Opalesque

Opalesque Round Table Series '09

NEW YORK

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Editors' Note

Dear Reader,
New York is still the dominant hedge fund center globally. Therefore we are particularly proud to present you our 2009 Opalesque New York Roundtable, where we have assembled the following round of eminent New York-based hedge fund managers, investors and advisors:

1. **Ed Robertiello, Managing Director, head of fund of hedge funds Americas at** Credit Suisse
2. **Tim Schuler, CFA, Senior Vice President & Investment Strategist,** Permal Group
3. **Carrie McCabe, CEO and Founder of** Lasair Capital
4. **Chris Acito, Founder of** Acito Advisory Group, **former Managing Director and Global Chief Operation Officer for** Investcorp's Hedge Fund Group
5. **John M. Bader, Co-Chairman and Chief Investment Officer of** Halcyon Asset Management
6. **Bill Geisler, Portfolio Manager,** Malbec Partners
7. **Christopher Pucillo, Chief Investment Officer and Portfolio Manager,** Solus Alternative Asset Management
8. **Katherine S. Kim, Senior Analyst,** Affirmed Capital

The Round discusses **fundamental changes in asset allocation of public and corporate pensions, who have started to allocate to alternatives straight out of their equity portfolio, rather than putting hedge funds into a "5% niche"**. You will learn details:

- **What macro signals do hedge funds use for their strategic positioning?**
- **Challenges for emerging managers: What happened to seeding?**
- **New insights on risk and reward of different asset classes and hedge fund strategies**
- **What are the "rescue mandates" that Credit Suisse and other notable firms are now getting?**
- **What are the huge opportunities investors can pursue in the secondary markets for hedge funds?**
- **What new hedge fund compensation models are already now being deployed, but why do hedge fund fees not seem to ever go down?**
- **What keeps many hedge funds from participating in TALF and PIPP programs?**
- and much more!

The Roundtable took place May 27th 2009 at the New York office of Abernathy MacGregor Group and was sponsored by Taussig Capital.

Enjoy "listening in" to the 2009 Opalesque New York Roundtable!

Matthias Knab
Director Opalesque Ltd.
Knab@opalesque.com

Cover Photo: Brooklyn Bridge, New York

Participant Profiles

STANDING (LEFT TO RIGHT)

Christopher Pucillo, Tim Schuler, Joe Taussig, Bill Geisler, John M. Bader and Matthias Knab

SITTING (LEFT TO RIGHT)

Ed Robertiello, Carrie McCabe, Katherine S. Kim and Chris Acito

Introduction

Tim Schuler
Permal Asset Management

I am Tim Schuler, Investment Strategist for Permal Asset Management. Permal was one of the pioneers in the fund of hedge fund industry, having invested with hedge fund managers for more than 35 years. As of today we have approximately 20 billion in AUM.

Prior to Permal, I worked for Credit Suisse in Sydney, Australia, where I was responsible for business development for the firm's alternative investments business, in both Australia and Asia. Before that I was a partner with EIM, where I was a fund of fund portfolio manager and investment committee member. I spent the prior ten years trading fixed income arbitrage and global macro in both London and New York.

Bill Geisler
Malbec Partners

I am Bill Geisler, from Malbec Partners. Malbec Partners is a relatively new alternatives platform. Currently, Malbec consists of my Emerging Markets strategy and Malbec's Quantitative strategy, which were seeded in the fall of 2007 by BNP Paribas. Our plan is to ultimately launch six or seven strategies on the platform. I run Malbec's Global Emerging Markets Opportunities Strategy. We invest in a broad spectrum of emerging market securities, ranging from local equities, interest rates, and currencies to external corporate and sovereign debt.

I came from the high yield business, and in 1991 I was approached by CSFB to start their emerging markets business essentially from scratch, so I am probably a dinosaur in the emerging markets these days. In 1996 I left CSFB to turnaround Lehman Brothers emerging markets fixed income business. I ran Lehman's EM business for over six years. Prior to joining Malbec, I was at Amaranth Advisors where I ran their emerging market strategy as well.

Joe Taussig
Taussig Capital

My name is Joe Taussig from Taussig Capital. We partner with hedge fund managers to create banks and insurance companies. Our partners have raised billions of dollars of assets in a nontraditional manner through these vehicles, most of it is permanent capital. The most visible of these is called Greenlight Capital Re, which is publicly traded. The assets are run by David Einhorn. It has over a billion dollars in assets, and about $200m of it came from their existing investors at the time we incorporated the company.

Chirstopher Pucillo
Solus Alternative Asset Management

I am Chris Pucillo, Founder and CIO of Solus Alternative Asset Management ("Solus"). Solus is a fundamental research-driven value firm with 50 employees, 15 of whom are investment professionals. We have $3.2 billion in AUM across our three funds; two of which are currently open. I have been managing our flagship fund, Sola Ltd, for approximately seven-and-a-half years, and our annualized performance during this time is approximately 27% net. Solus Core Opportunities Fund Ltd is a new fund that we launched in April of last year. Core is focused on the distressed market and returned approximately 21% net last year.

In July of 2007, I reached an amicable agreement with my partners at Stanfield Capital Partners to buy their Hedge Fund Strategies group, which I managed. We began to operate independently as Solus on July 1, 2007. The entire team of 42 people uplifted to form Solus, in a seamless transaction that resulted in no disruption of business activity. We have been an SEC-registered investment advisor since inception.

We are currently focused on undervalued opportunities, which would include distressed or bankruptcy situations. In preparation for this opportunity, last year we hired Steve Blauner, a 27-year bankruptcy attorney, formerly the head of Milbank Tweed's restructuring practice. Steve's legal expertise will compliment and enhance our existing distressed investment team.

Ed Robertiello
Credit Suisse

My name is Ed Robertiello, I am a Managing Director at Credit Suisse in Alternative Investments and responsible for the fund of hedge funds business for the Americas. Today, we run about $17 billion of client money.

We manage investments for many different investors, from sovereign wealth funds to high net worth individuals, who come through our private bank. We invest in about 250 different hedge fund managers across the spectrum of strategies, sectors and geographies. We have 60 investment professionals in our business, of which 22 are dedicated hedge fund research analysts specialized in each one of the hedge fund sectors.

Previously I was with Blackstone's fund of hedge funds group, responsible for manager selection for about four years. Before that I managed RJR Nabisco's pension fund for ten years. Back in 1993 we started an absolute return strategy within the pension fund which we grew to 15% of the funds assets. We were pioneers for corporate pension fund investing in hedge funds at that time.

Chris Acito
Acito Advisory Group

I am Chris Acito. In June I founded a boutique consultancy, Acito Advisory Group, whose expertise is working with investment management firms on their most critical strategic planning and implementation challenges.

During the prior five years I have served as the global Chief Operating Officer for Investcorp's Hedge Fund Group (HFG), which had nearly $8.5B AUM at its peak. HFG has two primary capabilities. First, the multi-manager products, which include both customized mandates (for larger institutional clients) and traditional fund of funds. The other part of HFG's business is a Single Manager Platform. Here Investcorp forms strategic relationships with leading independent hedge fund managers. Investcorp and the manager jointly start a new, co-branded fund. Investcorp seeds the fund with initial capital, provides risk oversight, and is responsible for the global capital raising efforts. The Single Manager Platform currently has seven funds across a variety of different strategies.

Prior to joining Investcorp, I co-founded a management consulting firm called Casey Quirk & Acito, advising investment management companies on business strategy, investment, and marketing issues.

John M. Bader
Halycyon Asset Management

I am John Bader, Co-Chairman and Chief Investment Officer of Halcyon Asset Management. Halcyon Asset Management is one of the oldest hedge fund managers around, founded in 1981. Halcyon has about $7.5 billion in AUM. We have multi-strategy, distressed debt, and distressed asset-backed hedge funds. We also manage leveraged loans, both in structures and in managed accounts.

