



# Opalesque Round Table

## LONDON

# Introduction

Dear Reader,

Do you remember a couple of years ago various reports claimed funds of hedge funds were doomed because of the multi-strategy managers? The fund of funds didn't look to good back then. In this Opalesque UK Roundtable held June 5th 2008 in London, we are offering you some important updates on this discussion.

**In addition, you will read:**

- Which strategies work and are in demand since the credit crunch?
- Why this is not the time to go into passive investments
- For what strategies is the credit crunch actually a good environment, who is striving?
- You hear a lot about that difficulty of valuing collateral - why this complaint is often without merit
- Vital points investors often overlook in discussing fees with hedge funds
- What UK based managers say about the FSA principles-based regulation
- What US investors often don't understand about UK regulations

The Opalesque UK Roundtable was **sponsored by Newedge Prime Brokerage Group** ([www.newedgegroup.com](http://www.newedgegroup.com)) and took place in their London office with the following participants:

1. [David Harding](#), Founder and CEO of Winton Capital Management
2. [Paul Dunning](#), CEO, Financial Risk Management Limited (FRM)
3. [Tim Haywood](#), CEO of Augustus Asset Managers Ltd. (formerly known as Julius Baer Investments Ltd.)
4. [Stephen Oxley](#), Managing Director PAAMCO Europe (Pacific Alternative Asset Management Company)
5. [Joe Leitch](#), Co-Founder and COO of Rubicon Fund Management
6. [Karsten Schröder](#), Founding Partner and CEO of Amplitude Capital
7. [Gerard Gardner](#), Partner, North Asset Management
8. [Alistair \(Ali\) Lumsden](#), Portfolio Manager, CQS Management
9. [Mark Salem](#), Managing Director of Mount Capital
10. [Duncan Crawford](#), Head of Capital Introductions, Newedge Prime Brokerage Group
11. [Philippe Teilhard](#), Global Head of Prime Brokerage, Newedge Group

Enjoy "listening in" to the Opalesque UK Roundtable!

**Matthias Knab**

Director Opalesque Ltd.  
[Knab@opalesque.com](mailto:Knab@opalesque.com)

# Participant Profiles



Seated (left to right)

**Stephen Oxley, Ali Lumsden, Joe Leitch, Gerard Gardner, Duncan Crawford, David Harding**

Standing (left to right)

**Karsten Schröder, Paul Dunning, Mark Salem, Tim Haywood, Philippe Teilhard,  
Matthias Knab**

# Introduction

## **Tim Haywood**

Augustus Asset Managers Limited

My name is Tim Haywood. I am the Chief Executive Officer of Augustus Asset Managers Limited, formally known as Julius Baer Investments Limited. The company was founded in 1983 and manages currently about \$14 billion across fixed income, foreign exchange and convertibles as our core asset classes. We have six hedge funds - all branded either JB or Octavian - based around these three core areas.

We also manage mutual funds, mostly absolute return and local-emerging debt and a variety of managed accounts and traditional mandates that span back over 20 years.

Inflows have been particularly strong since the onset of the credit crisis last summer.

## **Gerard Gardner**

North Asset Management

I am Gerard Gardner from North Asset Management. We are a global macro fund, our flagship product is the fund MaxQ. We have roughly \$700 million under management in this fund and \$1.2 billion overall AUM. We have a particular emphasis on Europe, but we do have a global mandate. MaxQ's objective is to generate in excess of 15% net returns per annum.

North has 20 professionals all located in London. MaxQ is jointly managed by three portfolio managers. We utilize a mix of strategic and tactical positions in our investment process. The investment mandate of the fund is broad but historically the fund retains a high degree of unencumbered cash as positions are generally comprised of highly liquid instruments. North was founded in 2002 with the bulk of the team coming from Morgan Stanley International.

## **Mark Salem**

Mount Capital Family Office

My name is Mark Salem. I am the Managing Director of Mount Capital, an asset management firm born out of a family office investment program. We manage global multi-manager funds, private equity fund-of-funds, and a real estate fund focused on Eastern Europe.

Our principal investments vehicle is a multi-manager fund which evolved not only to invest in hedge funds, but in long-only managers, indices, and individual securities.

We define our asset allocation primarily by the opportunity set and the best ways to exploit those opportunities and invest across strategies and across geographies. Our family office culture reinforces our philosophy to only invest where we have strong conviction. We act as principal investors first and foremost. This has given us the strength to be more flexible and at times more patient.

We have a five-and-a-half year track record of compound 12% net per annum, assets in excess of \$1.5 billion, and recently due to performance and conviction we've spun out our emerging markets program into a separate fund which has compounded at 33% net per annum. All our funds are positive for the year.

I have worked in finance for the last eight years: prior to Mount Capital as an investment manager for a long-short equity fund, and prior to that in a trading business in Asia and Central Asia.

**Ali Lumsden**  
CQS

My name is Ali Lumsden and I head the ABS Fund at CQS. CQS was established about ten years ago and has approximately \$10 billion in assets under management.

We manage a portfolio of hedge funds, loan portfolios, and natural resource-focused listed funds. The six hedge funds are the CQS Convertible and Quantitative Strategies Fund, the Capital Structure Arbitrage Fund, the ABS Fund, the Directional Opportunities Fund, the Asia Fund and a CQS fund-of-funds: the Diversified Fund. Fundamental research, operations, and risk management are at the core of the business and the firm has over 280 staff located in London, Hong Kong and Geneva. Investment staff comprise around 60 portfolio managers and 30 research analysts, as well as a staff of over 120 in operations, risk management and infrastructure.

**Paul Dunning**  
Financial Risk Management Limited

I am Paul Dunning from Financial Risk Management Limited. FRM is one of the leading independently owned global fund-of-hedge fund businesses.

FRM has over US\$15 billion under management. We have been in existence since 1991 and have been running money since 1998, giving us a track record of more than ten years. Over 300 corporate pension funds are invested with us. About \$10 billion of our assets are invested in a multi-strategy diversified style, with another \$5 billion in a suite of fund-of-hedge fund products.

We have over 200 people around the globe located in six offices and an investment team of around 50 people, most of whom have trading experience. This helps us to be closely aligned to the hedge fund businesses that we are researching.

**Duncan Crawford**  
Newedge

My name is Duncan Crawford. I am head of Capital Introductions for the Prime Brokerage Group at Newedge. Newedge is the result of the merger of Fimat International Banque and Calyon Financial in January of this year. I have been at Fimat in various positions for 17 years.

**Stephen Oxley**  
PAAMCO Europe

My name is Stephen Oxley, I am a Managing Director at PAAMCO Europe (Pacific Alternative Asset Management Company). We are a \$10 billion fund-of-hedge funds firm, we are independent; the people who work for the firm also own it.

Our main clients are institutional investors, 95% of the assets we manage are from institutions; 70% from pension plans. Generally we manage diversified, multi-strategy hedge fund portfolios.

We only invest in hedge funds and include most hedge fund strategies. Our business was founded in 2000 in Irvine, California, where we are still headquartered. We employ around 110 people and also have an office in London which I helped open in 2003, and we now have an office in Singapore.

