercise and they become the entire market. I am not sure that that's an end solution that anybody envisions.

Eli Combs: On the one hand I think it is reasonable to assume the Fed will keep trying QE. The market has faith that the Fed can control it, and I think May shows that they can't, and we think that they can't. There are good instances in the past where they don't have to raise the Fed fund's rate to get the 10-year 3% and 4% in recent memory.



However, on the other hand, the longer that QE persists, the worse the problem. What happens if the 10-year does go back up to 10%? The longer rates stay low, again, where they have been in the last year or so, the more risk builds up in the system.

If you look at the Savings and Loan Crisis in Texas, that event was essentially caused by

rates rising above where banks can support the loans that are outstanding. The longer rates are low, the more loans are held on the books at these lower yields. And for financial institutions that finance themselves short and they lend long, historically that has washed a lot of major financial institutions out of the market. That's what created the credit crisis.

It's a risk, and we think that the dynamic can change fairly soon, but if it doesn't change soon, the longer it exists when it does change, the more pain is going to be taken.

I wouldn't be surprised if, despite the Fed saying that things look better now and we are going to let rates rise, there are a series of surprise bankruptcies or insolvencies by leveraged financial institutions that simply mismanage themselves through the process. And that will create panic and that will increase the momentum for rates to rise, and that's the risk of not being able to control the outcome that I think a lot of people talk about.

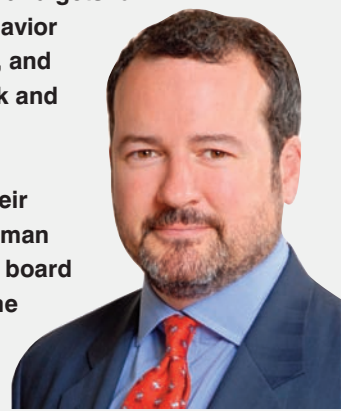


Damien Zinck: Regarding the rising rates environment, I think one area that might be worth looking at is the CTAs space. CTAs have generally experienced a difficult past few years. However some of them might be well-positioned to take advantage of trend reversals, including a trend towards higher rates. So it might be a good thing to have some CTA exposure in a diversified alternative investments portfolio.

Greg de Spoelberch Pursuant to the earlier discussion of structuring as it relates to the future of the industry, I'd like to talk about the outsourcing of fund governance. As managers and investors, do you think the current model used by a majority of hedge funds is sustainable going forward, and how should it adapt?

Eli Combs: We have a truly independent and active board which is unique, we think, among hedge funds. They are locally based, and they have the right to see full transparency into the portfolio. They also have the right to fire us as a manager of the fund, which you don't see in any hedge fund, but which should be an aspect of every hedge fund. You see it in mutual funds, it is common in the mutual fund world, but it is very uncommon in the hedge fund world.

The way we are set up, if you have a truly independent group that has a very solid reputation and gets full transparency, not five guys in the Cayman Islands, if the board starts to get a hint of bad behavior they literally can fire us as the manager. Our cornerstone investor is BlackRock, for example, and they are a big fixed income manager, so the board could turn management over to BlackRock and ask them to run this portfolio.



For example, with the SAC Capital investigation, if SAC had that form of organization now, their board would have shut them down, taken their equity portfolio, given it to someone like Goldman Sachs and said run this down, because it's not worth the risk. We hope that our independent board becomes a model for the industry. The way that some funds are organized, the structure is the exact opposite of the thing you would do if you tried to protect against the bad actions of a manager.

Art Vinokur Directorships are a significant area of focus for our operational due diligence process. For now, industry practice is heavily skewed to using offshore directors, and there is indeed some concentration with several law firms in the Caymans, for example, responsible for serving on a high number of boards. I find Eli's structure somewhat unusual and potentially beneficial. I guess my one question is what is the incentive for those experienced and independent board members to

actually sit on the board? It sounds like personal liability is potentially high while the upside is limited, unless they are significant investors in the fund who wish to have more direct oversight over their investment.

Eli Combs: They actually are not investors in our fund, and we don't want them to be. We want them to have absolutely no conflict. They sit on the board because they think it's the right thing to do, because they think it's the beginning of a good trend, a new and better trend for the industry.