The firm has about 100 people worldwide; our offices are in New York and London. Our primary focus at the moment is on the credit markets.

Katherine S. Kim
Affirmed Capital

My name is Katherine Kim from Affirmed Capital. Our fund, Affirmed Healthcare, is a long/short hedge fund focused on the life sciences. The fund launched on January 2, 2008 and we had a net performance of 6.0% in 2008 and 4.2% as of April 2009.

We are a sector fund focused on drugs, devices, and diagnostic tools. The strategy of Affirmed Healthcare is preservation of capital, first and foremost, and growth. We achieve this strategy through a two-pronged approach: first is a disciplined risk management strategy, which attempts to minimize losses; and second, a stock selection process which focuses on companies with a misperception in valuation that also have high liquidity, positive cash flow, and/or late stage drugs in development.

In December 2008, Affirmed Healthcare became the only seed selected by BBVA/Proxima in 2008 and the only healthcare focused fund on the platform. We accepted the offer for a $25 million investment. We are fortunate that BBVA shared our belief that the healthcare sector has significant long term potential for investors. Especially during a time when many funds were withdrawing capital, BBVA's commitment in 2008 provided a strong foundation to build a business.

Prior to Affirmed Capital, I was a Senior Research Analyst at Banc of America Securities and Head of the Biotech Group. For over a decade, I have focused on healthcare equities.

Carrie McCabe
Lasair Capital

I am Carrie McCabe, CEO and Founder of Lasair Capital. I have 25 years of trading, market, and risk management experience and have been involved with hedge funds since the early 90s. I built and ran both Blackstone and FRM here in the Americas. Last year I started my own business with a Fortune Ten Strategic Partner and Investor. We are an alternative asset management company, and our first investment strategy is a concentrated long/short equity strategy.

Clients are truly our priority and we are committed to keeping our covenants with our investors. Although technically, we are a fund of funds, I go to great lengths not to call it a fund of funds, because we are so focused. Our strategies feature a small number of excellent managers so our clients get the benefit of the underlying asset movement--as opposed to an overly diversified fund of funds which essentially delivers a bond-like return.

Matthias Knab **According to today's television, economists say the recession will end in the third quarter of 2009. Is it true? What macro signals are you watching in this question?**

Tim Schuler There are several points to consider about whether or not the third quarter sees the bottom or at least the turn. Since World War II, economic recoveries have been driven by personal consumption expenditures (PCE) and residential investment, and clearly with the current overhang in housing inventory, residential investment is not going to be a driver. It's also hard to see how with the savings rate climbing from 0 to 4%, on its way to potentially 8% or 10%, any sustainable uptick in PCE is to be expected.

There has certainly been a lot of discussion about the second derivative in economic data and the fabled green shoots, but we and our managers feel that if there is a recovery, it will be a muted recovery at best – 1% may be the new 3% in terms of GDP for quite a while.

From a market's perspective, there are questions about valuation. Operating earnings have bounced back, but revenue projections are very hard to make. A manager recently pointed out to me that in February and March of 2008, Boeing had an order book of more than 100 planes for each month, but this year they had order books of fewer than 10 during those two months. It is very hard to forecast that kind of decline and then project what revenues and earnings are going to be. So while we can look at the overall cost cutting efforts and say "yes, companies are leaner and meaner", it doesn't necessarily mean that we are out of the woods or that organic growth is just around the corner.

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It's worth noting that this time around one has to look at unemployment as a potential leading indicator rather than a lagging indicator, and with that, we are in a very different cycle. Unemployment is probably still headed northwards of 10%, as headcount reductions feeds on itself. We didn't get an inventory overhang first and then an uptick in unemployment; we had unemployment go up first, followed by an inventory overhang. We may be able to work off the inventory, but as more jobs are cut, it is hard for me to see how we get sustainable growth that quickly.

Maybe we should be looking further out the calendar towards 2010, because I find it hard to believe that the economists who missed the downturn so completely are going to be that accurate on the rebound.

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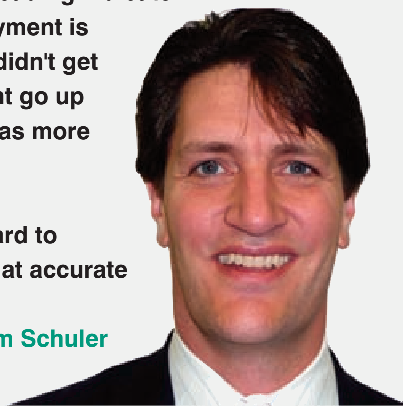

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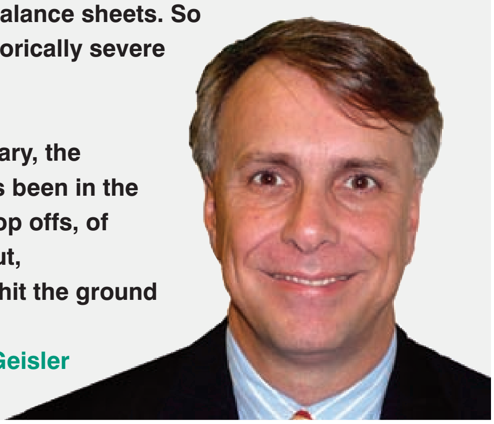
Bill Geisler

I agree with much of what Tim said. In our approach to emerging markets investing, we always look at the G10 and G3 environments first. I think we are different than 99% of the others out there in that we try to get an overall view of the developed markets macro environment first, to understand how they might affect risk in emerging markets. This has been my practice for over fourteen years and has been instrumental in trying to avoid systemic shocks or market dislocations.

Like Tim, we believed since late December that we would see an inventory cycle coming this spring. That inventory cycle would provide some euphoria, given how bad things were going into February, and that the markets would get a little bit over their skis based on this inventory cycle. The question is not so much if we will see the end of the recession by this summer or maybe by the third quarter, but rather what is the magnitude of the move up? We don't think it will be very great or sustainable, for a lot of reasons.

If you look at past cycles, we had very healthy financial systems and financial institutions. Now, there are a lot fewer investment and commercial banks out there, and many have pretty unhealthy balance sheets. So we think that we are in the middle of a short-term inventory cycle based on historically severe drops in global IP.

If you look at the German or the Japanese numbers in January and early February, the magnitude of their drops are extreme which neither I nor my colleague who has been in the business for 35 years have ever seen. When you see those kind of dramatic drop offs, of course at some point there will be a bottoming out or bounce in IP numbers. But, metaphorically, I can go over to the window and jump out, and eventually I will hit the ground and bounce, but I will still not be very healthy at that point.



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I think that the market is getting a little too excited about what we are in the middle of, the inventory cycle, which we think will last probably two quarters. After that, we think the growth is going to be pretty anemic for a lot of reasons.

John M. Bader

I don't particularly trust the recovery, but the important questions to me are why is this important and on what should I be focused in particular. First let's consider the stock market; in most cycles, the S&P rebounds before you come out. On the other hand, there are examples when that does not occur. We just had a big run. We could easily get a correction, though it may not happen.

Speculation about equity markets doesn’t interest me very much at present because, in a world where I can buy secured instruments and earn mid-teens rates of return, I am not particularly interested in owning stocks.

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I think the more relevant questions are what is happening in the credit markets and what can one expect to happen going forward? To answer that question, I would make several observations. First, it is much safer to make money in the credit markets after default rates have peaked. When default rates are high and falling, it is a great time to make money in the credit markets. When default rates are low and rising, there is a reasonable likelihood that credit investors will lose money.

