OPALESQUE

# Opalesque Roundtable Series '16

# ZURICH

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# Editor's Note

What options do investors have as the "Greenspan Put" has run out?

In Switzerland, the money market interest rate is -0.75%. Investors, not only in Switzerland, have earning pressure with a 10-year which is at zero or below zero, 58% of German bonds are now at negative yields. And, from the other side, basis diversification between stocks and bonds, respectively the "**Greenspan put**", has been running out.

We are now past a period of several years where you could have done very well without alternatives of any kind. But going forward, the basis diversification will not be the Holy Grail anymore, and the <u>asset allocation of the investors will have to be adapted to the new situation</u>. Investors have started to venture into assets they avoided just a short while ago as unsuitable. But the unanswered question is **how some of these alternatives will do in a world of waning or even reversing global QE?**

So, what should people look for? They should apparently look for independent cash flows, for which they should also have a clear understanding where those are coming from. Either they are a premium, or they represent a consistent source of value. And on top of it, if they diversify the main risk equity, that will definitely beneficial. One space investors are investigating and allocating to direct lending, and many also are getting deeper into the ILS space. Others are considering a come back of hedge funds.

With **Alternative Beta,** a sector that has been enjoying huge growth rates, investors have also diversified into new streams of returns which they typically used to see with hedge funds, but that are now offered through more beneficial structures and at lower fees.

Massive tail risk from disappearing liquidity

The managers of the Dacharan FX fund have a fairly good handle on liquidity in G10 FX, which is traditionally a pretty liquid area. They estimate that **liquidity in G10 FX is down about 30% to 40% from last year.** So, if you hit the market with a large order, there's not a lot of balance sheet on the other side. This is a great concern in the investment community, and Dacharan points out they are not the first ones mentioning it. It's a real issue, and the **tail risks are massive.** So, <u>if you have a liquid fund and you have done well so far, that may not mean you won't face issues going forward.</u>

This Roundtable also discusses in depth which factors are driving this reduction of liquidity, and how these issues at the same time represent an opportunity for long-term investors.

The Opalesque 2016 Zurich Roundtable took place end of 2015 in Zurich with:

1. Barry Thomas, PhD, Argentière Capital
2. Bruno Wicki, CFA, Zürcher Kantonalbank
3. David Beddington, Dacharan Capital
4. Dr. Lars Jaeger, GAM
5. Ian Hamilton, IDS
6. Markus-Alexander Flesch, Eurex
7. Markus Matuszek, CFA, Hermes Capital Management
8. Michael Knecht, SIGLO Capital Advisors
9. Rudolf Bohli, RBR Capital

The group also discussed:

- How did alternative beta do in 2008 (page 15)? How inexperienced alt beta providers can get their fees wrong (page 24)
- How to properly analyze funds and strategies post 2008 (pages 10, 14-15)
- Why even 6% and 7% type of yield will be the exception going forward (page 13)
- Why selling volatility to enhance yield is no different to increasing the leverage of your portfolio (page 11)
- Has short volatility become a crowded trade? (page 17)
- Where can investors find the best risk-reward across the spectrum of asset classes and instruments? (pages 8, 11)
- Invested in a "mega hedge fund"? Why you need to be really confident that these large funds are going to deliver reasonably high Sharpes consistently (pages 13-14)

- Why hedge funds should not try to turn themselves into huge investment houses (page 14)
- How do you determine the “right” fee level for a fund? (page 15)
- Why (and how) investors who have a balance sheet should use it (page 20)
- Why have more and more investors turned their back on UCITS and 40 Act funds? (page 22)
- Why “old-fashioned” fund of hedge funds still have a role to play (page 25)
- Why Malta's Recognized Incorporated Cell Companies (RICC) can be a better incubation platform for smaller funds (page 27)
- How setting up in the greater Zurich region has worked out very well for a good number of hedge funds (pages 27-29)

Enjoy!

Matthias Knab
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Cover photo: Switzerland - Top of Europe, The snow-clad Jungfrau (right) is 4,158 metres (13,642 ft) high and is one of the main summits of the Bernese Alps. The Jungfraujoch (left) -Top of Europe at 3454 metres (11,332 ft) above sea level.

# Participant Profiles

(LEFT TO RIGHT)

Matthias Knab, Ian Hamilton, Barry Thomas, Rudolf Bohli, David Beddington, Michael Knecht, Markus Matuszek, Bruno Wicki, Dr. Lars Jaeger, Markus-Alexander Flesch.

# Introduction

**Markus-Alexander Flesch**
Eurex

Markus Flesch, I am running the trading and clearing related Eurex sales business for Switzerland, Italy, Israel and South Africa. Therefore, I'm very happy to discuss industry relevant themes jointly with all of you at this Zurich hedge fund Roundtable.

**Dr. Lars Jaeger**
GAM

My name is Lars Jaeger. I am representing GAM where I am Head of the Quantitative Strategies. I was formerly working with Alternative Beta Partners which I founded as a spin off from Partners Group. Before that I had been with Partners Group as a partner responsible for the hedge fund and alternative beta business for the better part of ten years. My background is theoretical physics, so you could say that I am pretty much on the quant side. My main topic is the alternative beta space.

**Bruno Wicki**
Zürcher Kantonalbank

My name is Bruno Wicki. I represent Zürcher Kantonalbank, the State Bank of Zurich. Many years ago, starting around 1999, I used to run catastrophe bond funds. After a few years I transferred to RMF, now part of Man FRM, heading their New Alternatives initiative. At the start of 2009 I moved to Swisscanto which was acquired in the beginning of 2015 by Zürcher Kantonalbank where I now head their alternatives business.

**Markus Matuszek**
Hermes Capital Management

My name is Markus Matuszek. I'm the founder and chief investment officer of Hermes Capital Management, a to be launched hedge fund in Q2 2016. Together with a senior team we will be running a fundamental equity long/short portfolio, biased towards European ideas. Prior to that, I was a managing partner with Gabelli & Partners, a hedge fund that ran the same investment strategy, which is associated with Mario Gabelli's $50 billion asset manager GAMCO run out of New York. Prior to that I founded and ran Centurion Group for 7 years , an investment advisory and asset management firm and I've spent some time at McKinsey & Company advising on value-maximising changes to strategy, finance or operations both in developed and developing markets – an experience I do like to leverage when analysing companies and investment opportunities.

**David Beddington**
Dacharan

David Beddington. I'm a founding partner of Dacharan. We are an eight-year-old alternative investment management company. We run two funds, a short-term systematic G10 spot FX, and a systematic equity market-neutral.

**Rudi Bohli**
RBR Capital

I am Rudi Bohli. I'm running RBR Capital, a long/short European equity hedge fund which has been around for 12 years now. Prior to that I've been on the sales side for a boutique broker here in Switzerland.

**Barry Thomas**
Argentière Capital

Barry Thomas, I'm head of marketing and investor relations for Argentière Capital. We are a $2bn hedge fund based in Zug, Switzerland and launched two and-a-half years ago. We are an absolute return fund with a bias towards equity volatility strategies. Prior to joining Argentière I was at FRM for ten years and helped run the hedge fund seeding business that FRM launched in 2008.

**Ian Hamilton**
IDS

Ian Hamilton, I've been in the investment industry for the past 40 years and the last 14 years has been building up hedge fund administration in South Africa and also internationally under the IDS banner.

I've always had a passion for developing the industry further and have set up incubator platforms and asset management here in Europe so as to be able to help the smaller guys get on the ladder. That part of the business is called Scotstone.

**Michael Knecht**
SIGLO Capital Advisors

My name is Michael Knecht. I'm one of the three partners at SIGLO Capital Advisors. We are an independent consultant advising large institutions like family offices, banks and pension funds. At the moment, we are focused on Insurance Linked Strategies (ILS), private debt (meaning direct lending, loans etc.), and last but not least, hedge fund advisory.

**Matthias Knab** Let's analyze how the demand for alternative investments is developing. Michael already mentioned some of the areas he as a consultant has been focusing on. Obviously, this is also where some of the demand is. So, Michael, let's start with your perspective and experiences, what are investors looking for? What are their investment criteria?

**Michael Knecht:** This is of course a broad question, so let's start with taking a look an environment our main clients are facing. In Switzerland the money market interest rate is -0.75%. This is not a complete new situation for most of our clients, but the decision of the Swiss National Bank as of the 15. January 2015 to unpeg the Swiss Franc from the Euro has accelerated their problems. On the one side, they have earning pressure with a 10-year which is at zero or below zero. And on the other side, basis diversification between stocks and bonds, respectively **the "Greenspan put", has been running out.** We believe that the basis diversification will not be the Holy Grail anymore within the next crisis. The asset allocation of the investors will have to be adapted to the new situation.