**Joe Leitch**  
Rubicon Fund Management

My name is Joe Leitch from Rubicon Fund Management. I am the COO of the firm, and also one of the founders. We formed Rubicon in 1999. All five partners came out of Salomon Brothers after the second merger with Citigroup.

We began with \$42 million, and have managed as much as \$3 billion; now we are managing \$725 million. We currently have one flagship fund, a global macro fund. We take a top-down view, focusing on economic fundamentals, monetary and fiscal policy, and capital flows.

**David Harding**  
Winton Capital Management

My name is David Harding, I am the founder and CEO of Winton Capital Management. Winton is a CTA that was started 11 years ago. Now it has \$15 billion under management and employs about 180 people in three offices. We have a strong focus on statistical research in the financial markets. We run two funds - \$14.5 billion in the futures fund and \$0.5 billion in a multi-strategy fund.



**Karsten Schröder**  
Amplitude Capital

My name is Karsten Schröder, I am the founding partner and the CEO of Amplitude Capital. Amplitude launched its first fund in three years ago in June 2005. We started very small with \$5 million of prop capital. The fund is now soft closed and manages around \$650 million. We will also launch a new product after the summer which is kind of a high frequency stat-arb, cash equity product. The firm employs 12 people, most of them with a German speaking background. Most of us moved over to the UK to run this business.

**Philippe Teilhard de Chardin**  
Prime Brokerage Newedge

My name is Philippe Teilhard; I am the Global Head of Prime Brokerage for Newedge. Newedge Group is bank incorporated in France and a 50/50% joint venture between Société Générale and Crédit Agricole. It is a firm that has more than 3,000 people operating from 25 offices in 17 countries. Newedge Group owns 83 direct exchange memberships around the world, 58 of them being derivative exchanges, 25 of them stock exchanges, and we increase this number consistently to allow our clients access to new markets.

The business model of the Prime Brokerage Group within Newedge is based on a portfolio approach. We are not a narrow based equity prime broker or fixed income or foreign exchange prime broker: our business is to operate as a multi-asset, multi-instrument, portfolio based prime broker providing clearing, settlement, custody, cash management, execution, advanced cross-margining, leverage and reporting services to hedge fund structures and investors alike.

**Mark Salem**

We are in the middle of two major global adjustments. The first is the aftermath of the credit bubble, and the second is the introduction of almost three billion potential new consumers into the global economy. We think both have much further to play out.

The first dislocation is caused by excess: excess money, excess borrowing, and the second, the opposite: pure shortage. Shortage of materials, shortage of infrastructure, shortages of resources. I think within these two powerful drivers, the dislocations will continue.

Now is a good time to find opportunities and ways to capitalize on these two forces.

Regarding investment strategies, those that rely on leverage or exotic instruments are going to remain troubled. I don't think the credit crisis is over.

However, I believe there is going to be a lot of opportunity for managers and strategies that employ a disciplined approach and deep proprietary research. It is now clear investors can rely on such managers, whereas they cannot rely on credit ratings, in the same way that they could not rely on broker research at the height of the internet bubble in 2000. Managers who have proprietary research capability should do well.

**Ali Lumsden**

Aside from helping us with the ABS Fund, our in-depth understanding of ABS has really given us insight into the whole financial system and has helped us evaluate the risks and potential losses within it. It has helped us in terms of what's going on in the markets, which includes all those developments which were the precursor for the economic distress that we are seeing at the moment.

We have seen a massive buildup in leverage and I think the markets are now suffering downfalls based on those excesses. For us as a manager of an ABS fund, it is essential to be able to understand exactly what's driving the distress. At the moment, we are definitely positioning the Fund net short going through this market.

Apart from those shorts, there are certainly some very specific opportunities on the long side. When looking at asset backed securities, it is important to have a very strong understanding not only of loan characteristics, but also the geographic distribution and behavioural elements that can drive performance, along with the resources and strategies in place to collect on the loans.

**Paul Dunning**

Hedge funds have really good fundamental research skills. Be they in equity or fixed income or asset backed etc., the good managers are using these research and risk management skills to profit from the current markets. There is a lot of dispersion and technical mis-pricing of instruments. Those hedge funds that have excellent fundamental research capability with a strong risk management will succeed and those hedge funds that don't have those qualities will do relatively poorly.

I think we are now in the repair phase of the economy, with a lot of balance sheets being rebuilt, and that brings its own interesting opportunities and challenges.

**Duncan Crawford**

From a capital introductions point of view, since the credit crunch we have seen a marked move of interest towards more liquid strategies, away from the less liquid mortgage backed and credit strategies, but also from equity based strategies. There is particular interest in commodity, macro, CTAs and volatility managers. That is partly because they tend to perform well in these periods - in fact as a group they have performed extremely well - but also because of the liquidity. They can be in and out of their positions on a minute-by-minute basis, and investors see that as a great advantage.

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The commodity story is clearly also a very interesting one, being in the first major bull run for 30 years, there is considerable demand for commodity managers, but relatively little supply. For the foreseeable future I believe the preference for these strategies will continue.

**Stephen Oxley**

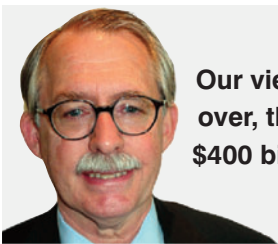
I agree with much that has been said. The dislocations create opportunities in many areas, we see a lot of idiosyncratic opportunities, which means it is very manager specific...it is about finding managers who really can navigate their way through these markets, who can exploit the inefficiencies, who are properly hedged, etc.

At our firm, as with any larger firm, there is a range of views as to which way the economy is going, but as we define ourselves as absolute return managers, that is what we want to provide to our clients.

For example, when we are reallocating the portfolio, we may to some degree see opportunities on the long side in certain credit areas like bank loans or distressed debt, and we would assume that some time later in the year there may be further opportunities, because defaults have not yet risen as might be expected in such an environment. We think there are considerable risks in other credit areas, and this is reflected by the managers in our portfolios who are generally hedging credit risk.

In the long-short equity portfolio, we prefer managers that are more tightly-hedged... In almost every strategy you can see now opportunities in the sub-strategy level, in particular niches or newer geographic areas. For example, we are doing a lot of research in Latin America, we think there are opportunities finding the right kind of long/short equity managers there.

For an investor, these times are challenging, the first quarter of the year was particularly difficult however our portfolios are up for the year.



**Our view is that this credit crunch is still evolving. We expect that when the credit crunch is over, there will be losses in the \$1 trillion range. Total write-offs so far from the banks are in the \$400 billion range, so we expect more write downs from the banks.**

**Joe Leitch**

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Our view is that this credit crunch is still evolving. We expect that when the credit crunch is over, there will be losses in the \$1 trillion range. Total write-offs so far from the banks are in the \$400 billion range, so we expect more write downs from the banks. This morning we heard the news that MBIA and Ambac may give up their attempts to retain the AAA rating which will have ramifications for banks, investors and the markets. If you look at the MBIA and Ambac, just a few months ago the market was very focused on these ratings due to the implications a downgrade would have on the banks. Now it seems as if the market is almost sleepwalking in regards to the potential MBIA and Ambac downgrades.