One can make good money in the credit markets after default rates peak; investing before the peak is, however, a dicier proposition.

The next logical question is "when do default rates peak?" The answer is that the variable with which default rates correlate more than any other is GDP. History tells us that defaults generally do not peak until GDP bottoms, and sometimes it takes a while before defaults peak.

So how does one play credit at this point in the cycle? There are extraordinary opportunities in the credit markets, but one has to be a little bit careful at the moment. Accordingly, I am much more focused (1) on shorter duration instruments of relatively healthy companies which have not yet defaulted; (2) on the “default calendar;” and (3) on event-driven special situations not correlated to the market.

A word on what I refer to as the “default calendar.” It is a little bit like following an IPO calendar. One by one companies are defaulting, and I am much more interested in them when they are on the precipice of default as opposed to seven, eight, nine months away.

I am not an economist, but one observation we have made at Halcyon is that margin compression often lags the revenue declines during an economic downturn. So far we have seen the revenue declines, but margins have not compressed nearly so much as in the last cycle, a downturn which I believe was not as severe as this one.

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One can make good money in the credit markets after default rates peak; investing before the peak is, however, a dicier proposition. If you bought before defaults peaked in late 1990 – early 1991, for example - you generated substantial returns. I think that was because you had a massive drawdown before defaults peaked, just as you had last year. But in general, it is safer to invest in credit once default rates have peaked.

The next logical question is ”when do default rates peak?” The answer is that the variable with which default rates correlate more than any other is GDP. History tells us that defaults generally do not peak until GDP bottoms, and sometimes it takes a while before defaults peak. Consider the last two cycles: In one, default rates peaked the year after GDP bottomed; in the other, default rates peaked coincident with GDP's maximum drop, i.e. in the same year. What I have never seen is default rates peaking before GDP bottoms, which makes good sense.

The current cycle may be different if you include General Motors, which I think is inappropriate for a number of reasons, not the least of which is that many observers of corporate defaults tend to focus on LQA (last quarter annualized) numbers. I am not especially sanguine about the economy and, ex-General Motors, I think defaults will continue to increase.

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A word on what I refer to as the "default calendar." It is a little bit like following an IPO calendar. One by one companies are defaulting, and I am much more interested in them when they are on the precipice of default as opposed to seven, eight, nine months away. We are still early in this cycle, no matter how you slice it, and I am concerned the economy can weaken further.

I am not an economist, but one observation we have made at Halcyon is that margin compression often lags the revenue declines during an economic downturn. So far we have seen the revenue declines, but margins have not compressed nearly as much as in the last cycle, a downturn which I believe was not as severe as this one.

So I am somewhat skeptical that we are out of the woods. The one caveat to this proposition is that until about five, six weeks ago, almost no CEO we talked to was positive, and now we are hearing a lot more optimism. That notwithstanding, I am kind of empathetic to Bill's view that we are in an inventory cycle, and some signs of a buoyant economy may be a bit of a fake-out. Be that as it may, we do hear a bit more optimism. Still, I am skeptical that the economy has bottomed. If it has, I think growth will be subdued.

Christopher Pucillo

I have been involved in the credit markets since 1989, and I find one of the most notable aspects of the current market to be the record-high leverage on the balance sheets of many High Yield companies, especially those acquired by private equity firms during the 2006-2007 period. During the last default cycle (from 2001 to 2003), we experienced approximately 35% cumulative defaults in High Yield. Given the difference in balance sheet construction between then and now, I find it hard to believe the current market will experience fewer cumulative defaults than we did in the last recession. It is not unreasonable to expect cumulative default rates in the 40%-50% range during this cycle, especially given the severity of this recession relative to the previous one.

By way of example, during the last cycle, companies had approximately 4-5 times leverage with the bottom 1-2 turns of leverage unsecured. In the current market, double-digit leverage is not unheard of, with 6-7 turns of leverage secured. During the private equity buying binge (from 2006 to mid-2007), companies were laden with massive amounts of debt, justified by cyclically high levels of EBITDA, and aggressive cost-cutting assumptions. Many of the performance assumptions never materialized due to recessionary forces, thereby exacerbating leverage levels as EBITDA levels declined

While it is important to focus on default risk, we believe it is as important, or perhaps more important, to also focus on expected recoveries. In our opinion, investors have not sufficiently focused on the low recoveries likely to materialize in the High Yield bond market. We have already seen several defaults and, to my knowledge, only a few have experienced a double-digit recovery rate in the CDS market. With the exception of Stations Casinos, which recovered in the 30s, recoveries have been below 15, with many in the single-digit range. However, we obviously won't know what the ultimate recoveries will be for some time.

In our opinion, the recent market rebound has little to do with fundamentals and is better characterized as return-chasing. We have seen the biggest rally in the lowest-rated, lowest dollar-priced assets, with fear of underperforming being the impetus. We are very cautious as to the sustainability of this rally.

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We've noticed an interesting trend that has recently evolved pertaining to asset class returns, as viewed by institutional investors. Single-digit equity market returns over the last 10-20 years have begun to look inadequate on a risk-adjusted basis, compared with current investment opportunities that are prevalent in the credit markets for good companies with good capital structures and covenant packages. Substituting equity allocations for leveraged loans with 10-12% returns is appealing amongst institutional investors, particularly in the context of 8-9% IRRs for pension fund liability structures.

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Ed Robertiello

We had almost ten years of a bull market in almost every single asset class you can think of until 2008, and it will take more than 18 months to correct. Tim first used the expression green shoots sprouting around, but they could easily turn to brown shoots. But I don't think anyone will disagree that there are tremendous opportunities right now to make money. Especially for pension funds and endowments, and more for hedge funds, who are uniquely positioned to deliver those returns.

Our portfolios are still very defensively positioned, with almost no beta and very little leverage on an aggregate basis. There are several hedge fund strategies in which we think we can make money. We have made a bet on tactical trading strategies such as global macro and managed futures. We have taken some of the allocation in long/short equity down, but the managers that remain operate in a low gross and net exposure range. We are in more tactical trading managers and have added some volatility arbitrage managers to the portfolio.

Fixed income arbitrage is attractive now. It wasn't earlier because managers needed much more leverage to make a decent return, but now the leverage is a quarter of what was historically used.

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What we hear from the hedge fund managers is that the opportunity set is rich and trades stay around longer because there is less money chasing it. The prop desks are almost nonexistent, especially in those riskier markets, and managers are able to analyze situations better, as opposed to in the early 2000's, where money flew to every single idea. At that time, you had to build a position immediately or it was gone; today managers are able to leg in to positions.

If you go back, those of us that have been investing for a long time in hedge funds see a period that we were familiar with in the 90's. Many investors are still stunned from the events of the second half of '08 and first quarter of '09. They are acting like deer in the headlights. We urge them not to give up on absolute return strategies. There is tremendous opportunity.

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Carrie McCabe I agree with your comments about the uncrowding in the market; both in terms of monies invested in the hedge fund format, as well as proprietary desks winding down. There are huge opportunities for us to achieve some great returns for our investors.

I also wanted to go back to Chris' comment about equities for a moment. Let's not give equities the

Let's not give equities the short shrift. Equities remain by far the largest asset allocation for institutional investors and our equity managers are not talking about 8% returns or how they get 8% returns; their performance is much better than that.

Corporates, and in particular public plans, have a real problem because they have a real liability stream that has to be met. It is not just that they want to make more money. Because of their structures, if they haven't already done liability driven investing, this is not the time to start that. They are really looking at the question of whether there is a better way to invest in equities. Hedged equity portfolios can help address that.

Interestingly enough, we see a major trend where clients investing in hedge funds are not putting them in an alternative bucket anymore, they are investing straight out of their equity portfolio. Coming back to the question how will these investors meet their 7.5%, 8% actuarial assumptions, they are looking at investing in equities via a hedged format by adding long/short equity funds.