What should people look for? They should apparently look for independent cash flows, for which they should also have a clear understanding where those are coming from. So either they are a premium, or they are apparently a consistent source of value. And on top of it, if they diversify the main risk equity, that will definitely beneficial. But where can we find those assets?

We as a team try to profit from a new landscape with the changes around Basel III and Solvency II. Those two regulatory frameworks are actually going to open up opportunity sets for investors which do have a balance sheet. We have our focus on the time intermediation. Our clients do have the needed long term horizon for this. We look into direct lending/shadow banking and also try to get deeper into the ILS space. On the other hand, we could as well imagine a come back of hedge funds.

**Bruno Wicki:** We are now past a period of several years where you could have done very well without alternatives of any kind. If you were basically long bonds for the last 15-20 years you were doing great with very little risk. There was in general no need for additional diversifiers. But that megatrend has now finally come to an end, even tough rates went much lower than we all expected. Most investors now look to alternative investments to provide them with some kind of yield or at least some diversification to their main risks - duration and equity market risk. They are **venturing increasingly into assets they avoided just a short while ago as unsuitable**, direct lending being one example.

But the unanswered one million dollar question is how some of these alternatives will do in a world of waning or even reversing global QE. Can they still prevail when the gigantic backdrop for equities and bonds finally comes to an end? Remember, QE lifted all assets up while greed and fear flows provided negative correlation among asset classes when needed. This underlying tide will soon be gone for long and bonds are likely to offer negative returns for years to come.

These are big issues a lot of people spend some time thinking about, and rightfully so, because if you're looking at the broad markets there are and will be very few places to hide.

**Dr. Lars Jaeger:** One of the things that my group and I have been looking at for a long time now is the subject of alternative beta. We used to be running corresponding investment strategies at Alternative Beta Partners and now we're doing the same thing at GAM. I'm actually surprised and delighted how quickly this former niche which we pioneered so many years ago has now entered into a very prominent spotlight. That is one of the reasons why we joined GAM in 2014. We have seen **huge demands for alternative beta products** from the largest investors in the world. Institutions like GAM are very attractive for them. Our company has the right resource base to execute these strategies and at the same time the team with the most extensive experience in this field worldwide. A series of investors used to allocate to hedge funds, and they have completely withdrawn from there and are looking to get exposure to alternative risk premia, or as we also call it "alternative beta" – a term we coined some 12 years ago.

What they're looking for is precisely what Bruno has said: Diversification into new streams of returns which investors used to see with hedge funds, or at least which have been the promise of hedge funds for a long time. And in some ways they have been disenchanted by hedge funds, and now they are saying, *"Well, we can get the same benefits by something that comes with structurally much more beneficial properties."* Meaning more transparency, independent risk management, liquidity, and last but not least of course, much lower costs. We experience a huge demand in that space, specifically from the largest and most sophisticated investors in the world.

**Matthias Knab** So it looks like alternative beta has reached its tipping point. I know you for many years and know you have been with this since the beginning, tell us a bit more how you personally experienced the past years that maybe have been a bit of an uphill battle until reaching this tipping point?

**Dr. Lars Jaeger:** When we started this approach, it was under the premise of hedge fund replication. Not in a statistical sense where you'd try to replicate something through factor replication, but much more of what we call "bottom-up replication", extracting the same risk premia that underlie hedge fund returns. For example, in the case of merger arbitrage, instead of allocating money to the merger arbitrage hedge fund, we would systematically trade into every single merger that's been announced, subject, of course, to some constraints of liquidity, et cetera, but still entirely systematically. CTAs have been systematic for some 40 years now. We can trade trend following strategies ourselves without paying the omnipresent 2/20 fees. So that is in a nutshell what we have been developing over the years: a whole **set of diversified strategies that extract the same return sources that hedge funds have extracted for many years, but at lower costs.**

And we have come to confirm that the returns that we generated were very similar to those of hedge funds, and – even better – net of fees, of course. But, yes, it has indeed been an uphill battle for at least two reasons: 1. getting acceptance from investors that risk premia are the main source of hedge fund returns and can be replicated systematically, and 2. we were being associated with fund of hedge fund businesses which were in demise after 2008.

Since maybe two or three years ago the tide has changed in so far as that people have discovered the story of alternative risk premium investing as sort of an independent way of investing. It doesn't have to do anything with hedge funds. Now you can do trend following and momentum, you can do value equity, you can do carry trades, and all these things, completely outside of hedge funds. In other words, *you do not have to think "hedge funds" when you think "alternative beta"*. I think that triggered a lot of thinking in people's minds that here we have an opportunity to extract independent return sources, in light of what Bruno was saying, with going forward equity and bonds maybe not yielding return patterns and correlation patterns as they used to.

And this is what has triggered huge demands. In Europe, the first spotlight that came onto this were probably the big Nordic pension funds announcing two or three years ago that they would go into this space. And in fact, their Dutch colleagues had already been in it, trading this themselves, but that was much lesser known.

And that ultimately led to some banks developing corresponding tools and models to extract those return sources, until we are now seeing every investment bank out there providing alternative risk premium investment platforms. And the assets they run today go into the billions. So, what we at Partners' Group and Alternative Beta Partners, and now at GAM have built is now being run in very large sizes at almost every large investment house in the world.

**David Beddington:** I'd like to just go back for a moment to the macro discussion. We talked about the bond trend for the last 15 years, but I would say that actually for the last 30 years we have experienced a consistent reduction in long-term interest rates and the risk-free rate combined with a bullish equity environment that broadly speaking we have had for the same period of time.

The two are linked – *this turning point in equity risk, and the turning point in bonds where your risk-return profile has significantly deteriorated – those two are actually linked by the risk-free rate*. Essentially, equities could continue to rally as the risk-free rate continually declined over a multi-decade period. But we are at what feels like the upper bound for bonds. How much further can bonds increase from here? So there seems to be a lot of downside relative to the interest rate return and that directly links to equities because if bonds sell off, the risk-free rate goes up. This means that the medium to long-term outlook for equities is uncertain as there is no longer a helpful boost from a continually declining risk free rate.

Now, we can't predict the future with clarity. The world is very uncertain and very complex. But there are these macro headwinds against equities, and I just wanted to link the bond aspect and equities which both Michael and Bruno implied. I wanted to explicitly state it.

Regarding alternative beta, I actually think that the **hedge fund or the active management alternative industry and alternative beta are doing different things.** For example, sometimes that difference is in trading time horizons or in certain nuances of the strategy. I agree that there is great potential in lower fee products that access a different return profile which helps people with their portfolio construction. So there's definitely a space for alternative beta, but still, successful hedge fund managers doing real active management should be earning their two and twenty. That will of course not be possible any more for managers that are just doing very simple alternative beta style strategies and trying to slap two and twenty on it. That won't work; the world has become too competitive for that.

In finance and probably also elsewhere in the world, things always tend to get a bit harder, which pushes people to work harder and invest more. But I know, for example, with Barry's fund, Argentière, who is also based in Zug, and my own company at Dacharan, the sort of sophistication in techniques and research that we've put into individual trades, execution, management of risk, the capacity to turn a portfolio around aggressively in a really short period of time, and so on, that is something that an alternative beta product – partly because it's rules-based and partly because of the structure of the product and the different return profile – is much harder for them to deliver. But there's room for both, right? I would be almost certain that there are active products that are very uncorrelated with GAM's products in the alternative beta space while having very different risk profiles than equities and bonds.

So given that we're in an uncertain macro environment, it's really important that people look at diversification and really **dig under the cover and not look at what the last three years of numbers look like when we still had QE support,** but what the future numbers might look like in an environment that we haven't seen before.

I keep reminding myself that the Fed is ending the largest monetary experiment since World War II. There is significance to this change in direction, and it is unchartered territory. None of us has a model that works perfectly for the future. And so, it's a time for research and it's a time for diversification.

**Barry Thomas:** I agree that with over six years of QE, the US has created a relatively unique environment of low interest rates. We started with QE in the US in April 2009, and the process has progressively been squeezing the yield out of everything since then. This creates challenges for investors globally in a zero-rate environment when they still have return targets of 6%, 8%, 10%. When rates are at zero, it gets pretty difficult and investors need to modify their return expectations in that kind of environment.

If you think of what's happened over those last five or six years, they started by taking short-term rates to zero and moving over to the longer term rates. The ten-year Swiss bond is now trading at negative 30 basis points. So that's what's happening in the most stable and developed countries, but even if you move to the periphery to a country like Portugal, the five-year bonds are trading at the same yield as US five-year rates. There's no fundamental justification for that, it's being driven solely by technicals and the distorting impact that QE is having.