Not only do we have three board members now, two of them are independent and they have stellar reputations coming out of this business. One guy was the former number two man at McKinsey. He was on the Board of the Council on Foreign Relations, teaches at Yale, and was on the Board of the Trust Company of the West. He started McKinsey's private equity practice.

The other led Merrill's alternatives business for a number of years, was the head of the Managed Funds Association, which is the industry lobbying group, and was a partner of a firm called Terrapin Partners. They are both extremely credible guys.

The next two board members, as we approach $500m under management, will be nominated by our underlying investor base and voted on by our investor base. Not only are the board members independent now, but our investors will have control over who is on the board.

The incentive is that they get paid as board members and we assume that the next board members would have the same characteristics as the last board members. Both of these guys are about 70 years old. Their compensation is not enough to live on, but it's enough to make them pay attention. They are really doing it because it's the right thing to do, and the reason we are doing it is because it's the right thing to do.

If this develops as an industry standard, it is a great step for somebody who has made their name and has experience in the industry, in any facet of the industry. It could be risk management, it could be expertise in exchanges, it could be direct lending. Whatever it is, the motivation is to be able to say, as I am stepping out of my career I can serve on five of these boards. I can be on five boards, get paid $80,000 a year per board, and make a nice living in retirement while we get the great benefit of their expertise.



The industry should move toward a model like that, right now you get five lawyers from the Cayman Islands who get paid $25,000 a piece and do anything you tell them. Just to add one more note, because I think this is important, you talked about activist managers. The whole hypocrisy of every large activist manager in the world is that they spend their whole time rallying against bad governance, but when you look at the governance of their own business it doesn't exist.

Theoretically, as K2 is a big and important investor, you should demand of your activist investors, "if you think you can fire the management of the companies you invest in, hire a board that can fire you. If you do things like put up a gate or style drift or change your transparency or do whatever, the board should be able to dismiss you." Unfortunately the industry doesn't run that way.

Jim Robinson One of the advantages of our reinsurance structures is that you have an independent board. It is an actual corporate structure, which is what you are migrating towards, and so really does represent the interest of the shareholders.

That's one of the main things as hedge funds expand out and address different investor bases. I think you are going to see these different kinds of applications of alternative structures. Structure does matter, and I applaud the effort, I think it's really smart.

It also provides, as you were saying, the graybeard, so to speak. Meaning, the opportunity to continue to use the accumulated knowledge of veterans and to leverage that in a positive way, so I think it's a great step.

Damian Handzy: You mentioned that this governance is standard in the mutual fund industry. Personally, I would love to see the hedge fund industry mature into retail. Why? Simply because I would love to be part of that history where hedge funds start as a cottage industry, see their growth hampered by media and other scrutiny and then blossom into the firms that everyone wants to invest with.

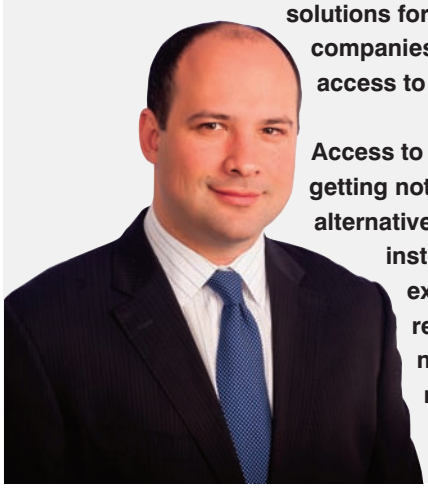


For that to happen, I believe the hedge fund industry has to adopt much better corporate governance and more standard and widely recognized practices. For a long time, the hedge fund culture was described as the Wild West, and it was. And while it's less wild now, that image persists for many people, so what do we have to do as an industry to get there?

Greg de Spoelberch Right, this is the big question on everyone's mind, how will retailization be achieved by the industry?

Art Vinokur: There is a new push for increased presence of alternative strategies in the retail markets, with the hope that retail will be the next big source of growth for a number of strategies, just like access to the diversification benefits of alternatives will be beneficial for a broader group of investors.

Discussing various strategies and their appropriateness for the retail channel, I think there is an asset-liability mismatch in some of the investments that Jeff's firm does on the lending side. However, there are structuring solutions for investing in some of those asset classes such as BDCs, listed reinsurance companies, and other potential sources of stable or permanent capital which also provide access to the retail channel.