We think the debate on the economy has to center on growth and inflation. We expect to see



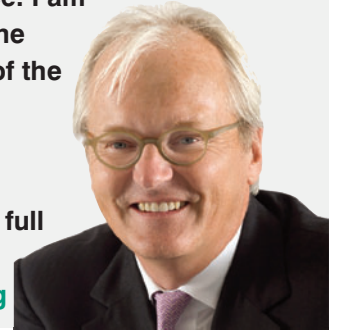
higher inflation initially, but eventually a more benign inflation environment as growth weakens. We believe the recovery will be more of an L-shaped recovery rather than a V-shaped recovery. In the US, consumers, who have historically been one of the engines of global growth, are faced with headwinds from both declining house prices and job cuts.

There was an average of 75,000 job cuts in each month in the first quarter. Last month was 20,000 but we're expecting something in the neighborhood of 80,000-100,000 for the May announcement.

**Probably people are familiar with the fact the CTAs - or some CTAs such as us - have done quite well in the last couple of years and Mark explained some of the background for this performance. I am referring to these two really major unanticipated surprises - and how far they affect the global economy: the emergence of three billion new consumers and the puncturing of the credit bubble.**

**One way we look at our strategy is to say that we make money out of unanticipated surprises. The futures markets move gradually to reflect new conditions, which in its full extent were not anticipated by the general investing public.**

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One way we look at our strategy is to say that we make money out of unanticipated surprises. The futures markets move gradually to reflect new conditions, which in its full extent were not anticipated by the general investing public.

Particularly in the last year, some of these surprises led to a protracted decline in the dollar and in bond yields, and the rising of commodity prices. The discussed two underlying trends have led to that, and we have profited from it and have had a rather easy ride.

I am afraid to say that we - annoyingly - have made it a habit to NOT to express any opinion...Not that we don't have opinions, we have lots of opinions, but we believe they are useless to anybody and we shouldn't actually air them...

So, we do not express any views going forward, and we really don't know whether the conditions will be good for our investment strategy or not. As a CTA, we would not be discouraged if they weren't for a period of time. We haven't discovered the formula that can make money all the time, but we're generally bullish over the next five years.



**I would also agree that probably the aftermath of the credit crunch is not over. I guess the reason why it creates such a good environment for quantitative strategies or CTAs is that we exploit the herd mentality of the market. So the more insecurity or uncertainty there is, the easier it is for strategies like ours to exploit this.**

Karsten Schröder

Karsten Schröder

Our views are similar to what David just said, because of the similar nature of our program. I would also agree that probably the aftermath of the credit crunch is not over. I guess the reason why it creates such a good environment for quantitative strategies or CTAs is that we exploit the herd mentality of the market. So the more insecurity or uncertainty there is, the easier it is for strategies like ours to exploit this.

You could say that over the last year, the subprime crisis has not been managed very well by the

major banks. There is a significant loss of trust in these institutions, so whatever they come out with - we had mentioned the write-downs - you don't really know if that is the end of the story, or if there will be more bad or "worst" news coming out regarding more write-downs or maybe even a collapse of an institution.

Taking a top view, we see a lot of movement in currencies and fixed income, and this leads us to believe that the markets are far away from a calm-down over the next couple of months. .

By now everyone would probably agree that the U.S. is running into a serious recession, so we have to see how the Fed's actions, the constant rate cuts, will impact inflation. If you think about it, the Fed's actions are to a large degree responsible for the scenario we now find ourselves in. The rate cuts which started in 2001 were done to basically cover the economy for the moment but created a problem in the medium term.

We will have to see what the medium term effect of the Fed's current policy will be. To that extent - and that's part of the beauty of our strategy - we don't really have to have an opinion which way this will develop, as long as it goes somewhere....Because of that extended uncertainty, I believe the outlook for CTAs will be pretty positive for the near future.

## Philippe Teilhard de Chardin

Half of the Newedge Prime Brokerage business is done directly with large investors who like statistical based investment strategies, and I agree that one of the key facts at the moment is the lack of predictability of the markets.

There is also a lack of trust, specifically a lack of trust regarding the value of collaterals. We noted the trend towards highly liquid instruments and price-able assets, while holdings in more exotic or liquidity sensitive assets are reduced.

I would be interested to see what the view of the panel is regarding how you value collateral. You all own collaterals in your funds - one way or another....



**You hear a lot about that difficulty of valuing collateral. It has also been said that these complaints may be coming from people who don't want to recognize the full extent of their losses. In the ABS area, with the ABX indices, we have an observable and liquid indication of where similar collateral is trading.**

**But still, some people draw certain conclusions or try to move away from that index by saying that their collateral is very different etc.**

**Ali Lumsden**

## Ali Lumsden

True, you hear a lot about that difficulty of valuing collateral. It has also been said that these complaints may be coming from people who don't want to recognize the full extent of their losses. In the ABS area, with the ABX indices, we have an observable and liquid indication of where similar collateral is trading.

But still, some people draw certain conclusions or try to move away from that index by saying that their collateral is very different etc. Looking at some of the data, dramatic house price depreciation is being seen with, for example, California being down 30% on an annualized basis for February alone.

Looking at sub-prime collateral, I don't think it is particularly difficult to actually assign a value to Mezzanine ABS CDOs. These are basically a collection of BB and BBB collateral with what we believe is a value pretty close to zero. The only difficulty is actually assigning a value on the basis of the longevity of cash flows. Many of the discussions that we hear from various entities, particularly highly levered entities, about the complexity of valuing these assets, are actually a fallacy. It's just that people don't want to recognize the losses.

In the US sub-prime mortgage market, foreclosures and real estate-owned pipelines have risen

dramatically. Before May, we saw only slow liquidation of this pipeline, thus the absence of realized losses which means people maintain inaccurate valuations, but there is a huge bottleneck that will eventually clear. Once you have real losses it does not matter what your accounting and provisioning assumptions were.

Looking at the May data, liquidations have become evident and we expect that to continue for at least the next six months. There is a release of that pipeline involving a lot more collateral liquidations, and the loss severities are deteriorating.

In the case of the monoline insurers and on the basis of the assumptions that have been made relating to losses, I believe that phase will be over very soon. We will see the next round of actual insolvencies as opposed to the liquidity problems that we've had recently.

## Gerard Gardner

We believe one of the key issues going forward is the polarity between large leveraged market-based economies in capital deficit competing with low leveraged essentially Keynesian-based economies in capital surplus.

There is a deflationary impulse coming out of the West's credit markets and an inflationary impulse coming out of East's infrastructure spending/export prices. This may force the central banks to contain inflation through the service sector, and this is coming at a point in time where the U.S. demographics are horrible. Furthermore the US consumer remains the headwater of global surpluses/deficits and this could finally be drying up.

There is a massive overhang of housing particularly in the US, and nobody knows how low US and UK house prices will go but this should crimp future household credit based reflation for some time. Credit quality overall should continue to deteriorate and debt recovery rates may be worse than historic norms given the unprecedented collateral overhang. We think this will lead to significant sustained margin and volume compression in the economy.