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Tim Schuler

Well, I don't disagree that there are opportunities in equities following a long/short format. However, as an investor, it is always desirable to be first cab in the rank rather than last cab in the rank for the same expected return. So from a long-biased perspective, when you think about credit versus equity, there is a clear distinction where we and our managers want to have first lien on assets if we choose to have long exposure. If we think about the way the world is structured right now, albeit with Chrysler as the exception to the rule at the moment, senior does mean something in terms of getting your money back. With defaults expected to reach double digits that claim to a company's assets becomes paramount.

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From an equity perspective, at 900-plus on the S&P, we are already looking at somewhat inflated multiples based on assumed earnings expectations. So there is a fairly significant opportunity in long/short equity, although it is critical to think about it in terms of both long and short exposure.

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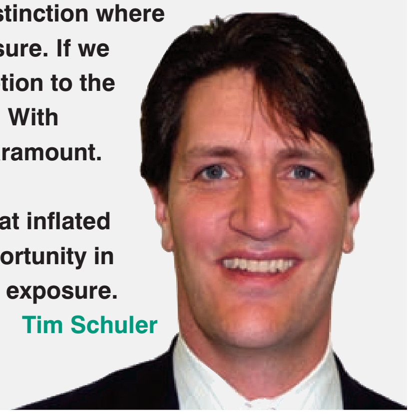

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The other area we have always focused on is macro. From a historical perspective, we cut our teeth investing in the macro space, and have always incorporated it into almost everything that we do. We have shied away from CTAs this year, as we believe last year was more of a non-thinking person's market, and this year the markets are much more tactical and more trading oriented - where we will eventually get from point A to point B, but I don't think it will be quite the same straight line we had last year. There will be more ebbs and flows as far as market direction. If we look at oil last year as an example, there wasn't a lot of ebb and flow between oil from 60-140, and back down to 60.

I agree with Ed's point - wherever we look, given that there are fewer players in the space, there is more time to construct a thoughtful portfolio. Not only can you analyze an anomaly and spend the time to actually get the money put to work, there is even enough time to actually go through multiple scenarios. You can research what is the most effective way to structure risk, reward, be it options, forwards or multiple structures, and still have time to put the trade on and leg into it, which two, three years ago was near on impossible.

John M. Bader

One should mention the distressed asset-backed space, in which I think some of the best risk-adjusted opportunities are available. When I look at down-cycles - in the economy or in credit - I like to label them. This can be a dangerous thing to do sometimes, but I find such generalizing helpful. I would describe the cycle of the early 90s as being about good companies with bad balance sheets following the over-leveraging of America in the buyout boom of the late 1980s. Looking at the downturn in 2002, I would say it was about fraud and "dot bombs." When I look at this cycle, the straw that broke the camel's back was real estate, but more than real estate it was really securitizations. Suddenly all the world was a securitization. Not just subprime: we had credit cards, manufactured housing, auto loans and so on. There was massive amounts of securitizations.

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The danger with a lot of such securitizations is that even though in theory many of the credit instruments created once had perfectly good ratings, subordinated tranches may be way out of the money. It is generally wise to stay near the top of capital structures and to focus on seasoned paper.

There are lots of seasoned securitizations where you can empirically see consistent cash flows, where you can invest in the top one or two tranches of asset-backed structures, and enjoy a runoff with tremendous returns. Never mind if you get capital appreciation.

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In addition to the many good suggestions made so far, I would add convertibles. This market was hit with such a dramatic sell off in 2008. The market has rebounded to a significant degree with help from non-traditional cross-over buyers; but there is likely to be still greater upside, particularly for managers with strong credit teams.

It was reported the other day on Opalesque that 80% of the convert arb prop traders in London are out of a job now. Overall valuations still look cheap and imply a very high (and unlikely) percentage of defaults. In the past, any of those dynamics would have attracted a wall of capital within about 15 minutes.

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John M. Bader

I am not especially sanguine about the convert market in the short run. While there may be some extraordinary opportunities in the convert space with short duration, the issue is that most converts are just another form of sub debt, and before defaults peak I prefer to invest at more senior levels of capital structures, focusing on secured instruments to the extent possible. The risk/rewards tend to be much better in senior debt. The big exception to that is converts of cash-rich companies that are puttable in the near-term; I think there are some very attractive opportunities along these lines.

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Lack of available leverage from prime brokers has played a big part in repricing all of the markets, especially the convertible bond market. Today, the demand and resulting prices/yields in the convertible and High Yield bond markets reflect the lower leverage available. Current demand in the High Yield bond market is largely driven by mutual funds that are 100 cent buyers. You no longer have hedge funds putting down $0.20 and buying five times that amount in bonds, which dramatically decreases the end-market demand.

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We are focused on looking for value across the entire capital structure and we are agnostic as to where we find it. It comes down to valuation per unit of risk. The question is; are you being compensated appropriately for the investment risk relative to your position in the capital structure and the liquidity associated with both the security and the asset class? In some cases, bank loans are significantly overvalued at the levels where they are trading today. In other cases, unsecured bonds of a company may be more interesting, depending on the leverage and other valuation metrics. This same analysis applies to the converts and equities as well.

In today's difficult credit environment, where we expect default rates to continue rising, it is important to have a strong fundamental valuation process. It is a "stock/credit picker's" market and we are finding significant investment opportunities due to the mispricing of risk on both the long and short side of the market. Even within industries, some companies are overvalued and others undervalued, based on their risk of default and expected recovery values.

Carrie McCabe

Tim made the distinction between long-only equity and long/short equity. Most long-only investors were down 40% last year. We find most big institutions want to believe in the word "hedge" in "hedge funds." It was disappointing that the hedge fund industry in general was down as much as it was last year even at half that amount; I wish we could have done better than we did - but we did protect on downside.

Especially in the equity sector, many sophisticated institutions are looking at hedge funds for downside protection, mostly because so many of them are underwater. The average plan in the United States is only 70% funded right now. There have been changes in the Pension Guarantee Act that forces funds with 70% funding to be fully funded in year 2011 - and it has to come from the corporate parent. This scenario is quite serious for the pension plan.

Apart from the downside protection, investors are also looking at hedge funds for out-performance on the upside. Using hedge funds comes down to being in equities, but in a smarter way. I work with very large institutions and I can see that they are not approaching hedge funds to be in a separate pocket somewhere anymore. Hedge funds are recognized as a format of running money, not an asset class, and increasingly the consultants are also embracing that approach.

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Ed Robertiello

I definitely agree with Carrie. We also see institutions using hedge funds as a tool as opposed to an asset class. This is evidenced by their re-naming hedge fund allocations along the lines of "absolute return", or "equity long/short strategy" or "fixed income substitute".

But honestly, at this time we find that many institutions are still in shock over the significant negative returns experienced in their portfolios during 2008. Their strategic allocations have been turned upside down and they have been disappointed by their advisors and asset managers. They need to re-assess the allocation plan going forward. Do they rebalance to the current plan or establish a new plan? Do they change advisors and managers that have disappointed and sell at the bottom or do they hold onto them? With regard to hedge funds, there may be some talk about investing in distressed or global macro - the buzzwords, the strategy de jour. It is an interesting sector, so they are right, but there is a lot more to asset allocation. We still see a lot of interest in hedge funds. Investors do their homework, but no one is really writing checks. I believe there is still a lot of investor fear about the markets.

We talk to a lot of pension funds and when you hear about the condition they are in, in terms of cash requirements and how fearful they are of private equity capital calls etc., it gets really scary. For some, an 80% funding would be a rather good position to be in. Quite honestly, I think they are going to need their own TARP, because there may be no way they are going to work out of it.

