



# Opalesque Round Table Series '13

# WEST COAST

Opalesque Roundtable Series Sponsor:



# Editor's Note

## Mutual Funds: The New Hedge Fund Seeders

Mutual funds can already do many of the investments that hedge funds are allowed to do, and the last piece for the U.S. SEC to change is the fee structure. But some multibillion mutual funds have developed new ways to utilize and work with hedge fund managers by allocating to them through separate accounts. The mutual funds get daily liquidity, can overlay their own risk management and oversight and are able to pull the plug any time they need to.

Thus, some mutual funds in the U.S. have become the new seeders for hedge fund managers, basically replacing some of the traditional seeders and putting significant amounts of capital to work. This Roundtable also discusses how hedge funds can raise millions with 40 Act funds in the RIA and variable annuity product space.

Meanwhile, investments in hedge funds among the 200 largest U.S. retirement funds increased by 20% in 2012, representing a five-year growth of approximately 67%. Moreover, the average public pension is anticipated to maintain allocations to hedge funds of anywhere from 5% to 10%. Currently, there are significant differences in allocations to hedge funds by public pension plans with some public pensions that have no allocation to hedge funds whatsoever while others have up to 27% in hedge funds.

## Information does not equal knowledge - what is proper risk management?

In risk management, the trend has shifted from purchasing a risk software to engaging a turn-key risk consultant. Most risk managers and most organizations have more data than they could have ever wanted, and in many cases they have no idea what to do with it. Kimberly Mounts, one of our Roundtable participants, compared it to purchasing a Lear jet and getting it delivered, but then having no way to fly it - you also need the right fuel, a pilot and the navigation tools to get you to where you want to go. Moreover, risk measurement can be "garbage in, garbage out" when the big picture (e.g. how hedges are set up) gets lost through a fixation on daily position reports. What should investors expect when engaging a risk consultant?

The Opalesque 2013 West Coast Roundtable - sponsored by Sunrise Capital, the California Hedge Fund Association, Eurex and Taussig Capital - took place May 5th in Las Vegas with:

1. Chris Ainsworth, COO and CFO, Maerisland Capital
2. Joe Childrey, Founder & CIO, Probabilities Fund
3. Chris Dopp, Senior Vice President, Eurex
4. Jason Gerlach, Managing Partner, Sunrise Capital Partners
5. Michael Kao, Founder and CEO, Akanthos Capital Management
6. Kimberly Mounts, Founder & CEO, MAP Alternative Asset Management

The group discussion explored the following themes:

- How Michael Kao achieves idiosyncratic option-like payoffs in capital structure long/short trades
- When does diversification become "diworsification"?
- Opportunities in global telecom and cable, media and gaming
- How to overcome the extensive search costs required to identify early emerging managers
- Five years after 2008, should investors still be afraid of structured, credit default or "collateralized anything"? When is structured credit becoming overcrowded?
- "Buying the dips": Is now the right time to go into managed futures?
- Why has Eurex launched futures on French and Italian bonds alongside their traditional German products?
- Why have California-based alternative managers over the long haul outperformed industry benchmarks by greater amounts and more consistently than other managers?

Enjoy the read!

Matthias Knab  
knab@opalesque.com

Cover Photo: Big Sur Coast, California



# Participant Profiles



(LEFT TO RIGHT)

Matthias Knab, Chris Ainsworth, Michael Kao, Kimberly Mounts, Christian Dopp, Jason Gerlach, Joe Childrey

# Introduction

**Jason Gerlach**  
Sunrise Capital Partners

My name is Jason Gerlach, I am the Managing Partner of Sunrise Capital Partners. Headquartered in San Diego, we are a 33-year-old systematic asset management firm that offers investors a compelling hedge fund opportunity as well as a range of strong retail advisory strategies. In addition to my work for Sunrise, I am the current President of the California Hedge Fund Association ("CHFA") which is member-based, non-profit organization established in 2010 to foster the growth and development of the alternative asset management community in California through the advocacy of sound business practices, events, resources and educational programs. Sunrise and CHFA are proud to sponsor today's Opalesque West Coast Roundtable and I thank everyone for joining the discussion today.

**Michael Kao**  
Akanthos Capital Management

My name is Michael Kao. I am with Akanthos Capital Management, based in Los Angeles. I founded the company in 2002. We are a capital structure long/short fund with an event bias. Prior to founding Akanthos, I helped start and run the relative value business at Canyon Capital Advisors. Prior to that I traded commodity derivatives for Goldman Sachs. At Akanthos, we manage approximately \$110m today, and about 45% of the assets are my own.

**Christian Dopp**  
Eurex Exchange

My name is Christian Dopp and I am a Senior Vice President on the Buy-Side Business Development team at the Eurex Exchange. Our team is responsible for all the exchange's relationships with hedge funds, CTAs and traditional money managers throughout the U.S., Canada, Latin America and the offshore financial centers.

The Eurex Group is one of the world's leading derivatives exchange operators offering a broad range of international benchmark products, including the most liquid fixed income and equity index markets in the world. With market participants connected from 700 locations worldwide, trading volume at Eurex exceeds 1.5bn contracts a year.

Additionally, Eurex Clearing is one of the world's largest clearing houses and is at the forefront of international development in risk management and central counterparty clearing.

**Chris Ainsworth**  
Maerisland Capital, LLC

I am Christopher Ainsworth and currently serve as the COO and CFO of Maerisland Capital, LLC, a registered investment advisor. I have over 15 years in the investment industry, predominately focused on capital raising and operations. On the operating side of the investment industry, I have developed and structured over two dozen commingled investment vehicles in jurisdictions around the world. That work included all details associated with the investment management industry from infrastructure, information technology, personnel, compliance, disaster recovery, business continuity, legal, finance and investor relations.

On the fund structuring side of my operating experience, I have developed the compliance procedures associated with accepting and managing external capital, various fund offering materials, completed regulatory filings, and negotiated the contracts associated with third party service providers. My marketing experience ranges from traditional asset management to alternative investments. I have raised money inside large organizations such as Bank of America's Alternative Investment Group and small start-up organizations. This experience includes developing and implementing sales plans and marketing campaigns to focus on efficient use of capital and resources to grow businesses at different points of their development. These campaigns have been focused on and developed for high net worth investors, family offices, multi-family offices, endowments, pensions (public and private), distribution channels and international growth.

**Joe Childrey**  
Probabilities Fund

I am Joe Childrey from the Probabilities Fund where I am the Founder and CIO. We had the great fortune of starting our fund, January 1st, 2008. We are a SEC registered advisor based in San Diego, California and run a long/short US equity fund

**Kimberly Mounts**  
MAP Alternative Asset Management

My name is Kimberly Mounts, I am the Founder & CEO of MAP Alternative Asset Management Company. We are a risk management and hedge fund consulting firm which advises on \$35bn in assets for some of the largest public and corporate pension plans. MAP's risk management consulting consists of providing independent assessments of the risks contained within our clients' portfolios. Our team members have extensive backgrounds in trading and pricing complex securities at top-tier firms. MAP Alternative Asset also consults on hedge funds, focusing on fixed income, emerging manager hedge funds for our institutional clients. MAP is a woman-owned firm therefore we also identify, select, and partner with the best-in-class minority and women-owned hedge funds.