**Looking at the state of the economy, I would say that we have a global consumer retrenchment, in particular a core market consumer retrenchment, financial sector weakness, inflationary fears and commodity supply shocks. All of these pressures point to a high risk of policy errors across the world. That's basically the driver for macro funds.**

**In foreign exchange, we're going to see a real and nominal appreciation in the emerging market currencies, as inflationary effects there are notable and local capacity utilization is sparse.**

**At the same time, market participants have reduced speculative firepower - the banks' prop desks are not the force they used to be, and some hedge funds have departed.**

Tim Haywood



We believe that the equity markets in general are going to struggle based on the outlook for credit and US demographics; we don't see how they can rise as the credit/leverage premium in them remains very high. There are signs that the credit crunch could turn into a cash crunch in Q3 if no further tax rebates are issued.

## Tim Haywood

Within the tranches of sub-prime CDO's that Ali mentions, there is a gulf between the small realized losses and the huge expected losses. Servicers often step in to advance the mortgage payments if the mortgage holder fails to do so, also paying for the upkeep of the houses of those who have already left. Whilst this continues, the underlying property is not re-sold. The failure to determine the clearing rate of housing means that the tranche remains 'current' even though the prospect of full capital repayment for the tranche gets increasingly remote.

I believe that the end game of full default of junior tranches is now more certain, but the amount of money that can be made going forward is somewhat reduced, because most of the tranche prices

have moved down to reflect where we are going to eventually go.

Looking at the state of the economy, I would say that we have a global consumer retrenchment, in particular a core market consumer retrenchment, financial sector weakness, inflationary fears and commodity supply shocks. All of these pressures point to a high risk of policy errors across the world. That's basically the driver for macro funds.

In foreign exchange, we're going to see a real and nominal appreciation in the emerging market currencies, as inflationary effects there are notable and local capacity utilization is sparse.

At the same time, market participants have reduced speculative firepower - the banks' prop desks are not the force they used to be, and some hedge funds have departed. The supremacy of speculation over fundamental drivers is under threat.

And so we may be seeing some change in the trends of the weak Dollar, the strong Euro and Yen funding, which have been pretty much one-way traffic for a while. Relative value investing is very exciting but the cost and availability of finance makes it more problematic to effect.

In other words, the arbitrage opportunity exists, but who has got the firepower to close them down? Maybe in many cases you want to use cash funds rather than hedge funds, as the latter have to rely on borrowing and face larger haircuts than they would have done, say, a year ago.

Last year, there was record issuance of convertibles, much less this year. What little high yield bond issuance there's been since last July has come in US dollars, with next to nothing in Euros.

Implied volatility is cheap again but new issuance continue apace, so there are pockets in the bond market that are definitely working, and there are pockets that definitely are not.

#### **Paul Dunning**

I would agree with Tim, except that I think there are a number of banks that aren't in markets that they were before. On the other hand, there are a number of hedge funds that have committed funding for their balance sheets from the banks on pretty good terms over the past year or two. Some of these funds, including some very large ones, are in a very good position now to execute their business strategy. I would be pretty happy if I was in their shoes....

#### **Mark Salem**

We are all hearing stories of how prop desks have been massively cut down because of the need for Tier 1 capital to compensate for losses.

As an investor in hedge funds, we employ a fair amount of skepticism in our analysis. However we also find that we now have to spend a lot more time, when looking at prospective funds, to understand what we're buying, what the underlying portfolio looks like, and what assets we are getting.

It may not only be banks that have been involved in the dubious evaluation of securities. It is important to be more cautious, skeptical and ensure you know what you are buying. If unsure about parts of a portfolio, it is mandatory to dig deeper and seek proper valuations.

There are certain things that have been going on which are going to come out in the wash at some point.

#### **Matthias Knab**

**Where do you think hedge fund returns will be going in the near term? The dynamics in the emerging markets have run out of steam for the moment, and some people think the commodities situation will squeeze and suffocate the equities markets.**

**Yesterday the CEO of a very large fund-of-funds told me he expects that in the coming years investors will turn to hedge funds for capital protection. The game will now be capital protection; people will be happy securing LIBOR plus a few percent.**

## Karsten Schröder

First of all, I would say there was never really an easy time to make money. The problem is that people argue with hindsight, so they will say "well, this was obvious...."

So, of course, you could have invested in the emerging markets, you could have invested in a range of things. One thing to keep in mind is that a hedge fund provides you with a specific, unique stream of return. Also what people forget in such a general discussion is that you are dealing with many different, unique investment styles. You could even say that it is wrong to call hedge fund an "asset class", when they are actually a range of very different investment strategies.

The whole industry has evolved so much, that whenever one argues about a specific fund's characteristics, it is really required to drill down into the strategy. However this is a big advantage of our industry, as it enables an investor to specifically define his investment outcomes. Whether they seek any kind of protection or want to focus more on returns, there will be a strategy within hedge funds and CTAs that may very well match that.

Compare that now to the long only world, where you don't have that many alternatives. You can go long only or you stay in cash or go into property, and that's about it...

To that extent, investors and also big pension funds more and more understand that they actually have to move into hedge funds and CTAs to secure attractive returns and also to have a more balanced portfolio and not being uploaded with a lot of beta or just getting basically LIBOR returns if you stay completely in cash.

## David Harding

I agree completely to what Karsten says; the people do say things like it used to be easy and I do never remember it being easy at any point in time either... I also think it is difficult to speculate in general terms about future return numbers, simply because under the word "hedge fund" you have now so many different industries, and in fact what are the perfect conditions for one fund are the worst possible conditions for another.

We see now the so-called long-vol funds and the CTAs making money and the vol-short ones have

**I don't think now is the time to go into passive investments; I believe it is the time to have much more active management. Talking about emerging markets, sure emerging markets are slightly down this year, but that hides the fact that Brazil is up about 19%, while China is down 30% (in USD).**

**This is a time to be much more selective in terms of the underlying stories and underlying strategies rather than just being too passive and over-diversified.**

**Mark Salem**



been losing money for the last 12 months. Partly as a result of that, the mood has shifted from "we don't do CTAs!" to "we currently favor macro/CTA funds and we're just pretty much waiting for it to switch back again in due course."

## Mark Salem

I don't think now is the time to go into passive investments; I believe it is the time to have much more active management. Talking about emerging markets, sure emerging markets are slightly down this year, but that hides the fact that Brazil is up about 19%, while China is down 30% (in USD).

This is a time to be much more selective in terms of the underlying stories and underlying strategies rather than just being too passive and over-diversified.

## Tim Haywood

To answer Matthias' question about the strength of demand for LIBOR plus 4% to 5%, if equities are going up at a 20% annual clip, I suspect that demand will fade...but let me bring together a couple of points here. In these slightly troubled times, if people really do want LIBOR plus 4% to



5% while, as Gerard had pointed out, the cost of capital is rising, raising the yields available, then how much gearing do fund managers really need? Can we not make 6% to 9% with little or no gearing?

What liquidity is going to be needed? Customers seem to like highly liquid, lowly geared and transparent mutual funds right now.

When you have daily dealing funds, the pricing of illiquid assets is an ever-present concern. If your assets are difficult to price, then they should be backed by longer term capital.

**Ali Lumsden**

From my experience, in ABS it is possible to achieve such target returns without leverage. In this environment - when you have seen such dramatic volatility with asset prices going all the way down from par to \$0.05 in the dollar in one year - I would question pushing strategies that introduce leverage, when you can actually get very respectable returns, provided you have the resources and capabilities to carry out the fundamental research in the first place. We are in an unprecedented environment where it is possible to deliver stable, attractive, hedged returns.