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Many of their boards have told them not to sell their equities down 40% - maybe they are starting to trim as we get these mini rallies. These funds have ongoing cash requirements as all of them have to pay benefits every single month, and so they are liquidating. It was the worst time for them to sell their bonds in the fourth quarter and first quarter, but they were doing it. So they have sold out of all their bonds, they cannot get out of their alternatives. Therefore, they will have to start selling equities. That is why many pensions say "we would love to invest, but we don't have any money."

The other traditional investor base for alternatives, the high net worth side, is also not ready to come back at all.

We currently do a lot of what we call "rescue mandates". Here, an investor such as a family office built a collection of premier hedge fund managers over the last three or four years, consisting of mainly long biased, long/short equity or equity event driven strategies, and they got clobbered in 2008. We are helping these investors reorganize their hedge fund portfolios, adding diversification and structure and articulating clear objectives for their hedge fund allocations.

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Chris Acito I don't think institutions are giving up on hedge funds; recent surveys and my anecdotal evidence all indicate a commitment to hedge fund allocations. That said, I think 2009 will remain a difficult year for raising capital. Many investors are facing liquidity constraints. Many others are still taking stock of the changing environment and are still months away from making significant investments. I think there is will be a very vibrant hedge fund industry in 2010 and 2011 - you just need to survive 2009.

John M. Bader

We are getting sizable inflows from some quarters, including the insurance industry among others. Consistent with Carrie's experience, some of these flows are not coming out of "hedge fund" buckets. Increasingly, institutions are viewing hedge funds as just another investment vehicle and are allocating to them from non-"alternative" buckets. I couldn't agree more with Ed's thoughts on the high net worth side. We manage some funds for a large private bank for which we have made money since January 1, 2008; yet we continue to get redemptions, even as we have begun to see institutional inflows.

A number of our institutional investors have reduced the number of their managers, and we are seeing some inflows from this phenomenon. Their overall capital allocated to hedge funds may be going down, but survivors are clearly benefiting, though with increased demands from investors for more transparency, lower fees and, in some cases, managed accounts.

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Investors have been reducing the number of hedge fund managers they allocate to as concerns about business risk rises. When a manager's assets are cut in half, investors may get concerned that a fund can't keep the lights on, or can't keep the talent, or that they would be cutting out essential processes like risk management.

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John M. Bader

Apart from insurance companies and pension funds, we see interest from sovereign wealth funds for the first time in a while. Also from select high net worth investors, generally U.S.-based.

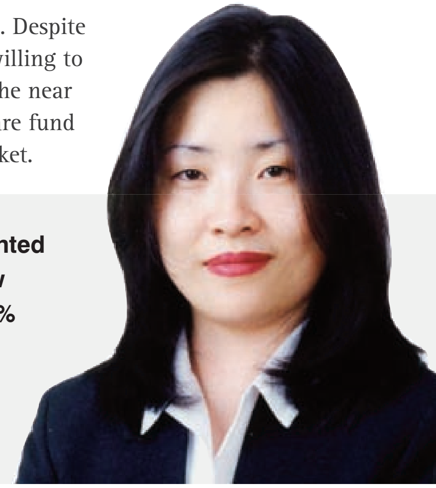
Carrie McCabe

We are experiencing significant inflows from corporates and publics. In almost all cases they redeem from long-only equity and put the funds into a hedged format in equity. A really important point, in all environments, but especially in this environment, is to focus very carefully on who you fund. We don't choose funds, we choose firms. We do an amazing amount of due diligence on firms, because we are choosing partners and firms and not just a fund by itself.

Katherine S. Kim

As an emerging fund, raising capital, especially during 2008 which had unprecedented withdrawals and fund closures, has been a challenge. Despite being one of the few funds which received seed funding and outperforming our benchmark index by 40% since inception - almost a year and a half ago – we have found that investors are hesitant to invest despite what we believe is a great opportunity.

In addition, we have found that fund of funds are interested in investing but remained sidelined until our assets under management reach a certain size. Despite our emerging status, these fund of fund investors are willing to meet with us and seriously consider an investment in the near term over a "name brand" or more established healthcare fund due to our funds' ability to preserve capital in this market.



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We said that there are fewer players and fewer prop desks out there trading, but the other side of that coin means less liquidity, and that the market moves tend to be very gappy as a result.

If you look at the Brazilian Real, for instance, it has recapped six months of losses in seven weeks. The reason is that once a currency or an asset has a certain price history to it and you have a sell off, it is much easier to get back to those extreme levels, because people now know it can get there. The Central Bank of Brazil has intervened to buy U.S. dollars every single day in the last nine days; this was the first time they have systematically done that since pre-crisis. So indeed there are less people out there trying to get in the trade, but there is not enough liquidity to provide orderly markets. Therefore, the price movements are very gappy, and many of the price gains happen very quickly.

One of the comments we heard during our Q1 '09 marketing efforts was "I don't want to touch emerging markets, I lost too much money last year" - even though our strategy was up last year. First, there are not a lot of places left where people didn't lose a lot of money. We are a little confused by that, because if you look at the 1980s and 1990s for emerging markets, what happened in the last year-and-a-half is the exact opposite of those events. Back then, we had a problem in a particular country or a particular region with pegged currencies, balance of payments

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For the first time in my career, emerging markets were a victim of what was happening in the core, rather than the other way around. We see tremendous opportunities in emerging markets for these reasons; it really comes down to the health of these systems. In fact, we actually may see the recession ending because the emerging countries start pulling everybody else out.

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So we actually saw the price dislocations in the fall were much greater in emerging markets than in the senior debt of many companies in the US where market consensus seems to be focused. In many cases, the severe price dislocations came from forced selling in a very short window rather than real economic reasons to sell.

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Tim Schuler The last six months I have spent a great deal of my time on the road around the world. Institutions and individuals are still in their shell, and are very, very slow to move out the risk curve, which reiterates the point that the current rally is not liquidity fueled. There is a lack of liquidity which is driving this rally, rather than ample liquidity – fewer sellers rather than more buyers.

Looking at pension plans and their actuarial assumptions, we are now in a very different world in terms of interest rate policy with essentially 0% interest rates in most of the developed world. Having a 7.5% or 8% actuarial assumption wasn't that hard in the past, when you earned 4.5% or 5% for your overnight money. In the current paradigm, there has to be some risk-taking to deliver those types of returns. I think this is a bit incongruous. How can a whole industry not move out the risk curve and yet assume that they are going to make 8% or 8.5%?

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I think here is where hedge funds bridge the gap.

One thought regarding Ed's point about his current "rescue mandates". It is true that some institutions thought investing in hedge funds was easy, a 5% allocation made sense, and now let's go out and buy a couple of blue chip names. For many, that approach probably didn't work out as well as they had hoped. In my view this does leave room the fund of funds industry, because no one is going to devote 50% of their time to a 5% allocation.

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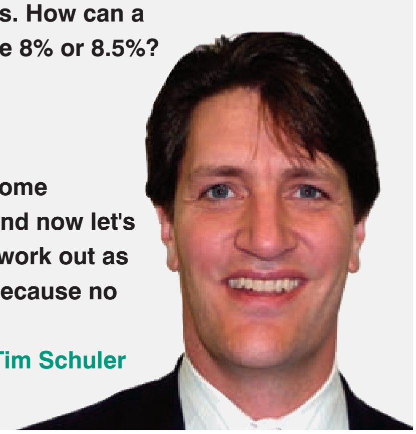

I think here is where hedge funds bridge the gap. Not that we can go out and guarantee these kinds of returns, but unless one is willing to stick their neck out, it will be difficult to earn those kinds of returns going forward. Attempts to hit that bogey in a long-only format would entail significant levels of risk and portfolio volatility, especially in light of the asset/liability mismatch inherent in pension plans.