I have over 15 years of experience in investments. Prior to founding MAP in 2006, I spent many years on trading floors in New York City, on the Fixed Income Derivatives' desks at Morgan Stanley and Goldman Sachs. There, our clients included some of the largest and most sophisticated investors in the world and we structured derivative trades across all the various fixed income sectors such as MBS, ABS, Structured Credit, High Yield, and Corporates in over 20 different currencies.

I still have the Wall Street work ethic so many are surprised to learn that I am a California native. I attended UCLA and earned a Bachelor of Science in Electrical Engineering. After UCLA, I was a systems engineer on a satellite program and held a top secret security clearance. I then earned my MBA from the Wharton School at the University of Pennsylvania.

I am active in our Southern California investment community and am currently on the Southern California Steering Committee for CAIA and President of Broads Circle in Orange County. Additionally, I was a founding member of the Southern California Chapter of 100 Women in Hedge Funds where I am also on the Steering Committee.





# Eurex Exchange's new trading architecture: More choices, greater performance, Eurex reliability.

Eurex technology sets global industry standards in speed, innovation and reliability.

This year we will introduce a new trading architecture for Eurex Exchange that will revolutionize how market participants access market opportunities.

Designed in partnership with exchange participants, the new trading architecture aims to enhance performance across the board, including reduced latency and increased throughput.

The architecture also features innovations to the all-important “back end” of capital market technology, including:

- Greater system flexibility, allowing for reduced time-to-market when introducing new financial products and new functionality.
- Improved functionality, including enhanced calendar spreads and user-defined strategies.
- High performance messaging architecture for minimum latency, high-speed communications and reliable database systems.

All this means a more dynamic and responsive platform for trading more than 1,700 products from around the globe – including futures and options on benchmark indexes, leading fixed income derivatives and access to one of the world's most attractive markets.

Technology that delivers a world of opportunity.

Discover more from Eurex Exchange.

[www.eurexexchange.com/nta](http://www.eurexexchange.com/nta)



**Michael Kao**

Let me start by giving you a bit more background on our investment philosophy. When I said we do capital structure long/short with an event bias, the first part of that description means that we are bottom-up fundamental investors across the capital structure, viewing the capital structure as a continuum of components with different risk/reward characteristics. Our aim is to structure the overall portfolio as a collection of thematically diverse, asymmetric payoffs by creatively combining disparate pieces of the puzzle, so to speak. More often than not, we are looking for catalysts to unlock the optionality inherent in our positions, which is what the “event bias” part of the description refers to.

**Michael Kao:** Although we ideally want the portfolio as a whole to exhibit the “right-skew” similar to the “hockey-stick” of a call option, we typically use a much broader range of tools than standard option positions to create this profile. We will be very deliberate in our trade construction by mixing and matching various pieces of a capital structure to construct a unique payoff pattern for a particular theme we want exposure to. To set up these option-like payoffs, we first start with a deep research process around the capital structure of the company. Many of the core names in the portfolio are names we have been following for years. By having an intimate understanding of the company’s capital structure and its history, we can be creative and opportunistic when certain events happen in a company’s lifecycle that cause parts of its capital structure to become misunderstood and/or mispriced.

We believe that in order to earn our keep as a money manager, we need to be able to outperform the crowd. We believe the only way to beat index-level performance is to over-weight our highest conviction positions. You will never find us to be a manager of 50 equal-weighted positions. We believe in what Warren Buffett calls “diworsification” and are content to have our top 10-15 positions represent 50% or more of the portfolio. That said, for us to sleep at night, we take great care in crafting a collection of bets that are *thematically diversified*, that is, diversification by underlying value driver. Thematic drivers could be valuation-based and non-event oriented like convertible or capital structure arbitrage or even just a cheap credit or equity, or they could be event-based like an M&A transaction, bankruptcy reorganization, FDA approval, a spinoff, an index inclusion, a bond tender or any host of other corporate events/actions. We plan these themes to be as idiosyncratic as possible, and try to avoid simply “renting” equity or credit beta in our process. Our YTD performance of 20% or so is out-distancing the S&P by 4-5%, and we have achieved it with only about 20% equity long exposure and very little traditional credit “beta.” In fact, at the moment, we are probably net short traditional credit “beta,” which brings me to the topic of macro risk overlays.



Although the “offensive” positions in our book are highly idiosyncratic, we also try to structure macro hedges to protect the overall portfolio from exogenous risks – of which there are many! We classify these positions as purely “defensive” positions.

**Michael Kao**

In the current environment there is a high level of “macro confusion” in the market with mainly two prevalent, conflicting trends. On the one hand you have all of the developed economies still basically digging out of the 2008 deleveraging. Whether it's market-imposed austerity or self-imposed austerity, most of the developed economies face these same set of fiscal headwinds. At the same time, however, the central banks of these economies are all throwing heaps of monetary stimulus at the problems. So it's a case of fiscal headwinds juxtaposed with monetary tailwinds. And because central bankers are all using the same playbook, none of them can really get a competitive leg up on one another from a perspective of currency devaluation. So what you have is a massive



tide of fiat currency being created that is lifting all risk assets. We view this environment as almost a “smoke and mirrors” type of risk-on environment rather than a “Goldilocks” scenario. Because the traditional financial signals are so manipulated by monetary policies, we don’t think it’s the right time to make bold asset allocation calls, which is why we are so focused on idiosyncratic situations right now.

By contrast, in the spring of 2009, it was very obvious that the best risk/reward within the capital structure, at least for us, was in distressed debt. Yet even then, it wasn’t like we made a top-down call. Instead, our pursuit of bottom-up opportunities led to a preponderance of distressed themes. By 2010, after distressed assets had run so far and fast, we believed the baton of returns would go to convertible arbitrage, which was an asset class that was particularly battered after 2008, so we made that shift; however, again, it wasn’t as if we made a top-down macro call. Our pursuit of the best idiosyncratic risk-reward profiles within a capital structure led us to a preponderance of convertible arbitrage themes.

Today, if you actually look at how we’ve sliced and diced our portfolio from a thematic perspective, you will see that there isn’t a preponderance of any one type of theme. Unlike previous years, our search for idiosyncratic opportunities is turning up a much more eclectic collection of bets rather than big bold asset allocation overweights. In addition, we have added a lot of “tail” protection in various themes, whether it’s “interest rates rising” or “credit spreads blowing out,” and so on.

So to summarize, at the moment, we are very “defensive on the macro” and very “idiosyncratic and eclectic on the micro.”