**Paul Dunning**

You also have to keep in mind that a LIBOR plus 4 or 5% return oscillates over time; it's not a flat line plus 4 or 5 per cent.

As a fund-of-hedge funds, we have been investing in a large range of funds and strategies over many years, so while at an aggregated level hedge funds as a group generated very attractive returns, on a fund-to-fund level these returns vary enormously. The returns also vary if you look at any one fund over a longer time period. In the first quarter of 2008, you can say this was a tough period and there was not a lot of alpha around for a number of strategies - does that mean it's gone forever? No, it doesn't; it just means funds have to pursue different ways of extracting alpha from the varying trading environments over different time periods. I don't see any reason why as an industry we shouldn't continue prove ourselves.

**Stephen Oxley**

We are still confident that over the long-term - I would say that over a cycle of three to five years - LIBOR plus 5% is achievable by diversified hedge fund strategies. We have always been a fund-of-funds using fundamental research to find idiosyncratic return - looking for managers with skill and not trying to jump on the back of particular beta trends. That is not always easy - to be precise: it is difficult, but it is achievable.

We believe that within the current environment, there are opportunities for this type of manager, and subsequently we think we will continue to be able to provide the type of returns which we have had historically.

We are seeing a bit more volatility in the returns and that's interesting: Historically, the volatility of our core funds-of-funds has been around 3%, it is going up and I think that reflects the industry, it has to do with the current environment. While we have said hedge funds are not really an asset class, but as a whole you can say that they move through cycles, much like other asset classes.

So now the markets display volatility and in our view also opportunity. As an allocator, you have to look for those, and dynamically allocate to active managers who can exploit them.

**Joe Leitch**

Macro funds generally thrive when dislocations occur in financial markets. Over the years macro funds have done well and should continue to do so. However, when people invest in global macro they need to appreciate the fact that macro is not a strategy that will produce the 1% a month type of returns. Having said that, we think we should be able to earn investors over the years a net return of about 15% year-on-year.

But that's going to come with volatility and there will be periods such as in 1999-2000 where macro will be flat to down. The years 2005-2006 were another of those periods, where given the lack of volatility it was difficult for the macro funds.

**Mark Salem**

Looking at distressed, everyone is saying this is going to be a great opportunity, and my question for the other allocators is given that there is a lot of money flowing in, is this a bit pre-mature? So far implied default rates have spiked, but not actual default rates...yet. Another factor is the "covenant-light" types of loans that have been issued more recently. These are going to make it more difficult for creditors to work their way through a restructuring. The economy is not implying we are going to have the V shaped recovery that we had after 2002. It will be interesting to see what happens to the IRRs of distressed funds for investments made today or this year if there is a protracted recession.

**Tim Haywood**

I do agree with your premise that distressed investing is more of a 2009 than a 2008 play. We think that slowdown is going to be later, deeper, and rougher than currently discounted.

**Stephen Oxley**

I'd agree with that and we are holding back, we are waiting either later in this year or early next year.

**Gerard Gardner**

We are pretty optimistic on the opportunities to generate returns, and like Ali we don't use a lot of leverage. The trend of declining leverage rates is secular, particularly in the US, and some highly levered hedge funds have ended in spectacular failures. Falling leverage rates will create more dislocations.

Rising leverage had been the trend for some 20 years or so, which means there are large accumulations with significant concentrations of risk some of which going forward will get unwound/re-priced.

**I am excited to hear that everyone believes that later, deeper, and rougher is the way ahead, because as a fixed income shop - one that isn't always long credit - this is just fantastic news!**

**Our fear is that the slowdown won't, in fact, be later, deeper, and rougher but rather passing, shallow, and benign. Actually, April and May were surprisingly benign, the way that equities rallied and credit spreads contracted. We found that quite perplexing, worrying, and annoying. So I am glad to hear that everybody believes it is going to be later, deeper, and rougher.**

**Tim Haywood**



And typically, that's what we look for: to take advantage of well-defined trends that can fail as fundamental underpinnings are weakened to the point of requiring re-pricing. This keeps market gap risk in our favor. One of the exciting things about macro is that it lets you exploit an unwind/re-pricing event, where positions can have option like behavior from the unwind itself.

**Tim Haywood**

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May I just check the consensus here? One year rates in one year's time in the U.S. trade at over 4% which seems to us to be the height of economic optimism, but as an asset manager, we are asking ourselves how we are going to cope if indeed the worst is past? I don't believe it, personally, but it is a scenario that could occur, affecting only Connecticut, the West End, the City and Canary

**When I go back to the United States, it's interesting: I think Main Street is really hurting and I think it's much worse than it is reflected in the press, I really do think it's quite serious, a very, very serious situation. Someone had just sent me a link where you could see a developer in California was offering a 'Buy One Get One Free' deal for houses.**

**Gerard Gardner**



Wharf, but not Main Street. It would be a great surprise to us if the worst has passed already...

**Gerard Gardner**

Am I the only American here? Ok there's Joe, alright. When I go back to the United States, it's interesting: I think Main Street is really hurting and I think it's much worse than it is reflected in the press, I really do think it's quite serious, a very, very serious situation. Someone had just sent me a link where you could see a developer in California was offering a 'Buy One Get One Free' deal for houses.

**Joe Leitch**

Yes, that 'Buy One House Get One Free' link was being circulated, but that is only part of the story. I have a friend who is presently trying to buy a house in California and guess what: in areas where you want to live, houses prices aren't down as much. In areas where there are large developments, houses are down in price. The real estate market is, as always, driven by location, location, location.

In general the U.S. market is quite different from the UK market which has limited supply. In the U.S. market, there is plenty of supply.

**Paul Dunning**

As a fund-of-fund allocator, we have a relatively large allocation to credit in our portfolios. In credit, or specifically distressed, we haven't reduced our exposure at the moment, because we believe there is plenty of un-levered opportunities in that space. Also, we believe in our fundamental research, such that we look to find managers who have repeatable skill. Those managers will shift within their own space to profit from opportunities as they become obvious to them.

In our case, adding to our specialist distressed credit exposure would be more likely to happen in 2009 rather than 2008.

**Ali Lumsden**

In the ABS market, I would add that there are still very significant opportunities, because prices have moved so much even at the top of the capital structure versus the equity markets. There seems to be a significant disconnect between equity and credit. To the extent that you can effectively deploy a hedged strategy, you are able to achieve some very strong returns. This can be done on a hedged and un-leveraged basis.

**Philippe Teilhard de Chardin**

To what extent do the members of this Roundtable believe that financial institutions or banks are competing for market return with hedge fund managers?

**Tim Haywood**

A lot of banks tried to adopt the Goldman Sachs model which makes a significant portion of its profits from prop desk activity. There are very few firms who have successfully adopted that model. Under the new regulatory regime, where you may be bailed out by the Fed at some future point, you may have to be more conservative, rather than a merchant banking style operation and foregoing such a safety net.

So a sort of bifurcation may occur. The sector will be clarified, where attracting deposits will be easier for Fed-controlled banks, or the freedom and risks associated with a merchant bank operation, employing prop desks running material risk.