So globally all of the yield has been squeezed out of sovereign credit. In corporate credit, investment grade is trading extremely tight, as is high yield. So investors have a problem, "Where am I going to get yield from to allow me to hit my return target?" Over the last couple of years investors have looked to equities, for good reasons, because you still had good companies paying a reasonable dividend yield. The S&P 500 was up over 30% in 2013 with Sharpe of over three and-a-half, that's pretty difficult to beat for anybody. But, as we mentioned, over the last 12 months or so investors have started to question the level of equities or whether or not they think they want to keep increasing their exposure to equities.

So where will people go and allocate? Sovereign bonds are too tight and aren't earning anything. Investment grade and high yield look very expensive, I am not sure I want to add to equities, and people hate commodities. So how am I going to make my 6%, 8%, 10%? One observation we as a volatility-focused hedge fund would make is that over the last couple of years, investors have started to start selling volatility, by which I mean selling options, in order to generate yield, because by selling options you're effectively earning a premium.

In some ways owning volatility, or buying options, is like owning insurance on the market. Like any insurance, you generally expect to pay a premium to own insurance. So by being the insurance company, by selling options (or volatility), investors are able to earn that premium to their enhance yield. This has created a huge imbalance between the demand and supply of volatility through an increase in supply for yield enhancement purposes. And that has created opportunities for our strategy as volatility now trades very cheaply and we are generally on the other side of that by structuring trades where we tend to run with a long volatility bias.

*However, selling volatility to enhance your yield is no different to increasing the leverage of your portfolio, and this is what people are effectively doing.* They are finding ways to leverage themselves in order to increase yields. Now we all know how leverage games typically end, and I'm not here to say when that's going to happen, but it probably unravels at some point. But the mismatch between the supply and demand for volatility is the kind of dislocation that we look to take advantage of, and *right now we run with a very long volatility bias, not because we are bearish but because volatility is trading so cheaply that it is possible to construct a portfolio where you can be long volatility and actually get paid to own that position, i.e you are being paid to own protection.* **Being long volatility, particularly in equities, currently offers the best risk-reward across the spectrum of asset classes and instruments** that we trade in our opinion.

Now that's something that happens very rarely that you can own insurance on the market and actually get paid. It's a little bit like owning health insurance or car insurance, but rather than you sending a check to your insurance company every month, the insurance company is actually paying you to own the insurance, such is the level of dislocation in volatility markets.

# Who we are and what we do?

The IDS Group is an independent fund administration group which was founded in 2002. We specialize in providing back office services to alternative asset managers including hedge funds, funds of hedge funds, private equity and property funds. We are the largest fund administrator in Africa with assets under administration of approximately $6bn and international offices in London, Malta and Mauritius. Our clients trade all investment strategies and we pride ourselves on providing a tailored solution to meet their differing requirements.

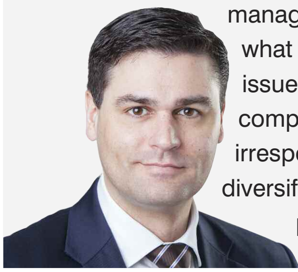
**What sets us apart?**
Understanding your business is our business. Our clients vary in terms of size, location and complexity but we treat every client as an important client. One size does not fit all. Our experienced team works with our clients to ensure complete understanding of their requirements and provide detailed and bespoke solutions as well as ongoing advice, assistance and support. We continually review our processes and integrated range of products and services to ensure we maintain the high service levels that our clients expect from IDS.

**When should you consider using IDS Group services?**
Whether you're looking to launch a new fund, make a transition to a new administrator or simply wish to outsource some of your processes, we have a solution to suit your needs.

**Rudolf Bohli:** That makes me all very bullish for asset inflows. I I tend to agree, the outlook for fixed incomes is rather poor, and we can debate the outlook for equity. So I think we'll see more-and-more assets going into alternatives, the outlook for alternatives in general is very good. The question is of course if you have a good strategy where you can continue to create some alpha.

To address the demand we see for alternatives, we have launched a new product this year which is basically the opposite of a diversified product. It's a single-stock product, and we found it to be a very interesting way of engaging with investors or potential investors because they exactly see what they get. So they get the full transparency, and if they might like it they might tag along, or they want to see how it develops and they come back when the next opportunity arises.

**Markus Matuszek:** Let me add some points to that. I do believe that uncertainty requires a more active investment management than in times when the macro picture is simpler. The big challenges investors are faced with is what they realistically can expect from such active management – for sure it is not a panacea for all their issues. Investors mention to us that they obviously want high performance, low volatility, ideally fees which compete with passive products and on top of that daily liquidity. I doubt that a single fund or house, irrespective of their strategies, can be the master of all traits in that regard so inevitably investors must diversify their portfolio, which is why there is certainly space for a hedge fund like us or alternative beta products.



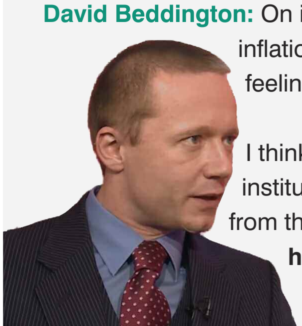
**Ian Hamilton:** At this Roundtable and in many other places there is a lot of historical talk about yields, looking at levels of 6%. But when you are in a zero inflation scenario and there is worry about deflation, one should be actually looking at capital preservation rather than talking about 6% and 7%. That type of yield is going to be the exception.

I think in the so-called institutionalization of hedge funds with pension funds coming in as investors, they are looking to have their capital preserved. They would love to get nice returns above that, but I think we've got to be realistic about expectations and  benchmarks, et cetera, and 2% and 3% returns in the low-inflationary or zero-inflationary climate is fantastic. You just have to look at pre-inflation eras as well. And this is an obsession I find here in Europe, and I can't understand why you've got to have positive inflation all the time. All that does is destroy savings.

**Rudolf Bohli**

And probably as a result you see that the largest inflows go into the largest hedge funds that offer lower type of return profiles but with a very low volatility and a very high chance of a positive return. I think that's a trend that we continue seeing. And as to whether we'll have deflation or not, I think that debate is still out there.

**David Beddington:** On inflation, I think there is room for debate about how well some of the official statistics are tracking inflation. I keep seeing the Swiss statistics that there is deflation in Switzerland and I'm not quite sure if I'm feeling it myself. Anyone who has bought a house in the last number of years may be confused as well.



I think it's an interesting structural point about the industry that Rudi also referred to, which is this institutional trend towards very large managers, $10bn, $20bn, $30bn+, and the low-vol returns that come from that. From being on the inside of hedge funds, I know myself that **the more money and assets you have, the harder it is to deliver attractive returns.**

So sometimes these managers may not actually facilitate investor needs. These are managers who don't really have a choice because of the weight of assets they are being offered. And if you get a 2% management fee, it takes an awful lot of discipline to turn those assets away.

Just run the math quickly in your head. If a fund is giving you 3% volatility, and has a Sharpe of two, that's actually a fair amount of skill. A Sharpe of two gross with 3% vol, that's a 6% return if we look at it very simply. Put a 20% performance and 2% management fee on top, throw in a few administration costs, and all of a sudden the investor is paying more in fees than he is getting back. And this is for a manager delivering a Sharpe of two. If that Sharpe drops to one or a half – so there is still trading edge there – but all of a sudden the investor is giving up everything to the manager. If that Sharpe flattens to zero for a year, the investor is actually giving back in fees a large chunk of the prior years' returns.

Therefore, **people need to be really confident that these large funds are going to deliver these reasonably high Sharpes consistently** in order to justify the high fees relative to the returns. The fee managers' charge needs to be viewed relative to the volatility and relative to the risk the managers are taking on behalf of investors.

Being a niche fund, the way I view it is that I am paid to take risk. We actually run with vol targets and try to hit a certain level of risk. We have risk management. So, if we don't think we have edge in a certain environment, we'll dial our exposure down potentially all the way to zero. We are in extremely liquid assets, so we can do that. But the point is by trying to hit a higher level of volatility as a business, we are also diluting the fixed costs. We are rewarding investors for the illiquidity premium that you should get for being in any structure that isn't on a listed market. If you have ever known someone who had to unwind a hedge fund portfolio, this isn't a two or three-month affair.

**Ian Hamilton:** You have hit the nail on the head. This is one of the things that has happened in the hedge fund industry where there are two classes of companies. You have the asset gatherers, often fund of funds, who are relying on 2% in their management fees, and then you've got your performance chasers which are the hedge funds.