**Chris Ainsworth:** Similar to some of Michael’s comments I would say that the current environment of currency printing by governments on a global basis has created an enormous amount of liquidity in the current market environment. This monetization has finally started to move people into riskier assets, but eventually it could create a lot of problems in the future. The timing of this current money printing could go on a lot longer than people could ever think before the bubble starts to break. Bubbles tend to last a lot longer than people think, and the current credit markets are extremely accommodative, and as long as rates continue where they are - meaning that the spreads between investable grades, corporate debt, and high yield continue to come in - we would think that potentially equity markets could continue to move forward for the current foreseeable future.

With the high liquidity, the rising tide is lifting everything at this point, which actually in our opinion creates opportunities not just on the long side of investing and riding that wave but also additionally on the short side. As a global long/short fund, we see these opportunities on a global basis and invest in local markets globally.

Some of the areas that are extremely interesting to us right now. Given our portfolio manager's background in the TMT space, we find the global telecom and cable space extremely interesting, offering huge opportunity. In the U.S. you have at this point two bidders for Sprint. There is a lot of noise and discussion about Verizon Wireless and Vodafone and how that will play out. In the landline world, you see a lot of interesting opportunities in the broadband and content space, and the convergence between the cable operators operating broadband, and the telecom operators who are getting squeezed in that same space.

In the media space, we see the content owners continue to take pricing up on the cable operators. The other interesting development is the resurgence of global gaming. There are opportunities in the Philippines around the opening of that market, Singapore opened a few years ago is already larger than Las Vegas in the global gaming space, and there is movement in Japan's parliament to open up gaming within Japan as well. What that means is that you are looking at a huge gaming opportunity in Asia and also in the United States where, local states are passing new laws to facilitate online gaming in order to generate tax revenues.





## Joe Childrey

The Probabilities Fund is a long/short US equity fund. We are primarily long and use quantitative and qualitative analysis. When building our model, we started out with looking at history. We believe that history is indicative of the future. We researched the S&P 500 and Dow from 1949 to the end of 2007, and looked for pattern recognition trends, patterns that we believed were statistically relevant, in terms of frequency and magnitude. We then built an overlay with risk management, where we also include certain political and legislative analysis.

We believe in history like two pioneers who I consider to be the two back testing hall of famers, John Bogle and Rob Arnott. When Bogle started the S&P 500 index fund, many people laughed at his strategy, and he raised about \$7m at that time. And Arnott got a lot of flack for the Equal Weight strategy which is now approaching a trillion dollars under management. We look at history and determine what has worked in the past, and it has served us well.

Coming back to the question what excites us, we are really pleased that we have been able to outperform the index by a wide margin. We essentially trade ETFs and our positions are that we are either in or out, leveraged, or short.

## Kimberly Mounts

At MAP, our primary focus is on increasing our clients' awareness and understanding of the risks and complexities contained within their portfolios by utilizing our team's expertise in trading and pricing complex derivative securities.

**Kimberly Mounts:** It is very exciting to us that public and corporate pensions as well as foundations and endowments are realizing the tremendous value-add that is obtained from engaging a risk consultant such as MAP. Fortunately, we have spent the past two years investing in expanding our processes and infrastructure in order to have the capacity to take on additional risk consulting clients.

The trend has shifted from purchasing a stand-alone risk software package to engaging a turn-key risk consultant. We liken it to buying a Lear jet and getting it delivered but then having no way to fly it. You need the right fuel, a pilot and the navigation tools to get you to where you want to go. This is similar to investors' experience with buying risk software alone – how do you know what the inputs are, how do you upload the data, who creates the reports and most importantly what do you do with the 100+ pages of numbers when you finally get them. Output in beautifully formatted reports is great but if it is in a foreign language, how do you know what it means? Our institutional investor clients are utilizing MAP Alternative as a risk consultant to alleviate all those issues. We provide a turn-key solution for their risk management needs. MAP does it all from getting the data from their custodian, scrubbing it for erroneous inputs, uploading each individual position into our risk engine, developing meaningful reports and most importantly, interpreting the results and giving tangible recommendations.



If you think about your portfolio, long/short equity is pretty straightforward to evaluate. Furthermore, we live in a world where equities (stocks) are pretty widely followed and understood by the vast majority of people. For example, if you open *'The Wall Street Journal,'* you have an extensive amount of pages in the Money and Business section dedicated to articles discussing or displaying equity prices and other equity risk metrics. Now almost everybody enjoys discussing their stock portfolio and investments at cocktail parties. However, it's not really cool to talk about your bond portfolio. Moreover, in individuals' personal investment accounts most people don't even own bonds. But, interestingly enough, almost all of us in our daily lives rely significantly on the depth, breadth, and well-functioning of the global credit markets. Many of us have mortgages. Most of us have had a loan, either a car loan or a personal loan, and maybe even credit cards. My point is that the global fixed income market is roughly twice the size of the global equity market, yet fixed income has traditionally represented about one-eighth of the hedge fund assets. With a market size that is twice as large, with only one-eighth of the players, that fact considered alone, by definition, is a great opportunity set.

However, due to recent outperformance, the fixed income universe has gained more attention from investors, particularly in RMBS, structured credit, leveraged loans, and high yield debt. If you look across the investor base, primarily the institutional investors, where are they allocating? Given the low interest rate environment, fixed income is currently deemed as being relatively risky and as a result everybody is piling their money into equities. We agree that there are opportunities in equity long/short, but we believe that fixed income hedge funds are ideally positioned to take advantage of the ongoing credit market dislocations, which we anticipate will persist over the next few years. Fixed income is more complicated to understand, and as I just noted there are fewer market participants. Even five years after 2008, when investors hear the words structured, credit default or collateralized anything, they don't want to touch it. Additionally, fixed income and fixed income hedge funds have lower correlations to equities, private equity and real estate. Finally, fixed income hedge funds can eliminate and even profit from the duration risks that investors currently fear.

In addition to our risk management consulting services, we also consult on hedge funds with a focus on emerging managers, which we define as firms having \$2bn or less in assets and being in existence for three years or less. Statistics show that emerging managers tend to outperform in their early years. This creates an opportunity to earn outsized returns for investors who can identify and select superior managers from inception. Within the emerging manager space, we especially focus on minority and women-owned managers given their proven outperformance and overall lack of investor attention. For example: For the five-year period from October 2007 to September 2012, the Rothstein Kass Women in Alternative Investments (WAI) Hedge Index outperformed both the HFRX Global Hedge Funds Index and the S&P 500 (with dividends reinvested), with cumulative returns over the period of 19.6%, -14.2%, and 5.4%, respectively.