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Carrie McCabe

I agree. Let me also point to the recent Bank of New York / Casey Quirk study that said currently 80% of the institutions that are either considering or are already investing in hedge funds want to do so through the fund of funds format, for all the reasons you just mentioned.

Joe Taussig

We have a number of bank mandates now, where we are starting banks capitalized by hedge fund managers who plan to invest - in some cases - between a billion and two billion dollars. Part of it is at the top of the capital structure, where you can pick up double digit returns, with cheap sources of funding that are not so volatile. We are talking about banks with deposits to equity of 5-8 times max, and only lending out half of the deposit base.

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John M. Bader

A plug for the fund of funds from a hedge fund manager. I can't remember whether it was Randall Cohen from Harvard Business School's own research or his description of somebody else's research, but it showed that some incredibly small number of fund of funds actually suspended redemptions. If you look at hedge fund of funds, the performance was substantially better obviously than long-only and displayed relatively high information ratios. However, to the extent an institution invested directly in a small number of hedge funds and picked the wrong ones last year, clearly there were issues.

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John M. Bader

Matthias Knab

Ed, you had mentioned secondary markets for hedge funds and thoughts on the fee discussion. Would you like to share with us more here?

Ed Robertiello

Sure. I think everybody has heard about this growing secondary hedge fund market; whether for impaired hedge funds or distressed investors, we are doing both. An impaired hedge fund may have shut down operations or split funds into a liquid share class and an illiquid or a liquidating share class, or created a large side pocket which could take years to liquidate. Just like any other distressed asset, there is a market for it with investors that are interested.

Other transactions involve buying perfectly fine LP pieces from distressed investors. These shares may have a lock-up and investors need liquidity now. Besides the discount to NAV, we are often able to inherit the original terms including high water mark, fees and liquidity.

We have been doing such transactions for our regular clients, adding such shares to their portfolio. I think as fiduciaries we owe it to them to try to find these kinds of deals, particularly for the 200 or so managers that are approved on our platform. We know a lot about these managers and their portfolios.

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Ed Robertiello

Some hedge fund managers are also making the connection and crossing sellers and buyers. They have an unhappy investor and want to get them off the books, so the parties are willing to transfer high watermarks and the remaining lockup, and the manager facilitates the transaction.

It does take a bit of paperwork. Usually it is a purchase agreement with three parties: the buyer, the seller and the hedge fund or the hedge fund administrator.

Investors able to provide the liquidity to the market can seize some outstanding opportunities. That being said, there are some managers that refuse to facilitate secondary market transactions for their shares. Instead some are offering to buy back the shares at a discount. So they do not want to participate.

Tim Schuler

At Permal, we actually launched and closed such a fund, called "Hedge Fund Opportunities", on March 31st. Being able to buy hedge fund shares at an average discount of about 30-35% has already produced a 20% return in the first couple of months. This has attracted interest in the second fund we are rolling out.

The dynamics of this fund is primarily driven by the underlying liquidity issues of the investor, not of the hedge fund portfolio that we have purchased. There may be 18 months remaining in a 2 year lockup for example - the reason for the sale is more the impairment of the investor rather than of the hedge fund itself.

Also in our case, the majority of the managers we were able to purchase for that vehicle are managers we already had relationships with. That made it a lot easier as well. We were able to go

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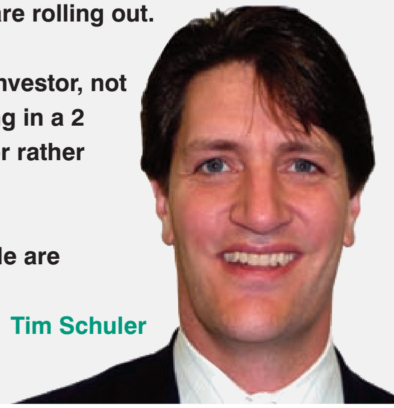

Tim Schuler

right to the manager and say, "Look, we realize that you have an unhappy investor and we have long-standing and healthy relationship with you If you don't reset your high watermark or lock-up period, and if you would prefer to have a known entity as an investor, we can make this happen."

Some of the discounts have been rather extraordinary; upwards of 50% in some instances. We have already received some cash distributions from managers and the vehicle is less than three months old. So there are a fair number of significant benefits to investing in this fashion.

Carrie McCabe Who is buying it?

Tim Schuler Seed capital, institutions and there is a lot of interest from some of the ultra high net worth sector, through family offices.

But really, when we started to promote this fund in December and January, the reaction was tepid because at that time nobody was coming out of their shell. Now that the first of these funds has come and gone, and we have shown what can be achieved, the response for the second opportunity fund has been significantly higher.

Carrie McCabe From mostly existing investors?

Tim Schuler The first fund was raised through our existing investor base, but now that the program is up and running, we have had outside parties call us with interest.

John Bader What percentage of these are funds that are suspended or gated?

Tim Schuler Most of them are not. As I said, it is more often than not the impairment of the investor behind the transaction.

John Bader What kind of liquidity is involved at the underlying funds' level?

Tim Schuler In most cases, the manager has locked up money and is in no hurry to give it back, but the investor just needs liquidity. The lockup is less than two years in most cases.

We told our investor base that it would require a lock up of two years, because we can't be in the same position as the distressed investor was before. With two years of time, it basically makes it a greenfield as far as the opportunities that are out there.

Chris Acito Matthias asked about fees. I think the often-predicted collapse of hedge fund and fund of fund fees has been greatly overstated. It is my observation that, for asset management, the manager selection decision typically tends to be binary: the investor either believes that the manager has skill or that they don't. Managing money is serious business that tends not to fall prey to discounting. To be facetious, it's like choosing a second-best heart surgeon because he charges 40% less.

In the long-only world, for managers with perceived skill, we have seen perhaps surprising price stability over a long period of time. I think we are going to see the same dynamics on the hedge fund side. Sure, the structure of fees may change quite a lot: longer horizon performance incentives, clawbacks, new benchmarks, etc. But in terms of the gross amount of money that a manager could earn if he does really well, I don't see that changing a lot.

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Chris Acito

Christopher Pucillo

A number of trends in asset demand and fee structures have emerged from the recent credit crisis. Some of these trends will likely be a temporary response to depressed prices and the recent lack of liquidity in the markets. For example, over the last few months, we have seen increased demand from some investors, particularly insurance companies, for long-only leveraged loan exposure in separately managed accounts. This increased demand is likely the result of both the attractive risk-adjusted returns in the leveraged loan market, as well as recent accounting changes that allow them to buy and hold-to-maturity certain investments without marking-to-market. However, the recent rally in loan prices will likely make a long-only structure less appealing going forward and we expect to see a movement in demand back toward long/short structures like hedge funds.

Another big topic of discussion in our industry has been the liquidity mismatch resulting from hedge fund investors redeeming significant amounts of assets over a short period of time, while managers were faced with the decreased ability to raise cash in the markets. The level of investor demand for capital was unprecedented and caused many managers and investors to look more critically at fund liquidity provisions. Unfortunately, investors and managers may not agree on the lessons learned.

Historically, investors and allocators often demanded monthly or quarterly liquidity. While credit funds could generally meet these liquidity demands in normally functioning credit markets, we have clear evidence that this model is not workable in dislocated markets. It is a duty incumbent upon managers to include this new paradigm into the structuring of the liquidity terms of their funds. This will likely lead a number of hedge funds to adopt more hybrid, private equity-type liquidity and fee structures or simply longer lock-up provisions. We believe that investor demand for "equity-like" liquidity provisions in credit market funds is not a sustainable model. Having said that, the push and pull between the liquidity needs of investors and managers must find a workable balance.