In this industry, there is always the temptation or danger at all times of not taking the discipline of saying, *"I'm going too fast, I am going to turn away money."* I have seen a lot of failures where a manager had a good working strategy, and then he gets greedy and grows and grows until he blows ups completely. So **knowing your limits and choosing to close a fund to new investors is a discipline that needs to be followed.** People have got to cut their cloth and not try and turn themselves into huge investment houses. But, when you have more and more institutions posing as hedge fund managers there is danger to the hedge fund industry. I sometimes say that an institution in the hedge fund industry is an oxymoron. Institutional investors create market inefficiencies that smaller hedge fund managers can capitalize on.

**Dr. Lars Jaeger:** Going back to the subject of active versus systematic management of alternative beta for the hedge funds. David, in fact just threw me an argument when he mentioned the example of a manager making a gross Sharpe of two but still only netting 3% after fees. This seems insane and is of course a huge issue, as you say yourself. So you can do two things; you can increase your skill set and generate even more alpha that will sustain even after fees, or you can cut the fees. The first is a tough one and may lack sustainability. The second approach entails moving into a more systematic low-cost approach. Ultimately, return-wise we may end up in the same space. But certainly, the the decision to cut fees and being more systematic when it comes to alternative beta is surely an easier – and more credible and sustainable – way.

But let me also state here explicitly that I'm not saying that the alternative beta is going to cover it all, of course not. **We will still continue having and relying on alpha skills.** We will still keep having highly-skilled managers operating in niches that extract extra returns.

What I'm saying is that the end the investor will have to judge our performance. And if you compare what we delivered in net returns versus average hedge funds -- having started this in 2004, I've been in this alternative beta space for probably longer than anybody else in the industry – we are always ahead of them in almost any market environment. Especially in 2008 we had a much better protection on the downside than most hedge funds did. And that's not because we're especially smart, but rather because I think we operate in a much more beneficial and benevolent structural environments – lower fees, better liquidity, less complexity, high transparency.

GAM actually exemplifies a firm that can do both, active and the more systematic alternative beta. GAM runs huge alpha funds with 1.5 and 20 or 1.5 and 15 fees, so funds that are exactly playing in your park. And at the same time, GAM is playing more systematic funds that charge a lot less. So there is definitely space for both and GAM is is a great example for it.

**Michael Knecht:** I think this overall cost discussion is always burning if interest rates are low, and that's completely natural. But we are somehow also a little bit irritated by it. It seems like nobody ever asks the question which everyone normally asks buying something: *"What is it worth?"*

If I look at the price of a car or a pair of shoes or any other product or service, it normally consists out of the production cost and then you maybe have a premium on top of it, depending on how good the product is. The same should actually happen in the fund industry. Not everyone is worth a 2 & 20 fee! I believe every investor has to decide if it's worth or not. And you have to ask yourself exactly the question some of you have touched on already: "What do I get? What is the process? Is it consistent? Do I believe in it? And what do I believe it is worth? What do I get paid for your risk?"

But just saving costs will not solve the earning problem. You should really ask yourself, "How do I diversify my book? And how do I earn money?" And I agree with Ian that no one said that we always have to earn 4%, 5%, 6%, 7%. Maybe we also have simply to accept that we are in a market environment where two-and-a-half percent or three percent in Swiss francs is an excellent result.

If I may also put up a question: we have been addressing the topic how the large hedge funds are getting bigger, and Lars also mentioned the alternative beta industry gathering a lot of assets. **Where we are actually getting worried with is market liquidity.** Brokers have thinner and thinner inventories, and some of that is a consequence of regulations. But these days, it's getting hard to sell a 10-year Swiss government bond. If you look at a single hedge fund manager running say $2bn – $3bn, let's take a normal long/short equity with a gross exposure level of 200, they will have a market footprint of $5bn – $6bn. Can we still trade that? Is this still feasible? Is the low-vol strategy still a low-vol strategy if liquidity is not there anymore?

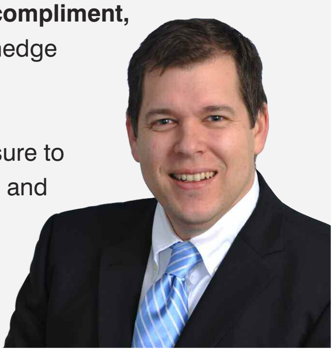
**Markus-Alexander Flesch:** I hear this argument about the liquidity within the last 12 months quite often. Especially you just mentioned the lack of liquidity that could affect those larger funds. I think that this is probably a fact which has been quite known for a while, because even in the government bond sector, which traditionally is deemed to be liquid, especially the Swiss government bond market, liquidity is rather poor. This is because 70% of the issuance though fairly small is absorbed by insurances, pension funds and asset managers and these bonds will never see the day light again. Therefore for an infrastructure provider or exchange like us it is extremely difficult to establish a secondary market and issue thereof a liquid derivative, helping investors to manage their investment needs in a more efficient way. However, there is another implication, which should be frightening and supports your argument: in a thin market without any depth, a bigger order of let´s say 500m will absorb any liquidity and spreads will go wide on the back of the return – a horrible scenario for any fund and investor, but this is more and more reality for many reasons, but the main reason here is the intervention of central banks.

But I'd like to make another point: I think we didn't touch upon regulation. MiFID II and MiFIR are almost at the door and at least from our perspective, we try to look into it since we are afraid of its influence on the traditional asset management market as well as the alternatives space. We believe the current concept of MiFID II is designed to have an adverse effect to further drying up markets, and  this on an acerbated path. Eurex is and was trying to stand in for the industry, lobbying for a constructive and fruitful dialogue with the European regulator. Though some of the regulation similar to MiFID II/MiFIR like FINFRAG are already effective, but at least the European regulation or the technical implementation is not yet there, but I think all the different layers of this new regulation would even just accelerate the problem of liquidity, eventually supporting intransparent Dark Pools or completely intransparent OTC markets,  the opposite of what the regulation was aiming for. I see that's one of the big challenges for the alternative space as well as a traditional asset management market.

**Bruno Wicki:** I would like to add a few things to the cost discussion which for us comes as a natural part of the industry evolution. These days we have access to much better timely information on exposures, transparency, liquidity etc. with standardized reports across asset classes allowing us to understand the different moving parts and risks in our portfolios much easier and more precisely. This includes better data on how individual managers make money. A better and more systematic analysis of financial reports allows for more detailed insight with respect to what is actually being paid for return streams and what these look like before any costs have been charged. All these developments also influence and in a way raise the bar for fees.

I agree with what we have discussed, that sometimes what was labeled as alpha before has become partially accessible as a source for alternative beta. This means active managers basically have to focus either on areas that cannot be accessed otherwise or improve the quality of their returns.

It has become a reality today that whoever wants to diversify their asset allocation can easily make use of these building blocks and automatization of return streams. Some of those blocks come bundled in a hedge fund that may also access different asset classes and different strategies, and some come as singular building blocks on the risk premium side where you can also build portfolios of exposures that you do not already have, acting as a compliment to your existing hedge fund exposures. This is actually what we do. We use **market neutral risk premia building blocks as a compliment,** acknowledging that there are other more efficient ways to access certain risk premia than through hedge funds.



Over the next couple of years many more people will figure out that they do not have enough exposure to alternative return streams that would give them some relief and flexibility as they start to suffer more and longer from their concentrated core bond and equity market risks. At the same time it will also become much more difficult, if not impossible, for a number of hedge fund strategies to print positive numbers.

**Rudolf Bohli:** Regarding liquidity. this reminds me on the aftermath of Lehman where people all of a sudden realized they don't have liquid portfolios. I just met some fund of funds guys, and they said they are still winding down portfolios after Lehman. So certainly, this is quite an unpleasant experience. On the other hand, I think regulation has gone pretty far already. FINMA has come out with new rules, and maybe there will be some more to come, but in maybe two or three years, the current reform efforts should more or less be completed.

We also offer weekly liquidity, so there is a compromise to strike in regard to return, right? On the other hand, if you can afford to be less liquid, that's probably where the larger return opportunities are. So as I said, we launched a single-stock fund where we own close to 10% of the company. That's by nature a rather illiquid investment, but we think we can actually make two or three times the initial amount for our investors over a longer time period, and I think that's certainly a very interesting opportunity.

**Markus Matuszek:** It is an interesting product indeed which must be catered towards specific investors that can take such concentrated positions. Regularly the biggest set of questions we obtain is around how we define and manage risk. Even having an experienced chief risk officer who runs portfolio analytics to help us understand what factor risks we take and – on a forward looking basis – work on hedge positions, eliminates unwanted exposures and does provide ideas for overlays or net exposure adjustment – all that is taken for granted by investors, although it is quite rare to see with our strategy and where we stand in the lifecyle.