**Mark Salem**

I agree prop desks are going to be cut down, but from an operations and investment point of view they are interesting, because the model allows them to allocate capital quite dynamically.

It's very unusual in my experience to find a hedge fund manager who says to his investors it is

**I can see an evolution in the fund- of-funds area where we start becoming less like firms which just pick good managers and more like the investment firms, in the sense that we are making more strategic or tactical investment decisions and then finding ways of implementing them. The way we use for implementing these strategies is by finding the right managers to make those trades for us, in a hedge fund format, on behalf of our clients.**

**Stephen Oxley**



time to take some of your money back because the opportunities set have closed down. Prop desks are much more flexible, and more able to do that.

**Stephen Oxley**

The prop desks have always supplied talent to the hedge fund industry. A number of our managers were former proprietary traders, and now there are even more feet on the Street which is a good thing in my view.

Also as a fund-of-funds, you've got fixed capital and you can allocate it in a more dynamic way. I think that is increasingly happening, not just with us but with other funds-of-funds, where allocators are looking for shorter term opportunities and asking managers to focus on specific trades.

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**Paul Dunning**

A fund-of-funds allocator has a number of options when he wants to go into such thematic investments. He can invest through a managed account with a manager, or just invest into the fund of a specialized manager. Hedge funds have a lot of opportunities here in offering such options to the allocators. Having such flexibility is part of the tool kit of an asset allocator.

**Mark Salem**

I completely agree with that, I just would not go as far as to say that it has to be a hedge fund. Why would it have to be a hedge fund? In certain areas you can find very good long-only managers, who can really pick stocks and we in fact have been able to overlay a hedge around that. In some cases this can mean to get better terms, better transparency, and much better liquidity. We don't want to only go for hedge funds; even though this is the majority of what we do.

**Paul Dunning**

True, on one side it doesn't have to be a hedge fund, but in the majority of your investments you want people who are executing their strategies in a very skilled manner, which particularly includes emphasis on their risk management capabilities. In our case, that is what we are looking for, and that's really where I believe hedge funds in general prove their worth. Therefore, we mostly allocate to hedge funds.



**Let me go back a couple of years ago where various reports claimed funds of funds were doomed because of the multi-strategy managers. The claims were that multi strat managers were going to take assets from fund-of-funds, cut out the middle man, save a layer of fees and their performance would be the same. And for basically the same sort of return, why do you need a fund-of-funds?**

**I think things have changed, and Amaranth had something to do with that.**

**Stephen Oxley**

**Tim Haywood**

I have a question for the two fund-of-hedge funds here. You say you are sort of looking no longer just to pick good managers, but actually searching for someone to implement a theme. Now, is this not just a re-run of the multi-strategy fund-of-funds versus fund-of-hedge funds discussion and which could apply their ideas faster and more efficiently?

**Stephen Oxley**

That's a very interesting point. Let me go back a couple of years ago where various reports claimed funds of funds were doomed because of the multi-strategy managers. The claims were that multi strat managers were going to take assets from fund-of-funds, cut out the middle man, save a layer of fees and their performance would be the same. And for basically the same sort of return, why do you need a fund-of-funds?

I think things have changed, and Amaranth had something to do with that. Fact is that over the past two years and going forward, institutional investors continue to allocate to fund-of-funds. Fund-of-funds are, and continue to be, the first port of call for an institutional investor when allocating to alternatives, because they recognize that there is agency risk involved in allocating money to one or two individual managers. Through fund-of-funds they are diversifying that operational risk and accessing the vast and specialist resources of the fund-of-funds manager.

I do think though that fund-of-hedge funds perhaps can learn from the multi-strategy model, and they can do it in a way where they are using diversified, external sources of alpha, using best in class managers for each of the strategies they are allocating to. So in fact you won't be limited to an in-house trader. He or she may or may not be one of the best, but as a fund-of-funds you can go out and pick the best in any class.

But it does mean operating in a different way, being more flexible, moving money around perhaps from time to time and setting up structures that enable you to do that. That often means creating managed account type arrangements. Or you invest in very specific, niche ways alongside managers or alongside other fund-of-funds.



**Being able to allocate to best of breed alpha more than offsets the apparent fee advantage of multi-strategy funds.**

**Paul Dunning**

**Paul Dunning**

Being able to allocate to best of breed alpha more than offsets the apparent fee advantage of multi-strategy funds.

**Stephen Oxley**

Correct. The other area to look at is the fee discussion. We now allocate significant amounts to the managers we work with. I think it's quite reasonable to expect therefore that those managers will give us some kind of a discount on the "rack rate fee", and quite often that is the case.

A multi-strategy manager that's getting an allocation from an institutional investor will charge them the full rate, whereas we are able to get lower fees for the underlying manager and pass those fee benefits on to our clients. That again mitigates the fee that we are charging. It may not discount the whole of the fee, but it has quite an impact, particularly in periods of high performance like last year.

Then the client is just paying for the risk management work and due diligence work, which they would have to do themselves and which would have a cost in any case. So funds-of-hedge funds almost end up being "free".. and that's before accounting for any additional return you might expect to get from a good fund-of-hedge funds.

**In our experience, in "real world" experience, you have to be aware that there are organizational issues involved when moving assets within a multi-strategy fund. Reallocating within a multi strat fund can create organizational frictions. That can make it actually much more difficult to reallocate between sub managers. It is often much clearer and in a lot of cases faster to redeem and move to a separate best-in-class fund, than to ask an organization to move money internally from one investment manager to another.**



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**Matthias Knab**

**As hedge funds and fund-of-funds, what asset flows - coming from end-investors - do you observe? What are end-investors asking from you?**

**Paul Dunning**

We continue to see very steady inflows, with no material increase in redemptions, adding up to pretty strong net inflows.

We could observe though that over the past six months some institutions took a bit longer to finally commit. 75% and more of our business is institutional in nature, and apart from some investors topping up an investment, most of the net inflows are new allocations to hedge funds. They have awarded a mandate and then maybe took a little bit longer to fund it, all of which is completely understandable given the environment. Some of these investors may be entering a hedge fund investment for the first time, so there is an understandable caution.

**Duncan Crawford**

As I mentioned at the beginning, there is a considerable move from the less liquid strategies to the more liquid strategies such as macro or CTA. In general investors appear to be reducing their overall risk and increasing their liquidity, however net/net we are still seeing allocations coming in from all types of investors.

Interestingly, we also see more and more pension funds who may already have an allocation to hedge funds through a fund of funds, starting to allocate directly into single managers as well. Additionally more and more ask for managed account type offerings in order to access managers, for the benefits of transparency, liquidity and counterparty risk.

**We are seeing very strong inflows, we are in our 49th successive month with very strong inflows, which is a reward for the years where it was not so easy to raise money. Assets are now coming from institutions around the world, a lot from pension funds. Back in 1993, people were writing articles saying "Finally! The pension funds are coming into our asset class!", and they said so again by the end of 1995 and 1997 and in 1999 again...At some point in time they did come and went into fund-of-funds, bypassing us then, but now they are coming directly to us.**

**Also, there has been no evidence that we are suffering from a capacity issue. Performance the last couple of years has been fine. A CTA may not have the ideal Sharpe Ratio, but periodically they make a lot of money for you, that is what they are supposed to do, and every so often they do it.**

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Also, there has been no evidence that we are suffering from a capacity issue. Performance the last couple of years has been fine. A CTA may not have the ideal Sharpe Ratio, but periodically they make a lot of money for you, that is what they are supposed to do, and every so often they do it.