Ed Robertiello

I think we all agree that one of the big problems uncovered in 2008 was the pervasive asset liability mismatch between hedge fund terms and what they were investing in. There were a lot of legacy issues, where the funds offering documents did not allow for side pockets. If the manager had revamped their documents in advance of investing in private positions, investors would have thought "yeah, okay, side pocket sounds reasonable", and no one would have said a word. They do it later in 2008 and they are forced to create side pockets in a poor environment or gate or suspend redemptions.

We want the terms of funds to be in line with the underlying investments. We turned down investments in CTAs and FX managers that had one or two year lockups, because there is absolutely no reason for that - they are in the most liquid markets in the world. However, in credit and distressed and some relative value strategies, you expect lockups. When lockups are necessary they should be in place if not and you are a long-term investor, you could get hurt...

John Bader

It seems that every time there is a big market downturn, the talk about fees comes up again. 1998 was a tough time, but we were up about 15% net for the flagship fund, and people called me and said "gee, would you do something about the fees?" I asked why, and they said "well, other people are." I heard the same fee discussion in 1994, in 2002, and you hear about it now. I was nervous about this in the early 90s, when we had a two percent management fee while a lot of funds only charged one percent. However, instead of management fees going down as I feared, as managers did well everyone began to charge two percent.

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I think the level of fees has to do with the supply of capital.

On the other hand, certain aspects of fee arrangements that arguably were wrong before do get corrected in this type of environment. This is the opportunity to establish new industry standards. For example, we are launching a new distressed fund, and I think one of the right things to do is to collect performance fees at the end, only after principal and a preferred return have been returned to the investor. The interesting thing is that in our last distressed fund it did not work like that, but it would not have made any difference for the investor. This procedure is relevant only if the investor does not get his principal back. But when it comes to the question why it wasn't done before that way, most managers would argue that other distressed funds did it that way, so why are you asking me?

John M. Bader

I think the level of fees has to do with the supply of capital. Right now a lot of hedge funds and most other financial institutions are strapped for capital; therefore there is leverage for the people who allocate money. They are trying to flex their muscles. But when the balance shifts the other way, people tend to forget about these things.

On the other hand, certain aspects of fee arrangements that arguably were wrong before do get corrected in this type of environment. This is the opportunity to establish new industry standards. For example, we are launching a new distressed fund, and I think one of the right things to do is to collect performance fees at the end, only after principal and a preferred return have been returned to the investor. The interesting thing is that in our last distressed fund it did not work like that, but it would not have made any difference for the investor. This procedure is relevant only if the investor does not get his principal back. But when it comes to the question why it wasn't done that way before, most managers would argue that other distressed funds did it that way, so why are you asking me?

This kind of restructuring fees makes good sense because it is the right thing to do. In our case, we have been around a long time, and we just want to do things right, according to best practices. Even if the market will do it some other way, I think giving back the principal first in a locked-up fund is the right way to do it, and we like to do the right thing for institutions.

What we are seeing is institutions making unusual requests that they never made before that are not related to the magnitude of the fees. Recently, an endowment asked us, "In a locked-up fund, do you think for an extra fee you could give us a 5% dividend, because we have annual commitments?"

Bill Geisler

Clawbacks are not an issue for me. I feel like if I had made a lot of money for a client and then gave it away, there is no reason I should be paid on that basis. So clawbacks theoretically I think make a lot of sense.

Generally on fees, there is an emotional response to fees - a lot of emotion over the last year - and then there is the logical response beyond that. The logical response is to look at the managers and evaluate how they managed risk during those times. Whether they were willing to cut risk when they were wrong and how well they understood the risk they were taking. In many cases, investors should say, I'm not going to pay two-and-twenty for that. If I want a beta manager, I might as well go buy a long-only fund. If in turn I want a true hedged strategy manager, there are some significant data points available now that can help me to assess who really is a hedged strategy manager and who isn't.

We worked hard for that positive return in 2008 and I wouldn't want someone to cut our fees because the majority of managers misunderstood the systemic risk brewing in the credit markets. As the emotion leaves and logic prevails, I believe people will continue to pay someone well who can protect the downside, make money in bad and good markets, but they will not pay for beta. If someone wants beta, they will pull it out of hedged strategies and go into long-only strategies, where they pay a lot less fees. The data points available now on managers will be the discriminating factor, not their fees. Therefore, I think two-and-twenty is not going to go away...

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18 months or two years ago, one of the biggest questions that we had from our investors and potential investors was about any capacity constraints - what managers are closed to you? The discussion now has completely moved away from that; there are presently no capacity constraints. In a perfectly open environment where we can choose to invest, the first point of discussion is not "will you cut your fee for us?", but is this a manager with whom we have ultimate confidence, who delivers the net returns we are interested in. We can negotiate details like having a segregated mandate - managers may be more willing to do that in the current environment - but we are not targeting fees as the first point of negotiation.

However, there have been managers that have closed or are in liquidation, who are in the process of reopening a new vehicle, and under no circumstances will we secede our old high watermark in order to make that investment. I think that is something that every manager worth his own salt should be willing to give any existing investor before they start rolling out a new fund.

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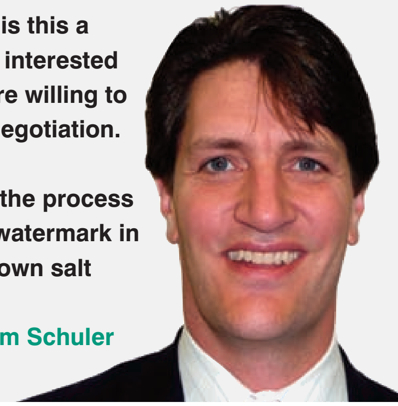

Carrie McCabe

In 2006, after checking the presentations of about a dozen distressed managers who came to me for prospective funding, I had to ask them "Why aren't you raising a private equity fund instead of a hedge fund?" Probably the third one looked me in the eye and said "Well, because it's easier this year to raise hedge fund money than it is to raise private equity money."

There is still a huge issue unfolding on how to better match the liquidity of the underlying assets of a hedge fund with its liquidity terms. I am still surprised sometimes at the answer I get when I ask a manager about his liquidity terms, knowing he holds something really illiquid in the fund. The manager will still tell me with pride "Well, it's quarterly"! Such answers can be frightening. This manager may quickly have a business problem that can easily become the investors' problem; and, of course, we are not interested in that.

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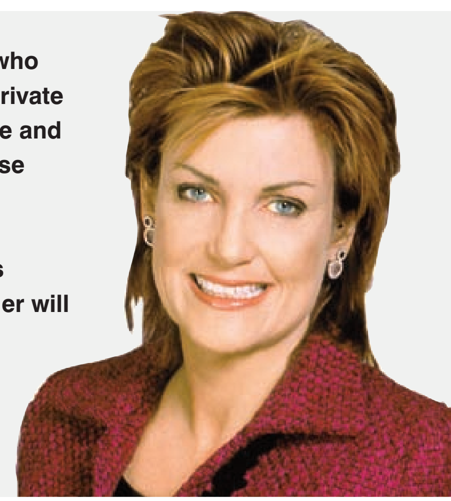

Matthias Knab

Chris Acito, you had mentioned recently the talent in the industry is going to be dispersed or is moving to places and how you deal with that. Can you just make the little introduction.

Chris Acito

In my introduction, I mentioned Investcorp's Single Manager Platform. For the most part, the managers with whom we partner are either new, or have relatively short track-records. As a result, we are constantly monitoring the teams and individuals who are looking to start new firms.