**Barry Thomas:** I think we need to consider a few other aspects when we talk about the question of liquidity. We also have to think about what happens in a more volatile environment where you witness deleveraging, and consider the impact of growth that we have seen in the industry over the last 10 or 15 years. The hedge fund industry is now at about $3 trillion, whereas 12 years ago it was perhaps at $300 billion, so certainly a massive growth.

Now if you argue that 12 years ago all hedge fund managers had unique uncrowded alpha generating trades, I might believe that. If you say right now that the $3 trillion is all invested in totally unique, uncrowded, alpha-generating trade, I think that's pretty hard to envisage.

I think most people would agree that there's a lot of crowdedness in positioning. Generally, a lot of hedge funds have the same kind of positioning. Now, alongside that, I would argue that a lot hedge fund strategies tend to be short volatility by nature, meaning that in a more volatile environment, those strategies tend to do badly.

What this means is that we have now **more crowded positioning in short volatility trades in a much larger industry.** So to use an analogy, now when the stadium is on fire, you get a lot more people running for the exit than was the case a few years ago. In other words, in a more volatile environment when investors are forced to de-lever, a lot of people are going to find themselves short liquidity. In that kind of environment, that's where probably the best dislocations and the best opportunities are going to be. Now, the question is whether or not you will be in a position of strength to take advantage of those opportunities, or whether as an investor you'll be handcuffed at those point. By running with a long volatility bias, what we endeavor to do in our portfolio during periods of deleveraging, when other people are panicking and having to sell, is to be in a position of strength to be able to take the advantage of those opportunities.

In more volatile environments, an investor who is long volatility may also typically find himself long liquidity, because investors who have gone short volatility to extract yield will be looking to close those positions by buying volatility back, hence there will be a strong bid for the positions that we own. This liquidity profile can therefore put us in a position of strength to take advantage of dislocations in volatile environments, because often things tend to overshoot in periods of deleveraging.

Post-2008 was the biggest period of deleveraging we have seen for a very long time, but we can also point to other examples in the past, also in the recent past like in 2011, where it was less severe but still a volatile environment.

So I think Michael's point or question on liquidity is a good one and an increasing challenge for asset managers.

**Dr. Lars Jaeger:** It's interesting that I keep hearing arguments which are in favor of alternative beta! If you want to be allocated to the alternative space, and if you are concerned about liquidity, well why would you not invest in strategies that are among the most liquid in the liquid alternative space which is alternative beta? We are using the most liquid instruments, and even if 10-year government bonds are becoming less liquid than maybe five years ago, they are still much more liquid than a single stock or anything like that.

So I just wanted to point out that this liquidity argument has been a very strong argument on the side of systematic alternative beta-type investments, and even if the market is getting less liquid, it's playing out in our direction. I think 2008, which is still a highlight in everybody's mind, makes that very clear. In 2008, when a lot of hedge funds had to gate and became basically closed, we were able to adhere to any sizes of redemptions.

**David Beddington:** Liquidity is something that I think Dacharan has a fairly good handle on. Our short-term FX fund is hard closed to new investors, so I when I mention that managers need capacity limits for certain strategies, I speak from personal experience.

In G10 spot FX we trade about $1.5 billion a day in a fairly technologically advanced setup. We have remotely located servers, it's all algorithmically driven. We are close to flat most nights. So our strategy has a fairly good handle on liquidity in G10 FX, which is traditionally a pretty liquid area. **I estimate that liquidity is down about 30% to 40% from last year.** I am not talking about the bid-offer spread, because there are plenty of high frequency guys keeping the bid-offer spread as tight as you like, rather about real market debt.

*If you hit the market with a large order, there's not a lot of balance sheet on the other side.* I believe there is a concern in the investment community, and we are not the first ones mentioning it, other people have mentioned it as well. I have been hearing things about market depth all year from a number of people, and we can confirm it from our own experience. It's a real issue. The tail risks are massive.

So*, if you have a liquid fund and you have done well so far, that may not mean you won't face issues going forward.* I mean, it is tough being an asset manager. I'm not looking for people to feel sorry for me, but in 2008, we were up 50% and we got redemptions because we were running a liquid fund, and some investors wanted to take their risk down and lock in their profits. It is important for asset managers to keep their trust and return capital when people want it back. But it's an important thing for asset managers to remember that just because you're up, you've offered good liquidity and you're a nice guy and you've done your job, that doesn't mean if the investor is scared he is not going to yank cash from you.

Lars, I'll just throw this question to you because I've had people ask me. With the alternative beta industry having growing a lot, do you worry at all that some of these products will have a similar experience, meaning that when you guys might do very well in a 2008 environment that it might also lead to a situation where all you guys then get redemptions at the same time as people look to de-risk from a diversifier that's worked out for them because they simply try to rebalance their portfolios, or if nothing else they may even just panic, God bless them?

**Dr. Lars Jaeger:** Well, certainly, that's an experience that I am able to share with you. It was 2008 – and again we are the only player in our filed who experienced 2008. We were not up 50%, but we were down a lot less than anybody else. And therefore people took money away from us, especially those investors whose FX hedge broke – especially in Australia, where the AUD went down something like 30% in October 2008 alone. So they needed to balance their hedge, and where they found liquidity was with us. And we were among the only one they found liquidity with, so that's why they wanted their money back. But we were able to deal with that.

Now specific to your question, the alternative risk premium space is probably not an area where, when the market goes down severely, you will make a lot of money. In the end, we are all short risks and we will lose some money going into a risk-off environment. It's just that our losses will be a lot more contained, as we are not going to face that extreme liquidity risk and asset liability mismatch like we have seen in the hedge fund industry.

**David Beddington** And so you think that all the strategies would do okay?

**Dr. Lars Jaeger** Actually our trend strategy made 64% in 2008, but that's only one part of the entire portfolio. We were short vol, we had an FX carry, we lost money. So in the end it was a balance, and I can give you the numbers. We were down about 10% in 2008 in total, and that compares to some average 20-25% loss in the hedge fund industry.

**David Beddington** So, many institutions were quite happy with that?

**Dr. Lars Jaeger:** Our investors were quite happy in 2008 with our performance. It was relatively speaking our best year in fact. But they still wanted some money back to cover their hedges.

Most specific, David, to your question on whether the growth in the alternative beta space will also have impacts on liquidity of the investments: Well yes, ultimately, it will have an impact, and we will surely have to monitor this. But I think the problem will be much less than for a large hedge fund manager who is trading many other more complex instruments.

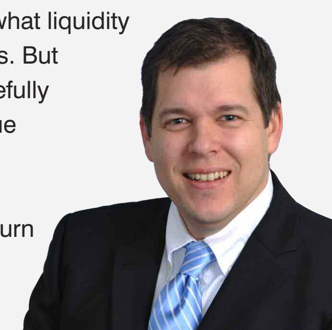
**Matthias Knab** How big do you think alternative beta is now?

**Dr. Lars Jaeger** The numbers are hard to estimate. The banks are the biggest providers now. We used to be the biggest simply because we were the only one. We trade about a billion. I think right now, talking to several banks, they told me they have multiples of 10 billion on their platform, so multiply this by what, eight or nine, ten banks? I think we will easily get into the higher double digit billion numbers in that space, possibly triple digit. I don't know, because there are no statistics on it.

**David Beddington** And that's spread across which asset classes?

**Dr. Lars Jaeger** Well, it spreads across all the premia available in all liquid asset classes, i.e. equity, fixed income, in FX, and commodities. The smallest is the commodity space, also in term of available liquidity, the largest fixed income. We are not talking distressed or junior loans or anything like that. We are talking bonds, FX, and equity markets, some commodities.

**Bruno Wicki:** I think that the liquidity aspect we talked about also represents an opportunity for long-term investors simply because they are able to make longer term commitments. They should obviously be very careful what liquidity risk they want, how much of it, and how much they truly can stomach in adverse market conditions. But because many participants have stepped back as liquidity providers, those investors who can carefully monitor, bear and manage liquidity, are now getting compensated much better. This is certainly true compared to the last few years or as they were heading into 2008.



So for the type of investors who at the same time will also be starving for yield or for sources of return this could be an option, but obviously it has to come in the right doses and wrapping.

**Michael Knecht:** Bruno, I couldn't agree more. In an environment where the big balance sheets of the world are apparently getting reduced, so if you have a balance sheet, you should use it. And yes, use it wisely, because you are most likely going to be locked in for five or ten years, but, from our understanding, there you really can get good risk-adjusted returns.

Let me also briefly come back on overall liquidity terms on hedge funds. If you are worried about basis risk or balance sheet risk of a single hedge fund, something which doesn't fit together for me personally is offering daily liquidity and having a long-term horizon in a market where there may be no reliable depth of liquidity in the market. Asset management is a business of trust, and if you have trust with someone, you should also give him kind of the time leeway so that this manager can implement his strategy, and you should also address that with your liquidity terms.