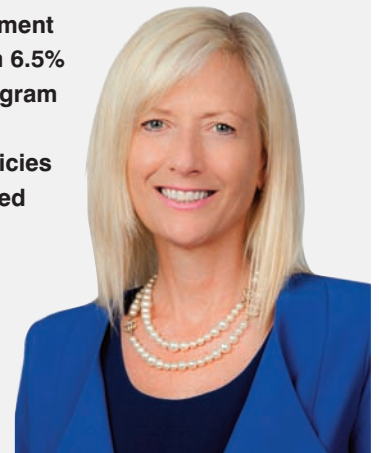
#### **Kimberly Mounts**

However, many minority and women-managers have difficulty raising capital due to their small size, lack of institutionally compliant operations and processes, and the extensive search costs required to identify early emerging managers who will outperform. This is where our firm believes we can add significant value for our clients. Our consulting on over \$35bn in AUA allows MAP to see managers at all stages of their life-cycles. We are able to identify success factors, how managers achieve critical mass and tap into our vast network of resources to benefit the emerging managers. Additionally, our risk management consulting capabilities allow MAP to provide managers with a secondary set of eyes and perspectives on their portfolio's risk.

MAP's clients also like to work with us as they are getting a valuable combination of hedge fund and risk consultant. Most pensions rarely trade internally so as MAP identifies unwanted risks, we develop strategies and recommend managers to mitigate those risks. This is a very cost effective way for our clients to achieve capital preservation and risk mitigation strategies as well as diversify their hedge fund portfolios.

**Kimberly Mounts:** Regarding the current investment environment going forward, we are very concerned about the Fed Funds rate remaining at 0%. We anticipate that this extraordinary monetary policy will continue until unemployment reaches 6.5%. This has been very well publicized and communicated by the Federal Reserve to market participants and we believe this is still a long time away. Given the current employment indicators and economic backdrop many economists don't expect unemployment to reach 6.5% until the end of 2015. Currently, we have an ongoing one trillion dollar asset purchase program per annum being administered by the Fed. So, in essence, we believe asset prices have deviated above their underlying fundamentals resulting from the aggressive monetary policies being pursued globally. We agree that the markets and investors are presently in uncharted territory. In recent history, you've never had central bankers across the world pulling or guiding us into a world with extremely cheap money for such an extended period of time.

Within fixed income, structured products are an area which we believe currently offers a compelling opportunity set. They are not understood by most investors and they possess some credit risk, but are more insulated from interest rate risk.



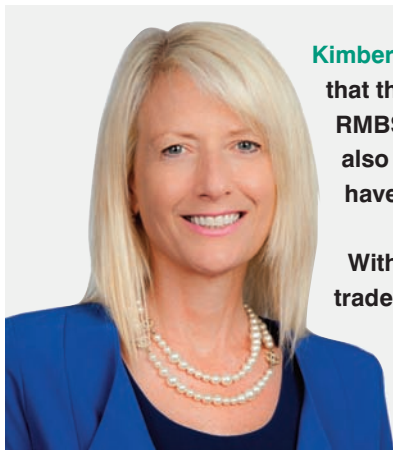
## Kimberly Mounts

So we still see opportunity there and we think given other relative and competing opportunities, that it's a great place for investors to be putting their money. Within that, we like the CLOs, at the top of the capital structure which are somewhat insulated from rising rates because of their floating rate feature. So, we think this is a relatively attractive risk reward opportunity set that offers seniority in the capital structure, current low default rates, low duration exposure, and the floating coupon rate advantage compared to high yield bonds.

## Michael Kao

Regarding continued flows into structured credit, what keeps us concerned is that with the vast preponderance of all hedge fund inflows going to the largest multi-strat funds, and with so many of these large funds making structured credit their largest risk allocations, how is this all going to end, especially in a world where reinvestment risk is so high?

Are you concerned that the strategy is becoming too crowded? And when the tide turns with respect to QE and the resultant abundant liquidity, how easy will it be to extricate yourself in a relatively crowded trade? And secondly, how much "juice" do you see remaining in that asset class?



**Kimberly Mounts:** Yes, MAP has concerns about structured credit getting crowded, but we feel that the structured credit market at roughly \$1.7tn (or more broadly, \$10tn if we include RMBS/CMBS/CMOs) is large enough to absorb the increasing demand from investors. We also think that even though people are getting into that trade, there are very few people who have the necessary skills, tools and experience to understand it well.

With our team's derivative trading floor backgrounds, we are easily able to discuss the trades, understand the opportunities and identify the best managers in the space. The Bid/Offer in the space is still extremely wide, and if you are on the right side of the trade, there are great opportunities. It's primarily a long only trade; therefore we typically recommend longer lock-up in that strategy.

## Kimberly Mounts

We focus much of our attention and resources on finding and selecting the best in class emerging managers. For example, we have a fund that we put in our recommended portfolio in 2007. At that time, over 50% of the assets were Partner capital and today the Partners are still the largest single investor in the Fund. This substantial financial commitment by the Partners gives MAP's clients tremendous comfort. Given their size then, they probably did more analysis per trade than anybody else. As far as capacity in the space, if you have \$1.8bn to allocate across all of fixed income, even if you are heavily invested in the structured credit space, the market and opportunity set is large enough to find abundant investment opportunities. This particular fund has grown to be a billion dollar plus fund, but they are still rather unknown by hedge fund standards. For our clients, we spend a lot of time and resources to uncover these "hidden gems".

## Jason Gerlach

Given our quantitative approach to investing, we are excited about the continuing proliferation of new and innovative investment technology, the continuing growth and expansion of global markets, and the emergence of interesting new price patterns and anomalies within those markets as global economies evolve and more and more investors participate.

**Jason Gerlach:** Since our 1980 inception, we have invested based on the philosophy that markets are inefficient and repeatedly demonstrate trends and related price patterns that when identified and traded with the proper techniques and assumptions present a compelling opportunity to generate consistent, low correlation returns for investors. While the last several years have been tricky for quantitative approaches such as ours, in our experience such periods of underperformance typically present the best opportunities to learn and improve our investment models, and this most recent downturn is no exception. Having learned tremendously from what we've seen in the post-2008 environment, we think our current investment approach is our best, most dynamic and adaptable strategy ever, and so far in 2013 it is posting excellent returns. Investors, having more confidence in markets given the current bull run in U.S. equities, appear to be committing to trades more confidently than at any time since 2008 and the result is markets that are



escaping the boxed-in ranges they had lingered in for much of the past four years. This is very good news for quantitative strategies such as ours.

Overall, we are really excited about the opportunity set for our investment approach in the coming months and years and are looking to embrace all of the post-2008 investor interest that has emerged in firms such as Sunrise. To that point, I would remind all investors that the beautiful thing about quantitative investment approaches is that historically they typically run in waves and as a result, the best time to buy is in the midst of drawdowns via a phenomenon commonly known as “buying the dips”. 2013 is so far proving this to be a wise strategy once again and I encourage anyone who has been discouraged by recent performance to give firms like Sunrise another look now.



#### **Chris Dopp**

As an exchange operator, our focus is clearly different than that of a fund manager, but in many ways, our current portfolio of projects is directly related to the goals of fund managers. Our job is to provide pools of liquidity in an efficient and transparent manner, so that fund managers have the tools to implement their strategies without worrying about the safety of their investors' assets.