Access to alternatives through regulated products or listed structures may be helpful in getting not only retail, but also institutional investor community with more exposure to alternative investments. Proportion of investment in alternatives is high for certain types of institutions such as endowments, and much lower for investors such as pensions, for example. If we do want hedge funds or alternative investments broadly to become a replacement for the 40% of institutional portfolios currently invested in bonds, it likely needs to be accessed in a standardized form with proper governance, risk management, and regulatory oversight, while preserving some of the alpha-generating capabilities and diversification benefits of alternative strategies.

Damien Zinck I think that one challenge is to combine the oversight and retail client protection aspects of mutual funds with the flexibility and variety of instruments that you can use as a hedge fund. That being said, I think it is an achievable task.

UCITS funds in Europe, which are similar to what we are discussing, can be accessed by retail clients and they utilize hedge fund type strategies. I think that some strategies will probably never fit into such a format, but many of them will, for example long/short equity strategies. I think it's a viable product and the investor base will be there.

Jeff Haas While I don't think everything fits into the retail channel right now, I wanted to pick up on a point Art was making regarding less liquid types of opportunities. I think what you are seeing and I believe

we will see more of, is a move toward more investment vehicles that create liquidity that allow access to the underlying illiquid activities. The Business Development Company (BDCs) are a perfect example of that. In a BDC the underlying business is investing in illiquid opportunities, i.e. private lending, and wrapping the investment activity in a public security that can be traded. This allows the retail investor to have access to an illiquid activity they normally would not have invested in.

Brian Lasher

The institutionalization of the business is likely unstoppable at this point and probably the next move is towards more retailization.

When I was in the real estate business in the early 90s, I watched the institutionalization of that business and the movement from private ownership to publicly-listed real estate companies. Mutual hedge funds and funds of hedge funds are this industry's public ownership equivalent. I remember the old real estate guys sitting around pondering whether we were still in the real estate business or in the public stock business. Our industry may be asking the same questions soon: Are we investors? Or are we in the mutual fund business?

Coming back to Jeff's comments, the challenge for the industry is the preservation of the individuality of its funds, the more illiquid strategies, and the more boutique nature. Because what we ultimately risk doing is just becoming managers of money as opposed to makers of money. At Federal Street, we want to continue to be a boutique that makes money for our clients as opposed to just collects assets and manage money for them.

Greg de Spoelberch

As far as the political landscape and the migration towards retailization of hedge funds, do you have anything to add as far as predictions or potential outcomes? Do you think it will gain momentum? Do you think there will be hang-ups? What will prevent the retailization of hedge funds from coming to fruition?

Jim Robinson: I don't see a lot of obstacles. You have got the regulators, which are the biggest force in the markets now. They are effectively, systematically squashing our competition in terms of other developers and investment products, whether it's banks or whomever. So I think there is very strong wind at the back of the industry in that regard, and you are seeing a lot of experimentation. I think you will go through another three to five years of experimentation, and it will cluster around a variety of different things.

BDCs are a really good example that Art brought up. You have seen a lot of issuance in that space, and I think they are going to become more and more a part of the corporate landscape, because banks are not coming back into the middle market. So using that as an example, I am really very positive about the industry's ability to grow itself very rapidly.

You have to remember pre-ERISA, there was no money management industry. What's the money management industry now, $50tln, $60tln, $70tln? Pick a number, and I think you are seeing that same kind of seismic change and generational shifts.

I actually begin my timeline in institutionalization of hedge funds at Long Term Capital Management, because the industry responded properly and accepted that managers owe investors transparency, risk management, professionalization, and information. We are now 15 years into the process. It's a 30 year process, so we have a long time to run, but there are already a lot of assets. If anything, things are moving faster and more strongly. It is a great business to be in.





Eli Combs: My view is that there are different ways the move to retail is being expressed. One is that hedge fund strategies are being expressed by mutual fund companies themselves, like the PIMCOs of the world, who are starting hedged strategies because they recognize that their long only funds are going to lose money over the course of the next five years. They are saying, we are going to add some shorts, or we are going to have a flexible mandate so that we can be long, or in cash, or go to different parts of the credit world to generate more absolute returns. That is a marketing tool I think for the mutual fund companies, which are basically big distribution companies.