The CTA story has gained ground over the years and people have lowered the bar, but there is another thing I wanted to point out. If you look at common stock equities, including large cap stocks with \$250 billion, they have usually a Sharpe Ratio of 0.2 or 0.3 or 0.4 and that's what people expect from a common stock. Now, every institution in the world invests in a common stock, so why should hedge funds have to have a Sharpe Ratio of two to be worthy of consideration?

There has always been an arbitrage going on, and this is gradually beginning to close. The question is how much money can we, as an industry, manage with a Sharpe Ratio of three quarters? It seems likely to be a pretty substantial amount...

## Philippe Teilhard de Chardin

Pension funds are coming in, and – I agree with David – when you look a bit deeper you will find that what they like in the type of strategies that Winton Capital manage is the capacity and liquidity embedded in those strategies.

For them this is a feasible investment proposition, it diversifies assets and offers a structured approach to markets exposure. I think this is an area within the hedge fund industry that offers the biggest growth potential in the years to come.

## Matthias Knab

**David, does the quant meltdown from last year still affect you - in terms that this is a topic that you need to discuss - or has this been overcome?**

## David Harding

It was mainly a question of confusion between the stat-arb category and CTAs.

At Winton, we were not really affected by that sell-off at all. The broad CTA market also lost money in July and August. We managed to circumnavigate that with risk controls, but what needs to be explained is that stat arb and CTAs are entirely separate businesses.

Teams get together under various names like long/short market neutral, stat-arb, pairs trading, and lots of other quant equity strategies - it's very respectable because they are based on "fundamentals". It is a mainstream and respectable business but there is no linkage between them and the CTA space. CTAs, as it happens, were also knocked down in February, as well as last summer, it happened the May before -- so we average one CTA sell-off per year...Anyone who has got experience with CTAs knows that, and anyone who is thinking of investing in CTA should know that too.

If investors get in to CTAs without knowing that there will be some sell-offs from time to time, then they are not doing their investors any favors, and they are not doing their due diligence properly.

## Karsten Schröder

The discussion last summer has been done on very high level terms, neglecting the necessary differentiation. Despite the facts that there are so many different styles and models, people just call everything that uses a formula to determine an investment a "quant", and then they say that "all quants" have failed...

In our case, the assets actually started coming in with the start of the credit crises. We have also made the experience that for the first two years at least, we found it very difficult to raise assets. I do have to say investors are probably the biggest trend followers out there, generally speaking.

Once the concept is proven, everyone wants to jump on, which is an effect we have experienced, and it looks like now there is this general concept that everyone wants to use a CTA to get some protection for the uncertainty going forward. In the last couple of months, there were a lot of inflows into that space, and also to our fund.

**Joe Leitch**

Also in the macro space we have seen strong inflows in the past year. As a macro fund, we run with a high level of cash, so we have been able to offer monthly liquidity with 30 days' notice, and that has helped attract investors.

Going back to the question "What are investors asking us at the moment?" Investors are basically asking the same questions that they have been asking for the past eight-and-a-half years: "How do your operations function, what's your performance allocation, what's your risk allocation?"

There has certainly been an increase in questions about valuation. We have seen more focus on valuations from our auditor, Ernst & Young. You could say that the auditor's attention to valuation has increased by several multiples over what it had been in the past years.

People are also currently very focused on cash management and the prime brokers given the recent events involving Bear Sterns..

**Another issue in the industry I want to bring up is the compensation scheme or the fee scheme. It is generally set up in a way that you can charge performance fee on paper profits. I see this as another big issue, also in terms of incentivization. At hedge funds and also investment banks, a lot of traders are incentivized to do certain trades - where the risk is clearly on the side of the bank or on the side of the investors - and they would still get paid for it. In the CTA business this is different, because you get paid on realized profit as it is a trading business.**

**You don't get paid for actually taking risks like liquidity risk or counterparty risk or opposition concentration. But if you charge your performance fee on a paper profit, the investor gets stuck if you can't unwind the trade in the end.**

**Karsten Schröder**



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I have always been very surprised how you can have this concept in the U.S. that you employ an administrator which you could potentially own. I guess that automatically bears a lot of risk and a potential for fraud. Some people have administrators where they have third party interest in. It is pretty different here in Europe, where the FSA and other regulators prohibit that, and thereby avoid a lot of fraud.

Another issue in the industry I want to bring up is the compensation scheme or the fee scheme. It is generally set up in a way that you can charge performance fee on paper profits. I see this as another big issue, also in terms of incentivization. At hedge funds and also investment banks, a lot of traders are incentivized to do certain trades - where the risk is clearly on the side of the bank or on the side of the investors - and they would still get paid for it. In the CTA business this is different, because you get paid on realized profit as it is a trading business.

You don't get paid for actually taking risks like liquidity risk or counterparty risk or opposition concentration. But if you charge your performance fee on a paper profit, the investor gets stuck if you can't unwind the trade in the end. Such things always surprise me when it comes to fee discussions. Here, people don't get to the core of such things but simply demand a kind of fee cut from every one, which I think is not the right way to go about it.

There could be a fairer way to tackle this issue, like paying a fee for a realized profit, but if there is no realized profit, why should I pay for it? And that is obviously very different according to strategy. I think that if you are locked up for three years, why should you pay out cash performance fee on a quarterly or annual basis?

**Tim Haywood**

Since July 1st of last year, our assets are up about 65%, mostly into high liquid strategies and UCITS III daily dealing funds. We recognize that the fixed income strategies perhaps have their day in the sun two years out of seven. I expect the equity strategies will come fighting back at some point. The world rarely ends.

Initially we contemplated launching our operation in Germany. But the country is known for, how do I put this, for its unacceptance of this industry in general.

If you compare the FSA with the German regulator, the latter is very rule driven, very prohibitive. The result is that you basically have no alternative asset management industry in Germany. As a manager, you have to operate in an environment where it is very hard to attract investors, and as a consequence the investors in such a country will not have access to very good funds, because it is a big hassle to operate in these jurisdictions.

There is one thing I want to add regarding the U.S. and U.S. investors. We find that U.S. investors tend to be very focused on signing side letters, which is not the case with European or Asian investors who seem to be more familiar with the FSA type of regulation. The latter actually know that a lot of the risks are actually taken care of with the regulation, whereas a lot of U.S. investors are so concerned about fraud and all these things that they come out with huge side letters that are actually covered by the regulatory situation here.

Karsten Schröder



Matthias Knab

Karsten, you mentioned the FSA regulatory environment - you are in a unique position, as you and your team moved from Germany to London to set up your fund here. What has been your experience with the FSA and the U.K. regulations?

Karsten Schröder

Initially we contemplated launching our operation in Germany. But the country is known for, how do I put this, for its unacceptance of this industry in general.

They put higher requirements of regulation of hedge funds on the agenda of G8 summit last year, which has been absolutely ridiculous because if you see what's happened in the markets since then. The banks brought the house down, not the hedge funds. I would also add that the German regulator, the BaFin, is not dealing with the matter in a reasonable way. They basically try to blame the responsibility for instabilities in this world on the hedge funds, driven by political motivation, and at the same time they do an extremely bad job when it comes to regulating the banks.