**Chris Dopp:** My fellow speakers have mentioned a broad spectrum of strategies and we have to develop innovative products and services that meet the demands of all of them. Whether it is equity long/short or systematic global macro, it is the diverse combination of strategies that bring integrity to any of our futures and options contracts.

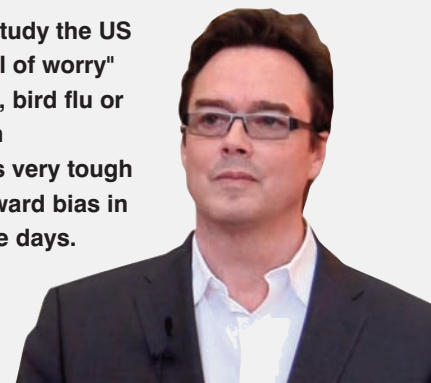
As an example, the sovereign debt crisis in Europe changed the landscape of trading in fixed income futures. Previously the domain of hedging and speculating on interest rates alone, the crisis brought about a new credit aspect to sovereign debt. As a result, the Eurex Exchange expanded its fixed income complex by launching futures on French and Italian bonds alongside our traditional German products. The result is that the marketplace has the ability to manage debt exposure in a more granular manner and trade relative value between sovereign names. The new products have been extremely successful in a short period of time and in many ways, that is due to the wide range of strategies that participate in the market.

As far as what excites me right now, it is the opportunity to develop platforms that fulfill both the new regulatory environment and provide additional levels of protection to all market participants. Eurex Clearing has launched its solution for central counterparty clearing of OTC interest rate swaps, EurexOTC Clear, which features operational and capital efficiency, protection against counterparty credit risk and the maximum level of client asset protection through full physical segregation of both positions and margin collateral. As an exchange operator and leading global clearinghouse, these are exciting times.



**Joe Childrey:** I would like to follow up on Jason's point about buying the dips. We study the US equity markets, and that led us to believe that the market is going to climb that "wall of worry" about 65% of the time. There will always be a crisis du jour, whether it's a fiscal cliff, bird flu or whatever is next upon us. If you look back in history there have been so many, from the Cuban Missile Crisis to Y2K, and trying to figure out how the market will react is very tough based on "this time is different" events. But, you have to believe that there is an upward bias in equities. In fact, we have found that about 80% of the upside comes from 20% of the days.

Investors have the opportunity to re-balance in a more efficient way, and I think Jason was on to it when he pointed to the dollar-weighted return versus the time-



weighted return in an effort to get the investor a better return on the investment. That means taking advantage of those drawdowns, which is an opportunity for pensions to force cost-averaging or re-balance and actually apply the buy low sell high maxim, which is easier to say than to do. This way that clients may receive a much better risk/reward going forward, versus an automatic annual re-balance or nothing. Shockingly, many of institutions have no re-balance at all in place.

**Michael Kao:** Joe, you mentioned that as part of your analysis you look at history. We do it too – I’m a big fan of Mark Twain’s quote, “History may not repeat itself, but it often rhymes.” As an illustration, let me take the discussion down from the macro level into one of the micro themes that we think is particularly interesting at the moment. But let me digress with a little history lesson first.

Back in World War II President Roosevelt commandeered the US railroad system to ensure reliable delivery of war material; however well intentioned, fear of government intervention and nationalization sent the bonds of the railroad companies down to five cents on the dollar.



A little known trader by the name of Cy Lewis made a historic bet. He said, ‘You know what? At the end of the war, should we come back to a capitalist system, these bonds ought to be worth par from a liquidation analysis perspectives. And so he made a very brave wager, putting down \$800,000 of Bear Stearns’ proprietary capital, and it turned into \$17m at the end of the war, when in fact those railroads were privatized.

Now the reason why I tell you this story is that if you think about the events of 2008, you see that the same thing happened over and over again, across multiple industries and multiple capital structures. It happened in Washington Mutual, General Motors, Chrysler, AIG, Fannie Mae and Freddie Mac. The point is that government intervention wreaked havoc in the capital structures of many companies, creating severe losses for investors but also creating incredible opportunities in their wake.

#### **Michael Kao**

We experienced this first hand in 2008 when the retail deposits of Washington Mutual were unexpectedly seized by the FDIC when those very deposits were the “crown jewel” asset on which our investment thesis in the distressed bonds rested. Our thesis for Washington Mutual bonds in the 60’s was that despite the aggressive mortgage-origination activities metastasizing at this particular bank as well as at Bear Stearns and Countrywide, what WaMu had that the others did not was a \$200bn retail deposit base, with 2200 retail branches. Furthermore, with a multi billion dollar market cap that we could short against, we felt that we had a 7:1 reward-to-risk ratio if one of the many multi-national banks that was reputedly eyeing WaMu’s deposit base took this company over.

Well, in March 2008, JP Morgan bid for WaMu at \$8/share when the stock was trading at \$12. It appeared to be our dream scenario – only, the offer got rebuffed, and WaMu took a cash infusion from a private equity group. You can imagine my horror and disbelief a scant six months later, 10 days after the collapse of Lehman Brothers, even as Fed and Treasury officials were scrambling to undo the damage of letting Lehman go, when Sheila Bair of the FDIC took unilateral action in seizing that “crown jewel” deposit base and literally gave it to JP Morgan for next to nothing!

The crazy thing is that Countrywide, which in our mind was an infinitely more toxic situation specifically because they lacked an equivalent “crown jewel,” wound up delivering par to their creditors while our WaMu bonds got marked down to 2c on the dollar! When something like this happens to you, and you know in your heart of hearts that you did not make an analytical error, you have to take a step back and admit that the world has changed. For us, it meant that we needed to figure out how to adapt, how to turn these headwinds into tailwinds. In retrospect, this WaMu

debacle wound up becoming the best thing that happened to us, because it forced us to follow the “pain trade” of government intervention in many other capital structures and to pick up the pieces where others got hurt.

**Michael Kao:** Let me give you two examples of where we directly benefited from this hard-won knowledge. If you look at the auto companies, the same specter of government intervention also wreaked major havoc there. In the spring of 2009, the government was pressuring Chrysler senior secured lenders into taking 35c on the dollar in a recovery, when the auto unions were given essentially par recoveries, which was a complete upending of the absolute priority rule of bankruptcy. And so basically the senior unsecured bonds of General Motors collapsed down to 5c on the dollar. Doesn't this sound like a modern-day railroad bond? That's exactly what I called it in my 2010 presentation to the Value Investing Congress on this subject. Basically, we put on our “Cy Lewis” hat and reasoned that a regular Chapter 11 process would yield a 50c on the dollar recovery, not a 5c on the dollar recovery. Furthermore, the outrageous upending of creditor rights in Chrysler was a result of the administration's political leverage against the lenders who were hedge funds and TARP banks. In GM, however, we thought that the legions of retail “mom and pop” bondholders would rebel against a similar cram-down tactic. In the end, we were right. Had we not sold any bonds to control risk along the way, we would have made 7-8x our money today, based on where the stock of new GM trades.