The other way that it's happening is the way that K2 is doing it, I would presume. We haven't talked to you guys specifically about your 40 Act business, but that's taking true hedge fund managers, using true hedge fund strategies to create diversified sources of return and generate alpha. Is that a fair way of saying what you guys are doing?

Art Vinokur That would be one way of doing this, yes.

Eli Combs The difference I think is that there is a very different mentality among hedge funds, and you pay for that. That story is going to be harder to weave its way into the traditional retail world because the retail world doesn't have much knowledge of hedge funds. That is because of the prohibition against marketing, so the retail world doesn't know who K2 is, but they know who Fidelity is.

My guess is that if there was a way to charge two and 20 in mutual funds, then there would be billboards for K2 as soon as you know it. It would be like, welcome to Connecticut, home of K2.

I think a lot of traditional hedge fund managers stay away from 40 Act products because you can't charge an incentive fee. But you can in UCITS, interestingly enough, which is why you see a hugely developed UCITS market in Europe with the right restrictions and regulations.

It's great for individual investors, because in our world, in credit, if you are long only credit you are at the end of the line now; I mean at the end of the 30 year line for positive price appreciation. Because the low absolute yield levels that 40% of your portfolio, as you talked about Brian, is destined for failure when rates inevitably rise. If not for the next five years in total, but for significant points of the next five years, and so people have to find some other solution for the "safe" part of their portfolio.

Art Vinokur Discussing potential risks of the retailization of alternative strategies, the most likely risks for this process relate to execution, operations, risk management, and distribution. Branding, access to advisors, quality of investments, those are all important factors to consider.

While the risks are there, the potential benefits for investors are quite significant as well. Modern Portfolio Theory dictates that having a less restricted investment mandate is better in the long run than running a restricted portfolio. So if the best you can do as a mutual fund investor is invest in long-only equities or long-only debt, in the long run you will likely under-perform a portfolio that has a less constrained mandate and can be flexible, and opportunistic. Our responsibility as a fiduciary is to do the best we can for our investors in whatever format they are able to invest in – whether it is in hedge funds, customized mandates, or any other structure.

Greg de Spoelberch I guess the last question would, in addition to the move to retail, what does the future of hedge funds hold. Where will there be a massive amount of change, just general or specific examples of what you see going forward?

Jim Robinson: To amplify what Art was pointing to, and what we have alluded to, is we are entering a phase of marketing. You have got your engines, you understand your sources of alpha and your ability to generate that. There will always be new ways of doing things, but I think the real opportunities for expansion are new markets, new investor bases, new products, new vehicles, and the industry is embracing it, it's great.



Damien Zinck From my perspective, I think there are reasons to be optimistic for the hedge fund industry. Studies show that institutional investors express the desire to either increase their allocation or have some allocation for those who don't already. As Brian mentioned, I think the risk of entering a rising rate environment is probably going to be a factor for investors to look more closely at hedge funds as a way to diversify away from long-only bond exposure.

Brian Lasher Hedge funds definitely have an opportunity as a bond surrogate. Their flexibility as well as ability to hold short positions generates returns a bit higher than bonds but with about half the volatility of equity indices.

Looking out further, an appreciation of a longer-term view of the markets à la Schumpeter suggests an eventual return to a secular bull market. At that point, hedge funds will yet again have to adjust the business model. Sometimes, it is hard to see such an exciting future, especially these days with 24 hour news coverage, social media and the other noise that has developed over time, but our country and industry has a bright future.

Damian Handzy: Art and Brian both hit on things that I think are key to understanding the potential future of the hedge fund industry. Let's look at who is attracted to join the industry? Hedge funds, in particular, attract bright people more so than other aspects of the investment management or financial services industry. That's one of the great privileges of working in the industry.

If you work at a hedge fund or a fund of funds and you are able to work with smart people, make good money for your investors and yourself by doing exciting things, why would you institutionalize that by going to a large slower, stodgier kind of firm? That speaks a lot to the potential future of the industry. What it means is we attract the best and the brightest, which means we are going to continue to adapt. The industry attracts intelligent and adaptive people.



As an amateur student of evolution, I'll maintain that it's not the strongest that survive, and it's not the fastest. Rather, it's the most adaptable that survive. If there is one characteristic that describes hedge funds, fund of funds, and people in this industry, it's that they are adaptable. We know that markets go through various cycles and we don't know what big storm is lurking on the horizon, but we do know that the folks who can navigate the change are the ones who can adapt the best, and I think for that reason, this industry is here to stay.