In the current environment, I don't trust the fund who says, "I am having daily liquidity", because if there's no market anymore, I guess you can assume what price you'll get. So I think you should also have the willingness to accept the illiquidity on the fund level and allow more room for that, because this will also protect your own money from being victim of a fire sale.

**Ian Hamilton** I am really glad you talk about this question of daily liquidity because it's something I am dealing in the South African market, where funds are now launching daily priced funds, and I think it's going to be an absolute nightmare. It's really the equivalent of a bank that is borrowing short and lending out long. This is what's going to happen to a lot of those funds who are going into chasing the retail market, and the retail market just reads one bad headline and it runs for the door, and as Barry said, that door is small.

**Rudolf Bohli:** I don't want to bash the retail investor that much. In my personal experience, sometimes they are even more coolheaded than institutional investors, because it's their money, and they are not losing a job, right? With institutional investors the question that can come up every quarter, every month, is: "Am I losing my job, am I keeping my job?"

In Europe, a lot of the public market funds went to weekly or daily liquidity because of the regulator. So the regulator prescribes it, but then, if you take a closer look, there is always some fine print in it that for example will limit the maximum withdrawal to say 10% or something similar. What this means is that as a fund manager you then have to manage your liquidity according to the maximum redemptions you may have to service.

By nature, I am more of a longer term investor. But on the other hand, it's sometimes also good to have always the exit door in your mind, no? So in my mind, asset management based on those principles is not necessarily a bad thing.

**Markus Matuszek:** We are setting up our own fund right now, and a lot of the discussions you just had actually are well-reflected in discussions we have had with investors in the US, as well as in Europe. We decided to put a product in place which, first of all, is in line with our long-term investment horizon. It is not about having everything that any investor will want as that will have you competing against the big boys, so there is no differentiation at all, making the fund redundant in the first place. Rather, we intend on defining our niche. Because we have the luxury to start without any legacy, we do have many discussions with investors about what our fund can and should do.

Liquidity is one of the risks out there, but what we find interesting is that we hear that almost exclusively in Europe. European investors seem to be kind of overexcited or worried about liquidity.

But if you really ask, what it really is that they are afraid of or why they need it, very often it comes down to the fact that those investors don't have balance sheet, which makes me wonder why they are in that product in the first place.

If liquidity is truly a concern and nevertheless you want to have exposure to that fund, it boils down to deciding your asset allocation and to what extend you feel comfortable to have less liquidity for a small portion of your portfolio.

The US investors are much more relaxed about liquidity since they understand that returns come from longer investment horizons. On the other hand, they are much more persistent to reduce fees. They could want to squeeze a manager down from the typical two-and-twenty to one-and-a-half twenty, maybe even less when you are a startup, but they are also committed to stay longer term invested. First, most of them don't have the luxury to spend and monitor you daily in what you are doing, because that's not the way they are set up. And more importantly, they have a greater allocation to alternatives and they do understand that the already mentioned element of trust is absolutely key.

The last point which we haven't talked about yet today, but we often hear from investors is about correlations. When you look at correlations in the sense of inter-equity or inter-asset class correlations, they have been spiking up after 2008, and they have been coming slowly, but gradually down, despite the recent reversals. Investors seem to question old wisdoms as to which strategies and funds can in such an environment generate returns – for sure you can't simply copycat those that worked 10 years ago as so many hedge funds got started particularly in the equity long/short space that you need to differentiate yourself.

**Ian Hamilton** I am talking now as an administrator. Daily valuations mean extra costs, there's just no way you can get away from it as an administrator. You can only do daily pricing efficiently when you have daily pricing of instruments as well.

**Bruno Wicki:** For me daily valuation is also part of the ongoing evolution I mentioned earlier. Yes, there might be a small extra cost to it, but if the whole long-only world can do it I see no reason for hedge funds not to provide this service to their clients. In my view, it could very well be implemented in our industry and it should be. Let me also take the opportunity to air my annoyance with audit holdbacks; these days there is no justification to prevent investors for up to one year from receiving the remaining 5-10% of their redemption proceeds. There used to be a reason for it in the early days, but given today's processes not any more.

Now, let me clarify that I was speaking about valuation, while dealing frequency is a different matter and depends on the underlying. In our own fund of funds we consider carefully where to spend our liquidity budget. Doing so, we take a close look at what liquidity is suitable for each investment, considering instruments, specific markets conditions and the strategy. We also happen to pass on very good managers with very liquid long/short equity strategies that offer quarterly of even annual locks just because they can and not because it suits their style.

I also think the ultimate decision whether to remain invested in times of stress or not has to lie with the investor and not the manager, regardless of how promising the opportunity is. It's his money after all.

**David Beddington:** Markus mentioned the difference between US investors' expectations and their willingness to have perhaps less liquid investments in the alternative space to capture that uncorrelated return and the alpha, versus in Europe where there is less tolerance for the illiquidity that comes with offshore products.

Europe has had a regulatory drive for UCITS products, which have really dominated certain markets. They force more NAVs, which as Ian correctly pointed out is an extra cost. But, *if you don't need that, you really don't want to be paying for it.* Also, you don't necessarily want to be in a fund with other investors who might use it, because they are going to cause churning as they redeem, and you are paying part of those redemption costs.

Also the US now has '40 Act Funds, which are sometimes considered to be a US version of UCITS, yet they haven't changed the market perception. What I mean by that is that US institutions are very happy to go with the offshore vehicle, very happy to take that monthly liquidity. They don't want to pay for extra NAVs, and are never going to use them anyway because they have an investment committee processes. Most of these investors know consciously they can't time their investments. We have a lot of pension fund clients, so I talk to them about the way that they work through their investment process, and they really know they can't time it. They are just not set up to make such investment decisions. So they don't need daily liquidity, they wouldn't use it and don't want to pay for the extra liquidity.

**Barry Thomas:** Liquidity isn't just a function of time; it's also a function of cost. If you are willing to pay enough, you can get out pretty much everything, in a day or a week or whatever. So these more liquid regulated products, which are meant to offer greater levels of protection to investors, may actually be subjecting them to greater liquidity risk if managers are not properly adjusting the composition of their portfolios to reflect the liquidity they are offering to investors. What that means is that in an environment of deleveraging with a high level of redemptions, those investors can perhaps be subject to extremely disadvantageous mark-to-market valuations if the underlying managers have to liquidate less liquid products in order to meet those redemptions.

**Ian Hamilton**

Just one last thing on liquidity. Why are pension funds and institutions going into private equity where there's a five-year lockup and no liquidity and they are quite prepared to accept the high fees and the lockup? Maybe we are not selling our products right or trying to compete with the long market too much.

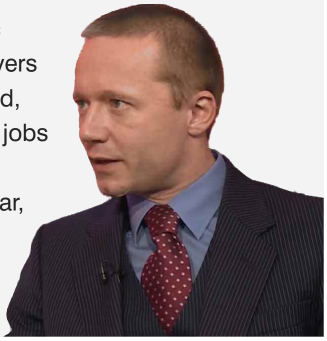
**Rudolf Bohli:** In our world, people are obsessed about liquidity and with mark-to-market. The beauty of private equity is that they have their own special way of doing mark-to-market, and it produces very steady returns. On the other hand, the liquidity of the public markets is what creates the volatility.

In my opinion there is this big scare going on out there about central banks, QE, sovereign debt crises, FX wars and all those things, and that the end of the world as we know it may be near, and all of that creates more volatility down the road. But maybe we are just in a low growth, low inflation environment and have to deal with lower returns. On the other hand this creates a lot of opportunities for bottom up longer term investors.

**David Beddington:** I often think that whenever an argument in macroeconomics seems overwhelming, I believe it is important to imagine a change of the dynamics and momentum. For example, remember a few years ago everyone was talking about peak oil, and how we were going to run out of the stuff and so it should be priced at 100, 200, whatever model or valuation they had at that time. Do you notice how today no one is talking about peak oil anymore?

It's very easy to extrapolate one's current environment indefinitely into the future. So while it's true that we have low inflation now, it's always important to try to imagine a change in inflation dynamics.

Morgan Stanley came out with an alternative thought piece, talking about inflation and demographic changes. So, really quickly, if you have a large aging population of baby boomers who want care givers and people to facilitate their quality of life, given that they are reasonably asset rich, thanks to the Fed, that's going to require service jobs and will allow pricing pressure for people in middle class service jobs to this elderly group of asset rich people. That's just one simple scenario where from demographic changes you could actually see an uptick in inflation from wages. I am not trying to debate that too far, I am just pointing out that it's possible to create alternative scenarios where the current environment doesn't persist indefinitely into the future.