#### Michael Kao

In May 2011, I gave a second address to the Value Investing Congress, in which I recommended buying preferred securities of Fannie Mae and Freddie Mac at 2c on the dollar. This is very topical today, because these preferreds are now trading north of 20c on the dollar with a shot at much higher recoveries – possibly par and higher. Basically, in the first week of September 2008, Hank Paulson put the GSEs into conservatorship, and in so doing, drew an arbitrary line between the debt securities, which got explicit government guarantees, and the preferred and common stocks, which essentially got eviscerated. Never mind the fact that \$18bn of the \$36bn outstanding of this formerly AA- rated preferred came to market at Treasury's own behest; Treasury promised \$1 of regulatory relief for every \$1 raised. Never mind the fact that the community banks who bought these securities at par were told by their banking regulators that they would be able to use these preferreds as Tier 1 capital to guard against losses! Instead 10 community banks went bust directly as a result of these purchases, and another 35 went to the brink.

Today, the country is essentially caught between the proverbial Scylla and Charybdis of privatization and nationalization. On the one hand, full privatization seems like a distant possibility given that the GSEs now guarantee 90% of all new mortgage originations; on the other hand, full nationalization seems suicidal when the Treasury would run the perceptual risk of adding \$5tn of off balance sheet liabilities to the already swollen \$16.5tn of national debt.

**Michael Kao:** Our thesis was and still is: that a more regulated public-private partnership is really the least of all evils and that given the opportunity, the GSEs can be capitalized in such a way so as to yield the taxpayer and economy as a whole a very large return. The successful restructurings of both GM and AIG prove this out, but in the GSE's case, we think that a proper recapitalization could yield the taxpayer north of \$150bn of profit, not to mention all of the indirect benefits of higher tax revenues on gains, reviving the preferred marketplace, reliquifying the balance sheets of wounded community banks who bought into these preferreds, which would then lead to increased lending, etc.



When I first gave this speech, everyone thought it was such a longshot, and again the securities were trading at 2c on the dollar. After all, the Treasury had injected \$190bn of senior preferred, and every journalist out there opined that this money would never be paid back. Yet here we are today, just two years later, and the GSE's have already



paid \$130bn in dividends and profits to Treasury. However, under the current terms of the conservatorship, none of the \$190bn has officially been “paid back,” and the Treasury has a 100% profit sweep from the GSE’s with no accountability to anyone. We think not only is this wrong, but from a pragmatic standpoint, it is keeping the taxpayer and economy as a whole from benefiting hugely from the reversed fortunes of the GSE’s.

**Michael Kao**

I am sharing these examples because these were some of our best performing ideas since 2008 and are good examples of 1) how we follow capital structures over long periods of time and opportunistically pounce when the time is right, 2) how we learned from our mistakes in 2008 and turned a headwind into a tailwind for our investors, and 3) how we try to invest in themes which are not typical beta bets. Certainly not all our themes are this asymmetric, but these two happen to be the two I gave public presentations on.

**Matthias Knab**

Chris, your firm was set up not too long ago, how have you been faring in terms of raising capital, and what are some of the trends you could observe in that field?

**Chris Ainsworth**

The capital raising environment post 2008 has changed drastically. We are in a world with Fed funds at zero, and the expected return, using Bill Gross’s term the new normal, is a mid to upper single digits.

**Chris Ainsworth:** The traditional source of capital for new launches prior to 2008 was the fund of funds world, and there had been drastic changes in that sector. In fact, many of them went out of business, merged or otherwise drastically changed their model. One interesting effect of the consolidation in the fund of funds space is that the surviving ones are now so large that they only allocate to some of the largest managers.

So, in order to get to sources of capital you have to be creative. Unless a manager is in a situation where they can fund themselves to start, an emerging manager has to sell a part of his business through the seed capital route or join a larger shop such as the Millennials of the world.

I want to talk about another source of capital which used to be taboo in the hedge fund environment, but given some of the regulatory changes even pre-2008, the world between hedge fund managers and mutual fund managers has drastically changed. Mutual funds are now able to use leverage, derivatives, and short securities. There are not many differences left between a mutual fund and a hedge fund nowadays.

We believe that one source of capital for the hedge fund space going forward is this continued convergence between mutual funds and hedge funds. In our view, the 40 Act space is not just here to stay, but in a lot of ways will continue to replace the fund of funds industry.



**Jason Gerlach**

In many ways 2008, between the failure of major financial institutions and the Madoff scandal, was an epic breach of investor trust, perhaps the greatest such breach of investor trust in history. Subsequent problems such as the ongoing insider trading investigations at various big name long/short equity funds and the MF Global collapse have further eroded investor confidence. Topping things off has been middling performance by many alternative strategies in the last couple of years. The net result has been many skittish, non-committal investors who are reluctant to invest in all but the largest, multi-billion dollar hedge funds which for various reasons (both real and imagined) are perceived to be “safer.” This phenomenon is somewhat ironic given that the whole alternative investment industry spawned from the concept of small, innovative firms engaging in creative risk-taking and in so doing, achieving outsized reward for investors.

By flocking to bigger hedge funds which in many instances are unable and/or unwilling to deliver outsized returns, investors are in effect discouraging risk-taking and the investment innovation that made the alternative investment industry great in the first place. It's a vicious cycle that firms like mine, Joe's, Michael's and Chris's are hopeful will reverse course soon. In the meantime, creativity is the operative word indeed when it comes to raising capital and we're doing anything and everything we can to buck the trend against smaller and medium-sized managers.

**Kimberly Mounts:** We believe the best base for a successful fund launch is actually the manager's personal wealth. Accordingly, the majority of the funds in our recommended portfolio for our clients have the partners as the largest single investors in their fund. Our clients, and investors in general, get more comfortable investing in funds where managers have a significant amount of their own skin in the game.

During the due diligence process investors typically ask the managers how much money do they personally have invested in the fund? The question really should be how much of your liquid net worth do you have invested? Unless it's a significant percentage of the manager's liquid net worth, we are concerned that the fund's performance and alignment of interests will not be properly calibrated between the fund manager and the investors.

Regarding Chris' point about the mutual funds, yes, 130/30 has been around for a while, but the average investor there was very disappointed. It was a fad that quickly went away. I think investors have long memories and doubt many 130/30 investors will be piling into mutual funds as an alternative to hedge funds anytime soon.



**Chris Ainsworth:** I completely agree that 130/30 was a completely ridiculous phenomenon in almost every sense, but with the changes in the regulatory environment, things have moved to a different level and the funds being formed now are not 130/30 funds any more.