In Germany, the state banks or state controlled banks were the ones that screwed up in the end and billions were lost. If you compare the BaFin and the FSA, the FSA is more focused on working together with the industry and making the hedge fund environment a safer place for the investors and a more credible place for us as the managers.

If you compare the FSA with the German regulator, the latter is very rule driven, very prohibitive. The result is that you basically have no alternative asset management industry in Germany. As a manager, you have to operate in an environment where it is very hard to attract investors, and as a consequence the investors in such a country will not have access to very good funds, because it is a big hassle to operate in these jurisdictions.

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**Joe Leitch**

There is no doubt that the FSA's principles-based regulation has definitely helped the hedge fund industry grow in the UK, and as Karsten just mentioned, simply having an independent administrator takes away a lot of the problems of the industry.

As we know, in the U.S. we have had hedge funds that not only did their own administration, but also controlled their own audit firm, and that is going to invariably lead to problems. The problem for the industry is that every time there is a scandal, the regulatory burdens for everyone increase. At Rubicon we have been in the hedge fund business since 1999, and it seems the regulatory burdens continually increase.

We were initially regulated by IMRO and then FSA. Now we are dealing with new regulations from MiFID including best execution, trade reporting, and the Capital Requirement Directive. As regulations and compliance continue to increase, it is more a burden on the smaller or the start up firms, and is pushing the industry towards having larger and larger firms. However I believe that the industry benefits from the entrepreneurial spirit of new managers.

One request I have regarding our industry regulators: to have more global coordination, for example between the Hedge Fund Working Group in the UK and the President's Working Group in the U.S. We are in a global industry as the markets are global. With more cooperation, regulators could help both the industry and themselves.

**David Harding**

I think that we are at a beginning of a long regulatory bull market now. I believe there will be a boost to regulate the industry broadly in all the countries around the world for many years to come. I am sticking my neck out here, but I want to add that I always thought that was a thing to come.

One would have to examine each regulatory measure individually to examine the different regulatory impacts, and how each one affects the different parts of the industry. For example, in our case something like defining a "speculative position" would affect the regulation of swaps, disclosure of swaps and swap positions. And there are many other such concepts in the case of investment banks that have been margining for CDAs and CDSs.

Looking at investor disclosure, that isn't where the problem is, that has been thoroughly done. In fact, investor disclosure could go the other way - they could actually allow hedge funds to accept investors with less protection. I think there could be a lot of regulation coming, as the various political forces progress striking at the heart of the investment banking industry and the hedge fund industry.

Let's just hope that those regulations come out in a thoughtful and beneficial manner, and it will take time to come out with thoughtful and beneficial improvements in regulation.

**Tim Haywood**

Is that really a bull market or a bear market? I suspect that some of us would deem this extra regulation as a bear move rather than a bull move... But yes, things like counter-party exposure on OTC contracts - there has never been such a large off-exchange market like CDS. The trend to go on-exchange from OTC will be pushed by the various authorities. The clearing house option is more appealing to the authorities than to the investment banks, so the battle is on.

**Matthias Knab**

**What should be included in a global regulation, and what should not get lost?**

**Karsten Schröder**

There are two objectives that the regulatory bodies should focus on. One is to avoid fraud and make the industry safe, and the other one is to also consider interest of other counter parties and also the interest of the general economy. I guess that's where Germany is coming from when they fear hedge funds could "attack" single companies and basically having an impact on the economy.

Since we all operate in a free market, that's something we have to deal with and I don't think it's wise to regulate this. But on the other hand, when it comes to safety, transparency and to the avoidance of fraud, it would be so much easier if there would be a global scheme or a global



regulation that a hedge fund would subscribe to.

This does not even have to be mandatory, you can actually do it voluntarily so that an investor would have the choice and say, "I will only invest into hedge funds that subscribes to these types of standards." The industry will move itself.

I don't think it would be the right way if the regulator puts a legal obligation on it. If you establish a reasonable standard for investor protection, for the protection of the assets, the hedge funds will do it themselves, because the investors will require them to do so.

**Mark Salem**

My only concern is that investors may get fooled into thinking that just because there is a sort of regulatory stamp, everything is now safe. There are audits, but frauds do still happen.

I don't think that we will end up with a situation where for extra regulation you can somehow mitigate any type of risk. It will remain incumbent on each investor to do his home work.

If I could voice a message to the regulator, it would be to guard against stifling innovation and flexibility in terms of allowing the market to move forward and take advantage of opportunities. Too many roadblocks will slow progress.

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**So the best way is for hedge funds themselves to self-regulate in some way and to come up with a set of standards. The manager then either subscribes and complies, or explains why they are not complying.**

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So the best way is for hedge funds themselves to self-regulate in some way and to come up with a set of standards. The manager then either subscribes and complies, or explains why they are not complying.

That process has started. There are a lot of initiatives from the U.K. Hedge Fund Working Group, the U.S. President's Working Group on hedge funds. One of the issues for those two organizations is that they can't be too prescriptive, because there are distinct regulations in each country. That means you can't actually standardize something that then causes a problem between one jurisdiction and another. This is very complex and quite difficult territory.

I believe self-regulation is the right answer, and it will evolve over time into a very important and a powerful movement. Notwithstanding that, I agree with what Mark said, whatever the regulations, you still have to go and do your due diligence, and you can't and don't want to get away from your own detailed analysis.

**Stephen Oxley**

There are two sides to regulation. One, there is the capital market side regulation - the regulation of the markets as they function - and hedge funds have always been subject to that type of regulation. If they break the rules, they get knuckles wrapped like any other operator.

On the investor protection side of regulation, there are moves to bring retail investors into hedge funds and that clearly needs to be regulated. I would just point out to be cautious here, as we also need a regime where professional investors are free to make decisions, and where hedge fund managers are not going to be inhibited in the way that they manage portfolios for those professional investors. It is the caveat emptor element on the professional investor's side.

There is also some pressure to protect vested interest, and the managements of companies, particularly from the activities of activist-type hedge funds and private equity. This is more politically driven - hedge funds as locusts - particularly in continental Europe and I would resist that.

**Matthias Knab**

## **Any reflections on the future of our industry?**

**Stephen Oxley**

I like to point out some aspects when it comes to the growth of our business, because I think there are certain fundamental forces at work here. The global pension industry is valued at about \$25 trillion, the hedge fund industry is about \$2 trillion, funds-of-funds are about \$1 trillion, and probably about 30% of all assets in hedge funds come from institutional investors.

Apart from the global pension fund industry, sovereign wealth funds come into play with now about \$5 trillion, going probably go to \$20 or 30 trillion in the next ten years. There are huge fundamental flows of assets that are going to come into hedge funds, because these institutions are diversifying their strategic asset allocation, particularly pension plans. Pensions move from having three asset classes to now eight or nine different asset classes, and some will come through funds of funds and some will go direct.

Depending on various estimates, about 70% of the flows we see into hedge funds come from institutions now depending on various estimates. And that's going to continue. We as an industry have to be prepared to receive this money and manage it sensibly.

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