**Markus-Alexander Flesch:** I doubt that the end of the world is near, so I disagree a bit with Rudy here, however I have sympathy with his arguments about influential factors and the negative, perhaps even deflationary environment we are currently embarking to. I do agree that 2016 will be, in my opinion, a year of elevated volatility, which was not the case a year back. But the reason for the higher volatility might not solely be the changing equity bull markets, but more the effects of changing rules and policies of liquidity providers, be it banks or other market participants. Even in the most liquid markets investors need risk takers or at least "risk-recyclers", meaning companies interfacing different markets and "transforming" risk taken into different asset classes. However driven by regulation **Basel III (Leverage Ratio) or the consequence of the new Volcker rule imposed by Dodd-Frank make risk taking nowadays not very attractive and popular, and all markets will struggle with this.**

I´m convinced that drying up liquidity in all markets is one of the key factors for this elevated liquidity. Having said all this and being asked what could be the consequence for smart investors, I believe more and more investors should actively bet on European volatility. For me to predict individual markets is difficult, but I dare to say that **volatility as an overall asset class will be one of the key performance driver for Alpha** in the different fund vehicles and the curious or absurd conclusion is that the regulators are indirect responsible for this, which I believe is and never was the goal of financial market regulation.

**Matthias Knab** We often like to look at new products or other innovations in the alternative investment space. Rudy, maybe you want to add more about your new single stock product?

**Rudolf Bohli:** In our flagship products we do long/short equity. We try to identify about 30 positions on average on the long side, and 20-25 on the short side. Historically, we generated about 20% p.a. on the longs over the last 12 years versus the index doing like 4% or 5% p.a. And on the short side, we generated substantial alpha, but we only managed to break even basically, so that tells you a little bit about how tough shorting is.

The idea about the single stock activist fund came about because we not only saw the opportunity in that stock, but also thought about ways now to actually capture this opportunity. So we decided to wrap it in its own product, because we couldn't really run that trade as effectively in our main flagship product.

But on the other hand, it also helps to differentiate us within the long/short European equities space. Long/short equity is the most common hedge fund strategy, it has also some of the lower entry barriers, and so often investors want to know what's your edge? How do you manage to find stocks that outperform or underperform? So we also found it helpful to point to activist positions, because there it's easier for an allocator to understand where the alpha comes from.

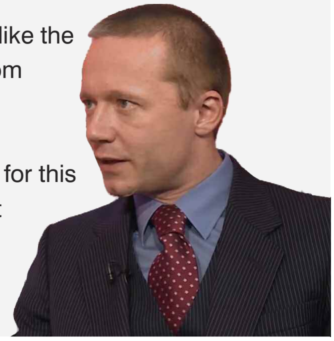
**Dr. Lars Jaeger:** We and particularly Bruno referred to the evolution in our industry, so let me also add some comments how the alternative beta space has developed. When we started this some 12 years ago, we were basically in a position that we had to execute every single trade ourselves. If we wanted to do merger arbitrage, we had to go and buy stocks subject to an announced mergers; if we wanted to do volatility, we had to sell options; variance swaps weren't even out yet, or at least did not have enough liquidity.

Now we are moving into a setting where all this is extremely institutionalized. We now have choices like: Do we want to execute those trades ourselves or have some external party do it for us? For example, do we really want to trade a variance swap ourselves? There are now dozens of providers that offer to do it for us. Sometimes they provide the exposure more cheaply than I could do it; sometimes – in fact most of the time – they are much more expensive.

One key thing we have to judge is fees. I am seeing a lot of competitors in the space offering very similar products. And depending on how much experience they have in trading the underlying instruments they are paying absurd fees. Some are paying 75 basis points for a simple FX carry trade. I could do that for like 10 or 15! But some of the asset allocators, especially former fund of hedge funds that more recently have discovered the alternative risk premium business, have **very little experience in judging if these fees are justified or not**, as they never traded the underlying instruments themselves. They say "70 basis points doesn't sound as much, we used to pay 2 and 20, come on!" But in light of what you really should get charged in terms of the actual costs to implement the trade, it could be as low as 10 or 15 basis points.

This means that one of the challenge we see in the overall alternative beta space is that providers of risk premia they consider it an attractive high margin business. This applies especially to many of the bank products. So we are still seeing a trend in the alternative beta space from some of the providers thinking that is a 75-100 basis points business when in fact on average, including everything, it is really only a 40- 50 basis points business.

**David Beddington:** On the topic of new products, I wanted to mention the systematic equity strategy that we run and the recent upgrade to our process, which we brought in this summer.



We were talking to investors who were concerned about the issues that we have discussed tonight like the pricing and liquidity in equity markets, how much value there might be going forward; protection from bond market-inspired volatility as central banks pull back some of their macro support, etc.

This sparked a number of very interesting conversations where investors are trying to find solutions for this – a fund that can protect them a bit, where they can get a reasonable probability of a decent payout during a more volatile period. This led us to enhance our equity strategy.

One component that we run is a very successful single stock momentum strategy, so we broadened the mandate of that to alter our fund return profile and lower our correlation with equity markets. We let ourselves go net short when the signal indicates that downward momentum is likely. It isn't a guarantee of making money during a volatile market but it improves our odds.

We asked ourselves, "Why are we equity market neutral?" What investors often want when they think 'equity market neutral' is someone who can make money when equity markets are down. This is what investors are really looking for, together with doing okay when markets are going up. So it's the hedge fund Holy Grail.

We still view ourselves as market neutral because we are market neutral over time. This isn't a static delta that we are running. But we have edge on the signal and we are letting it come in when that edge has a good probability of being right, so that we can get short at the fund level based on bottom-up alpha signals that should have edge.

So this enables us to differentiate our product, as well as to satisfy the demand from investors who are looking for managers who have a reasonable chance of delivering an okay return in a volatile market.

This worked well for us in August and September of 2015 where we had nicely positive months.

**Barry Thomas:** We just run one product which has been pretty successful and we are about to close that from additional asset raising because we have had strong growth. But it's interesting to reflect on the kind of additional products that investors have approached us about potentially running as a reflection of certain trends in the industry.

One request was if we can run our existing portfolio in a more leveraged way? So by asking effectively a more leveraged version of the existing fund, investors are looking for more return and are willing to taking a little bit more risk as a consequence.

The second area that investors have been interested in is whether there are opportunities in less liquid strategies or trades within our investment universe we can't take advantage of in our existing fund, but we could potentially do in a different structure with longer liquidity terms.

And the third is actually what Lars' had suggested earlier, investors are interested in potentially using volatility products to replicate or beat the performance of an index or benchmark using a more passive or systematic investment process. This is what you might call a 'smart beta' strategy which can be implemented on a lower fee basis, because it's a more passively managed strategy, and it would generally tend to be replicating or trying to beat some kind of market beta.

It's interesting how those requests we have received from investors reflect themes and needs within the investor universe: *Investors want more return and are willing to take more risks;* or alternatively, they are willing to take more liquidity risk in order to generate the returns. Or they would like to pay lower fees, for exposure to a more passive small beta or an alternative beta type strategy.

**Bruno Wicki:** I know the question was about new products. However, I still would like to just say a few nice words about the old-fashioned fund-of-funds. I actually think the beauty of the nature of these portfolios – and we also run two of those – is that you can adapt your exposure.

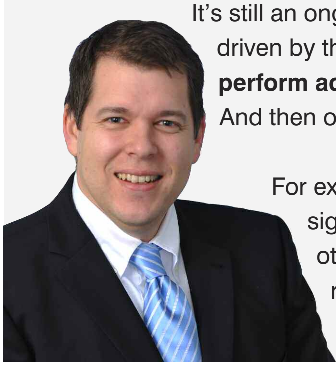
Probably not all of the three trillion hedge fund assets out there are producing alpha, but there are a lot of very skilled managers and they run many different strategies.

And obviously one of the skills that cannot be replicated easily with algorithms is the adaptive analysis of the landscape and then roll out your strategy accordingly. Hiring hedge fund managers allows you to do just that.

So the exercise of active risk taking and risk managing has also evolved with the markets over time. I think this is still one of the strong arguments why you actually can add some value with a portfolio of single hedge funds. The vast universe of investment approaches allows for the creation of interesting diversified return streams tailored to fit the rest of the client's portfolio, which is exactly what fund-of-funds are supposed to deliver.

**Rudolf Bohli** Bruno, I totally agree with you and conceptually it makes a lot of sense, but my question is given that a lot of fund of funds investors got burned in 2008, are they buying into this concept and your value-add? I think that all the institutional pension funds etc. can use this approach and expertise, but do you see them they actually coming back to funds of hedge funds?