As long as a boutique nature is preserved, where it's 30, 50, 100 or maybe 200, but not 5,000 people working at a hedge fund or fund of funds, adaptability and flexibility will continue to define success. So that's where I see the industry going.

Eli Combs I agree with that. I think it's adapting, moving in two general directions. One direction is that it's being dominated, as we started the conversation earlier speaking about, by the largest funds. So on the one hand the large direct funds are getting to be their own institutions and they are not really about creativity. They are about being institutional or getting institutional capital, and they fit a good spot for institutions.

On the other hand I think there will always be a place for smaller, high performing firms that are very focused and have a very specialized niche, and we are an example of this. We have a billion dollar cap on subscriptions, which is a hard cap enforced by our independent board. We want to be a small firm with a manageable number of people and be very focused on what we go after. We love

one specific area, corporate credit. We don't love structured credit, and we don't ever expect to love structured credit, but what we do we know very well and we really like it.

Eli Combs: To summarize, I think the industry is going to be dominated by large multi-strategy funds that can go after deep, deep markets. That will be the $10-50bn funds for institutions, if institutions want to go directly, or it will come down to what Brian and Art do; allocators whose main goal is to find that portfolio of small managers or harder to access managers, just because of geography or other constraints, where you can create a portfolio of those for institutions who wouldn't be able to do it otherwise.

That will allow the small creative class of investors to continue to exist and do what they find to be exciting.



Base & Precious Metals
Energy
Transportation
Trade Finance
Merger Arbitrage
Relative Value
PIPEs
Entertainment Investing

OPALESQUE'S GOT TALENT

Real Estate
Behavioural Finance
Collectibles
Funds of Funds
Statistical Arbitrage
Infrastructure
SRI
Credit
Agriculture
Long Bias
Insurance
Structured Finance
Long/Short
Forex
CTAs
Volatility Trading
Event-Driven
Fixed Income

Find countless new ideas, opportunities and investment talent in the new:

Emerging Manager
Fund Database

A SQUARE (Alternative Alternatives)
Fund Database

- ☑ Performance
- ☑ Diversification
- ☑ Uncorrelated
- ☑ Alternative
- ☑ Alpha

Logon now at www.opalesquesolutions.com

Opalesque subscribers get free access!

accurate
professional reporting service

No wonder that each week, Opalesque publications are **read by more than 600,000 industry professionals in over 160 countries**. Opalesque is the only daily hedge fund publisher which is actually read by the elite managers themselves



Opalesque Islamic Finance Briefing delivers a quick and complete overview on growth, opportunities, products and approaches to Islamic Finance.

Opalesque Futures Intelligence, a new bi-weekly research publication, covers the managed futures community, including commodity trading advisers, fund managers, brokerages and investors in managed futures pools, meeting needs which currently are not served by other publications.

Opalesque Islamic Finance Intelligence offers extensive research, analysis and commentary aimed at providing clarity and transparency on the various aspects of Shariah complaint investments. This new, free monthly publication offers priceless intelligence and arrives at a time when Islamic finance is facing uncharted territory.

Alternative Market Briefing is a daily newsletter on the global hedge fund industry, highly praised for its completeness and timely delivery of the most important daily news for professionals dealing with hedge funds.

A SQUARE is the first web publication, globally, that is dedicated exclusively to alternative investments with "research that reveals" approach, fast facts and investment oriented analysis.

Technical Research Briefing delivers a global perspective / overview on all major markets, including equity indices, fixed Income, currencies, and commodities.

Sovereign Wealth Funds Briefing offers a quick and complete overview on the actions and issues relating to Sovereign Wealth Funds, who rank now amongst the most important and observed participants in the international capital markets.

Commodities Briefing is a free, daily publication covering the global commodity-related news and research in 26 detailed categories.

The daily **Real Estate Briefings** offer a quick and complete oversight on real estate, important news related to that sector as well as commentaries and research in 28 detailed categories.

The **Opalesque Roundtable Series** unites some of the leading hedge fund managers and their investors from specific global hedge fund centers, sharing unique insights on the specific idiosyncrasies and developments as well as issues and advantages of their jurisdiction.

OPALESQUE

www.opalesque.com