Quite simply, in my experience, there have never been as many talented investment groups seeking new opportunities. Why? Recent events have driven substantial declines in AUM and put many managers under high water marks. As a result, many hedge funds – even some of the largest – are unsustainable. In addition, so many of the banks have significantly scaled back their proprietary trading activities. Many talented investment professionals are seeking new homes.

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For investors, this environment creates two challenges. First, investing blindly in blue-chip hedge fund names is problematic as these firms may be among the most vulnerable businesses. Second, how do you find this next generation of great firms?

It also presents a substantial opportunity to those who are willing to provide seed capital and other support to newer hedge fund businesses. Many of the great firms of 2012 are being created this year. Smart investors will be highly rewarded for proactively supporting the reconstitution of the hedge fund industry.

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Right now, however, there is a surprising paucity of capital aimed at emerging managers. Some of the multi-strats are aggressively accumulating talent, but not everyone wants to be part of someone else's firm. Many of traditional seeders are on the sideline.

Katherine S. Kim As an emerging manager, we find ourselves having investors who want to invest but would prefer that our assets under management were higher. Once we grow in size, we look forward to bringing in those potential investors that have been waiting on the sidelines.

Ed Robertiello What investors want at this point are open, premium managers. The question is, will you spend that marginal dollar to do due diligence or negotiate a seed deal? Or do you allocate to someone who has a proven track record and meets all your other requirements? We had a seeding fund and made a few investments in 2008. We stopped the activities. There are just too many other things to focus on and quite honestly, we didn't find much investor interest.

What investors want at this point are open, premium managers. The question is, will you spend that marginal dollar to do due diligence or negotiate a seed deal? Or do you allocate to someone who has a proven track record and meets all your other requirements?

Ed Robertiello

Matthias Knab **But Affirmed Capital did get a seed investment,no? Tell us as an emerging manager, how did you manage to get the seed investment? What is required for emerging manager get seeded?**

Katherine S. Kim We received seed funding in December 2008 from Proxima Alfa Investments, a wholly-owned subsidiary of BBVA, which is one of the world's largest commercial banks. The process took nine months with interviews with at least 30 people who all had an influence on the outcome. Three other potential seeds made it to final rounds and we were the only fund selected.

Affirmed Healthcare has a unique strategy which we believe has helped us preserve capital during unprecedented market conditions. Our portfolio and risk management strategies are differentiated. This combination, BBVA/Proxima, thought would make the fund marketable.

Matthias Knab **Matthias Knab: Why do you think BBVA Proxima selected you, how are you different from the others?**

Katherine S. Kim We believe Affirmed Healthcare was selected for several reasons:

First, healthcare is a defensive sector spurred by the aging of the population and rising healthcare costs and that is able to withstand the current economic downturn. In fact, healthcare costs in the U.S. were an estimated $2 trillion in 2008 (or 17% of GDP) and is expected to grow to $3 trillion by 2012. Second, we think there is a current misperception that healthcare reform will have a significant negative impact on the sector. However, we believe healthcare reform will be moderate at best and the impact especially on certain segments within healthcare such as biotechnology and diagnostics/tools will be minimal, thereby creating opportunities. We also believe innovation in the sector will continue and themes such as personalized medicine and stem cell research will lead to capital inflow and continued M&A activity.

Affirmed Healthcare has a strict portfolio and risk management strategy. We seek low volatility, high liquidity and minimization of drawdowns. This leads us to a stock selection process that is primarily focused on large and mid-cap companies with positive cash flow and/or drugs that are either on the market or in late-stage development. Only 10-15% of our total AUM, for example, can be in stocks with market caps of under $1 billion. This philosophy matched the risk management of Proxima so Affirmed was a natural fit. When we first started the interview process, we were already substantially outperforming our indices which supported our risk management strategy. We maintained this relative outperformance and preserved capital. From a commercial bank's perspective, preservation of capital is important and we were able to achieve this goal in a difficult market.

John Bader Hedge funds that were seeding people have also disappeared to a certain degree. We were never in the seeding business, but when we wanted to recruit the best talent, we had a strategy of putting them into business and securing a certain amount of capacity for ourselves. That was the best way to access what they were doing.

As the world got more and more competitive and people used more and more leverage in existing strategies - leverage we were not willing to stomach - we were trying to recruit the best people for niche strategies to produce alpha. So to secure that talent, we chose in certain instances to promise a certain amount of capital and to make a commitment to raise more. Right now, the phones are ringing off the hook from great people who either are unemployed or want to leave their existing firms. Therefore, we don't have to make the kinds of seeding deals we did before to attract talent. This is another reason seeding is harder to come by today.

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John M. Bader

Ed Robertiello Are any of your firms going to participate in TALF or PPIP? John, I know from an email I just received that Halcyon put out an overview on the two programs. I have heard from hedge funds that they are not really interested. There is not enough detail about the program and they are afraid to even touch it because the Fed could change the rules of the game at anytime without them knowing the consequences.

Chris Pucillo We looked at the TALF and PPIP structures, and one of our issues was the maturity of the non-recourse financing being offered by the government for TALF. Although the maturity of the financing may be in-line with the average life of the TALF-eligible assets, these assets have an uncertain final maturity. Even with an increase in the maturity of the TALF financing, it would not match the maturity of the assets. The underlying premise of both programs is that the government would provide cheap, non-recourse leverage and, as a result, the investor would be willing to pay a higher price for the assets. However, when the government financing expires, the buyer in the market at the time may be less willing to purchase the assets at that artificially high price if he does not have access to the same inexpensive leverage.

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Christopher Pucillo

Tim Schuler In addition, managers we have spoken to say that they do not have a built-in reason to participate in the programs. If you look at a PIMCO or a BlackRock, who actually own the underlying banks' debt, it is in their interest to bid things up as high as they can possibly go. If you pay par for something that is worth $0.20, but you are only on the hook for the first 5 cents, you are unconcerned about the other 75 cents in potential losses. If paying 5 cents allows the bank in question to sell its assets for face value and therefore continue to pay all principal and interest to you on their own debt, you should do that trade all day long. At essentially 20:1 non-recourse financing, it makes perfect sense for these bondholders to overpay for what the Treasury calls "legacy assets". The hedge fund managers we talk to say that they just don't have the incentive to overpay for the securities in question.

John M. Bader When I had some early conversations with the Fed about some of the programs they were looking at, my first response was why would I want to be buying new par assets on a leveraged basis to earn a low 20s return potentially with 10:1 leverage, when I could buy existing assets trading at distressed levels with no leverage to achieve the same kind of return with a lot less risk? In my view, programs for legacy assets are a lot more interesting and generally worth looking at.

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Tim Schuler

I personally am somewhat skeptical of the PPIP, although we put in our application. My grave concern is that the rules may get changed along the way, and I also don't know how much prices will be bid up, to Chris' point. On the other hand, to the extent that it's done with capital that one could draw down, one doesn't have to bid. We also wonder if one does participate, does that then mean the rest of one's business gets subject to incremental regulatory requirements? Accordingly, we have not determined yet to go forward.

It has been expressed to us that perhaps one should think differently about Fed programs versus Treasury programs. PPIP is a Treasury program, and some people suggest that one might be better off participating in a Fed program. I'm not opining on that, but those are some of the things that we have heard and think about.

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On the other hand, there is so little response to these programs, and the government is so interested in having people participate to create demand for what is going to be a big supply of debt. If you are one of a small number of people who ultimately do participate - if one can get comfortable with the rules, and all the other caveats - maybe there is something interesting to do.

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On their earnings calls, several banks have discussed their interest in potentially acting as both a buyer and a seller in the PPIP program. Based on many of the factors discussed, participation from asset managers is likely to be insignificant; therefore, we may end up seeing banks emerge as the only buyers, resulting in a taxpayer-financed asset exchange.

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