I know that at least 10, maybe 15 fund of funds that are 40 Act. What is happening is that multi-billion mutual funds are allocating \$25/\$50m to managers and because they can do it through separate accounts, because they get daily liquidity, because they have the infrastructure to provide their own risk management and oversight and pull the plug if they need to. That means they are able to seed a manager, basically replacing some of the traditional seeders and put huge amounts of capital to work.

There are many players in this space including Hatteras, Simple Alternatives, and Altegris. Altegris has raised large amounts of money this year. They are focused on the retail market, which means they tap into money that most managers with private placements would not get with their typical million dollar minimums.



**Joe Childrey:** Today, even if your track record stands out, you still have to be creative in raising money. We were up in 2008 and have been up every year since we launched on January 1 2008. We were up double digits in 2011 and up almost 30% in 2012. Our benchmark is the S&P 500 and the HFRI. We are up a 130% net and 170% gross, while the market is up 20.

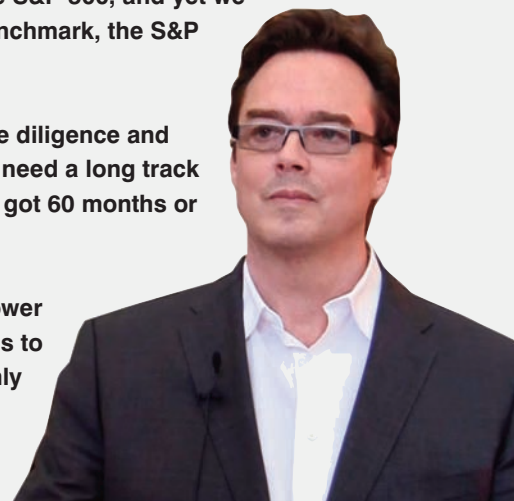
The money raised in the LP is mostly friends and family. Luckily, we've made a ton of money as partners, and subsequently launched a 40 Act Fund. Guggenheim, the Security Benefit Unit and Jefferson National heard us talk about our strategy and asked if we could manage money for their variable annuity products. We accepted and managed money in separate accounts, raising 25 million. We raised about \$25m in six months in that venue with

Guggenheim and Jefferson National, which is a variable annuity company.

There is a new trend of no load variable annuities. It's RIA driven, sort of a fiduciary model, as opposed to its suitability commission model. Neither one is better than the other. It's just a different model. So we decided to create a 40 Act Fund and we launched May 1 of this year. I believe this space, particularly the variable annuity space, is very interesting, because a lot of what hedge funds do is very tax inefficient and now that advisors have these no load, very low fee annuities available, for their clients. We have a 0.37 correlation to the S&P 500, and yet we are trading the S&P 500. Probabilities Fund is unique in that we trade the benchmark, the S&P 500, that we benchmark against.

Advisors are much quicker to make decisions. They are going to do their due diligence and then make a decision, whereas in the hedge fund world, there is a lot of "we need a long track record, we need more assets", and then when you ask them, "okay, we have got 60 months or 63 months, how many more months do I need? Is it 70 months? 80 months?"

But, in the 40 Act Fund world, you have the liquidity and transparency and lower fees, so I truly believe in this a space industry, the hedge fund industry needs to look at. This trend of liquidity, fee compression and transparency will certainly continue.



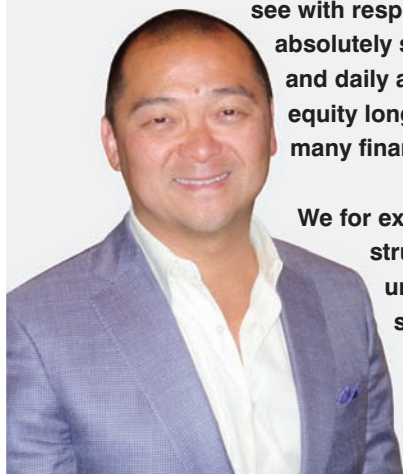
#### **Chris Ainsworth**

One thing that's going to change will be structures. We went through this period where everybody wanted a partnership, because they didn't want all the embedded gains in the mutual funds.

Given the market declines in 2008 most investors have not worried much about embedded capital gains. So everybody wants simplified tax structures such as 1099s. In the next year everybody is going to go back to not wanting embedded gains. It's a constant vicious circle.

**Michael Kao:** I started my firm back in 2002 during the heyday of the funds of funds, and with very little marketing whatsoever we grew from \$100m to \$750m when we decided to soft close, because I had a premonition that the inflows were fueled by "hot money." Unfortunately, that premonition proved correct, and we subsequently lost a lot of that "hot money" from redemptions in 2005 and 2008.

In both years, we experienced such strong redemptions from "hot money" investors that their actions exacerbated the selling pressure in our positions especially during times when liquidity was already scarce to begin with. The issue I see with respect to these hyper liquid 40 Act Funds and UCITS funds is that unless you are absolutely sure that you won't have any asset/liability mismatch in terms of your strategy liquidity and daily and/or weekly liquidity terms, you should not be taking this kind of money. Maybe an equity long/short manager can handle daily or weekly liquidity, but as Kimberly mentioned, so many financial assets in the world are non-equity assets.



We for example deal in a lot of less liquid distressed assets and other parts of the capital structure that simply cannot be accommodated in daily liquidity vehicles. For that reason, unlike perhaps most hedge funds that have actually increased their liquidity post '08 simply to raise assets, we went the opposite route. We went from 60-day liquidity to 90-day liquidity in order to avoid having the issues that we had in '05 and '08.

When it comes to the changes in the investor base and investor behavior, just by



virtue of their size, the pensions and the (surviving) funds of funds no longer allocate to the small managers. I guess from our standpoint, we are actually okay with that, because like I shared earlier, we have a ton of skin in the game with approximately 45% of our AUM being my own capital. Including my stake, essentially 90% of our AUM is essentially a combination of high net worth and family office money, which we deem to be very sticky. We don't have any outside investor that is large enough to put us out of business, and our bread is buttered by making money for ourselves and our investors, as opposed to drawing that fee income.

**Chris Dopp:** From my vantage point of speaking with both fund managers and institutions, I completely agree with Michael's point regarding the difficulty smaller and emerging managers face in raising assets. The institutionalization of the investor base favors the largest fund managers as most pensions, for example, cannot represent more than 10% of a fund's total assets. With allocations getting larger, that rules out most managers under \$1bn in AUM.

As an illustration, total AUM in the managed futures industry is now almost \$340bn, making it the largest single strategy in hedge fund space. Yet, 65% of all assets are managed by the 35 largest CTAs and the remaining 35% managed by over 900 CTAs. Over the past five years, the imbalance has grown.

I don't know what the catalyst will be, but I do expect this trend to change over time. More and more pension and institutions are starting emerging manager programs and a fair amount of research has shown that average rates of return decrease as AUM increases, albeit with lower volatility. Perhaps, the previously mentioned shift toward retail structures and the growth of managed account platforms will help move the needle for smaller managers.