**Bruno Wicki:** You are right, there are some scars left from the last crisis, but we finally see an increase in interest, and this has also to do with the things that have improved from the providers over that period. It has to do with how things have become institutionalized and how terms are now in line with the exposures that underlying funds offer.



It's still an ongoing process that takes even longer in Switzerland. But we clearly see progress, which is also driven by the fact that we are able to show how we can **provide access to strategies and how managers perform active risk taking and risk management that many end investors simply cannot get otherwise.** And then on top of it you have us as the fund-of-funds manager with the ability to adapt our exposure.

For example, we are invested with funds that are long volatility and funds that are positioned to have significant positive returns in a rising rate environment, so we have all these tools available including other alternative asset classes like insurance-linked securities, real estate, commodities, alternative risk premia which can serve us as building blocks in an overall asset allocation.

**Markus Matuszek:** We are the newest kid on the block, so we also have a new product. Together with a great team of seasoned professionals who bring a great pedigree from houses such as Gabelli, Chilton, Cheyne, Alken, Duet or Bluecrest, we spent a considerable amount of time to make sure we have a team in place that shares a DNA and has similar values. That has been an important step as we are already at this stage (pre-launch) working on and along investment, risk and portfolio management processes which we will apply once launched. Our hedge fund fits into the fundamental equity long/short bucket, yet we anticipate trading level 1 securities as we also consider more than just the equity in the capital structure. Our investment horizon is up to 4 years and within that we manage a concentrated portfolio of 20-60 European-biased ideas, though tend to stay on the lower end unless there are well understood short-to-medium term ideas. Investors can benefit from discounted fees in our founders' share class to which we got already some hard-committed tickets. Our lawyers are in the final stages of their process, so that on our end we are down to getting more day 1/dollar 1/early stage money for our launch.

**Ian Hamilton:** I have launched in Scotstone a whole new hosting structure. It is a RICC structure and the structure can host AIFMD and all different fund types, with no cross-contamination and ease of exit of a fund manager.

The aim is that when a fund is successful and grows to a certain size, it's easy for fund manager to take his track record and his fund out of the structure and to stand alone. Whereas in a typical incubation platforms this is actually quite difficult because when you get to a certain size and want to leave, you have got to start a new fund and you lose your track record.

So it's something actually worth considering. We do this out of Malta, and I think Dublin is also now bringing in the same type of structure. This set up makes it a lot easier for startup operations.

**Matthias Knab** Markus, tell us again how you're structuring your firm?

**Markus Matuszek** Our fund is a traditional Cayman master/feeder structure. Our manager is run out of Jersey and offices in Switzerland and London. We were able to get substance to Jersey which has become for many hedge funds quite a popular place – in Switzerland and London, we performed the remaining functions. That setup is quite advantageous as we don't incur higher overall costs, while being able to tap into the UK talent pool.

**Rudolf Bohli:** No question, London is bigger, but I must say, if I compare the environment from 12 years ago when we launched, at that time there were only a handful of hedge funds here whereas I find now there is a lot more talent here in Zurich. It has also become a lot more international. Some people relocated from London because they get great tax deals.

Regarding the Swiss regulator FINMA, I must say I think they are also in a learning process. We all know that regulation globally gets tougher, and the big advantage with FINMA is that, like with any public office here in Switzerland, you can always sit down and discuss stuff with the authorities, on very reasonable terms.

And yes, FINMA has also become more demanding, but on the other hand, that's also a good thing, because that puts us managers also on a different level. It's not "regulation light", but a regulation that counts for something.

**Markus Matuszek** For us, one challenge we found in Switzerland is that the talent pool is still relatively limited, and depending on who you are looking for, you may have to relocate someone to Switzerland, which can be extremely difficult if that person is senior and has family. As such the decision to have these 3 locations has not been regulatory arbitrage – it is where we can attract and retain the talent we need to run our hedge fund.

**Bruno Wicki** One of the things that you certainly have here in Switzerland is a lot of assets and there's some benefit to being close to those assets and decision makers.

**Barry Thomas:** 100% of our investment team and 95% of our entire group – we have a small office in Chicago – are based in Zug. Our experience with the talent is different in the sense that we haven't had an issue.

I relocated myself and my family to Zug to join Argentière, but we have grown significantly since then, and we are adding people, including senior portfolio managers, often people with families. It's of course somewhat more of a challenge to move your family than to just move if you are single. But we have not had any problems with persuading the people who we really want to relocate.

If you are a family, then I would say tax is actually a small consideration. The biggest consideration in my experience is that quality of life and schools are very good here compared to London, and we consider that to be a very good draw for people.

I am not saying you can get all the talent locally here in Switzerland or in Zurich, but in terms of getting people to relocate from other places, we have actually been pretty successful in that and we have not found that to be a barrier at all.

One issue that was potentially more of a concern for us when we were launching in Zug was if the location would be a barrier for us in terms of investors who need to come and see you in your office. Actually, 75% of our investors are North American based, and they do come here, so we also found that not to be an issue. We have now **more and more funds in Switzerland,** and particularly in Zug, and that also tends to feed off itself. So when an investor visits Zug, it won't be just for one meeting, they can come and have three or four meetings and fill a day, and that helps the managers locally when investors don't feel like they are having to out of their way for just one meeting.

**David Beddington:** From a hedge fund's perspective, Zug has an interesting community. Many of the hedge funds in Zug know each other. For example, I am part of a dinner group that meets quarterly. It's very useful to stay in touch with each other. We have a growing critical mass of proper institutional funds in Zug, which is beneficial to all of us, because we need investors to make the trip, and I agree that it's pretty easy to fill a day with meetings in Zug now.

I still read some British newspapers, because I lived there for seven years, and sometimes they tease Switzerland. Some managers are moving back to London, because of this or that. But the truth is, if you are 25, making big money for the first time and you are not married, living in a place like Zug can be tough, because if you want to show off, you'll find that no one here cares that you have got a Ferrari; they don't even notice. No one is impressed with you.

[Laughter]

If you come with a family though, my experience is the same as Barry's. We relocated our entire team here. All of us have families, and the quality of life if you have kids is very nice, and the expat community is welcoming, so Zug is a beneficial environment, and as an industry we have now built critical mass. I also find that there's a collegiate atmosphere among the funds in Zug. I don't think any of us view each other as competitors. We are all rooting for each other, because it helps bring people to town.

From a regulatory perspective, one thing that I don't think regulators have taken on board is that many hedge funds have relatively small teams with maybe half a dozen or one dozen people. We are a niche firm, so we are relatively small in terms of headcount, but from a regulatory perspective, we have a Jersey regulator, we deal with Swiss regulation, we report now under AIFMD to the UK, so we need to be in touch with UK legislation, and the US regulatory environment is also something we need to be informed and up-to-date on.

So all of us here have become international businesses, but none of the regulators are considering this when they drop the regulatory workload on us. We are doing similar things for many of the regulators, but it is always different enough that we have got to redo it for each regulator. And if you don't, your business doesn't work.

Only US managers can just get regulated in the United States because that market has 75% of the assets.

If Europe wants a hedge fund industry – and this is an open question whether they do or whether they don't; sometimes you get mixed messages – if they want a hedge fund industry, they have to be aware of the regulatory burden they are placing on relatively small firms, but large taxpayers. It isn't the quality of the compliance protection for investors that I'm talking about but the coordination of the various bureaucratic demands across so many different jurisdictions, and the amount of work that's involved with that.

So a very conscientious hedge fund manager actually has to spend a huge amount of time and resource just trying to be compliant. And even now, a lot of us are in awkward circumstances. Let's say you run into a guy at a hedge fund conference, but his business card says he is based in Italy. If you don't have a UCITS fund, I am not even sure if you can email him afterwards saying, "nice to meet you."

So we still have this very restrictive atmosphere across Europe. It was said in the past that AIFMD would unify things, and it hasn't at all. I have been in this industry 15 years; the rules were clearer before about who you can talk to, how you can talk to them, and what they can do.

Switzerland did need to change, so what has happened here regarding regulation is absolutely necessary, but as people have been politely saying, there's a learning curve, and hopefully we are not yet at the final stopping point.

I say this as someone who has always been a fan of regulation and has made an effort to have a regulated structure, because I believe in it. So I think the old Swiss way needed to go, and they were correct to make that change, but it would be useful to have regulations really focused on key issues that investors have, rather than getting lost in some issues that investors don't have.

For example, an easy, but small one to pick on is the Swiss paying agent. Any fund in Switzerland needs a Swiss bank as a paying agent that no investor in any fund is ever going to use. But the banks have to do the forms and we have to give the banks free money, and it's a waste of everyone's time, and it doesn't add any value to the actual hedge fund investor.