**Matthias Knab**

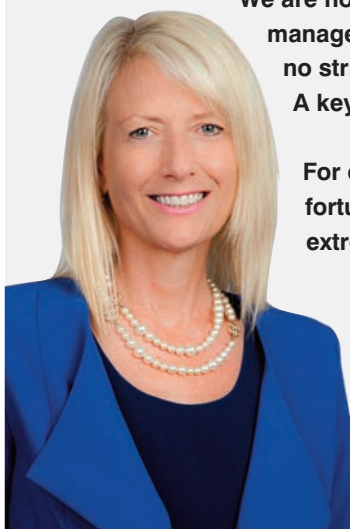
Kimberly, you said you are also focusing on emerging managers. From your experience what does it take for emerging managers to succeed? Who makes it and why?

**Kimberly Mounts:** At MAP, we have identified and target preferred manager features that we believe increase the manager's likelihood of success. While much of our due diligence process is proprietary at the preliminary level, we look at partner capital in the fund, team's co-investment, prior successful track record, and overall experience. Ideally, the manager is very seasoned and has demonstrated an ability to weather market cycles and learn from them.

We are not looking for people who are trying to hit it out of the ballpark. Often times we feel those managers are taking outsized risks to generate returns. We just want the singles and doubles and no strike-outs. You don't need to hit it out of the ballpark but you do need to protect our capital. A key to a hedge fund manager's success is surviving and ideally thriving in the downturns.

For example, in 2008 you were a winner by losing the minimum amount of money. We are very fortunate because many of MAP's very small recommended managers in 2008, are now extremely large managers, given they were top performers during the crisis.

Furthermore, allocating to emerging managers includes an increased risk in the fund's investment style, organizational structure, and internal operations due to their small size, scope, and lack of institutional processes. This is why our risk management due diligence team focuses on identifying the major risks of a prospective manager, measuring how big the risks are, evaluating if the risks are acceptable and determining how best to control the risks.



## Kimberly Mounts

Our risk consulting services give our firm unique knowledge and access to institutional resources and industry relationships. It also assists in the synergistic development of our investment strategies, helping us to more clearly identify where investment risks reside in portfolios and where opportunities for investment returns exist.

Through our partnership and mentorship with emerging managers, MAP broadens their scope of risk management to encompass not only credit and market risks in their investment portfolios, but to also encompass operational risks. We proactively seek to manage risks by identifying operational risks and working with our emerging manager funds to develop best practice systems, processes, and outsourced partners to mitigate potential operational issues.

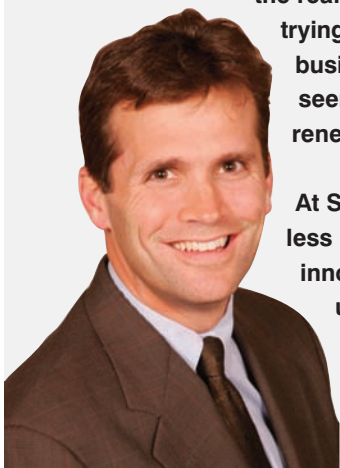
**Kimberly Mounts:** On the investment risk side, MAP requires 100% position level transparency prior to an initial manager investment and on a monthly basis thereafter. Manager position data allows us to analyze and monitor the risk profile, spot check exposures, evaluate style drift, and ensure compliance with our established investment guidelines. Full position transparency also allows MAP to better partner with our emerging managers and serves as a secondary source for their risk management furthering their development.

Within the emerging manager space, we feel that minority and women-owned funds offer investors the opportunity to achieve increased returns due to their under representation within investors' portfolios and their proven track records of outperformance.



**Jason Gerlach:** The concept of investors looking for “safe” hedge fund strategies and managers who are not trying to hit “home runs” may make sense in some circles but in my opinion it is antithetical to true investment innovation and the real purpose of hedge funds and the alternative investment industry in general. If we’re not trying to provide our investors with “home run” results, what’s the purpose of us being in business? Should we just shutter our hedge fund businesses and all run mutual funds? It seems to me the world has plenty of those and that what will serve global investors best is a renewed commitment to innovation and the discovery of new, more dynamic sources of alpha.

At Sunrise, we are certainly developing some retail friendly strategies that offer lower reward but less risk, but we will never abandon our core hedge fund business and the strategy of continually innovating in the search for outstanding returns. For three decades our investors have understood and appreciated this focus, and I know from my regular dealings with prospective investors that there are many who are looking for the same thing, notwithstanding the seemingly counter-intuitive push by some current investors for “toned down” hedge funds and alternative strategies.



## Matthias Knab

How do you deal with the downward pressure on fees? Fees have come down, the average hedge fund fee is not 2 and 20 anymore.

## Kimberly Mounts

I absolutely agree with Matthias, fees are coming down. We have seen large institutional investors able to negotiate lower fees for early stage investments, longer lock ups and larger ticket sizes. Additionally, they are doing separate accounts, so they can get most favored nation clauses.

And yes, there is a growing trend of investing in alternative beta, and we like alternative beta. But that’s the key: it is beta versus alpha. You should pay hedge fund manager fees for alpha, but not for beta.

**Chris Ainsworth:** A wise institutional investor told me a couple of years ago that 10 years from now there will be very few asset managers period that will be able to command hedge fund fees, and most hedge fund strategies or alternative strategies will be replicated in mutual funds that will be paying only management fee.

I think the last piece for the SEC to change is the fee structure. Mutual funds are already allowed to do many of the investments that hedge funds are allowed to do. In many ways this is good to get the investments in a more regulated environment to protect client assets, but I think there needs to be a great deal of thought about what is in the best interest of the client, and how do you compensate the managers that perform and get them into the mainstream for average investors to benefit?



**Matthias Knab** Let's turn this discussion to the region we are dealing with – the West Coast. What can you say about running your business in this part of the world, what benefits come from that?

**Jason Gerlach** That's a great question. I think there may be something different about California managers.

**Matthias Knab** Are they happier?

**Jason Gerlach:** Happier... yes... very true in many cases I think especially when I have conversations with my peers who are enduring a rainy London winter or a classic New York blizzard. Jokes aside, there is a study that Meredith Jones of Rothstein Kass did and a whitepaper summarizing the key findings of that study will come out later this year.

Having discussed it with Meredith, my understanding is that the study is going to show that statistically speaking, California-based alternative managers have over the long haul outperformed industry benchmarks by greater amounts and more consistently than other managers.

Now, we can speculate all day as to why that may be, but as owners and proprietors of a quant trading shop, my colleagues and I at Sunrise put a lot of stock in statistics. Having survived for three decades and also having produced quality returns so far in 2013, our view is that being out of the kind of “group think” mentality that can emerge in the New York/Connecticut region, in London, or in any of the other global financial center is important and allows for more creativity and innovation and ultimately, more independent investment approaches that when successful, can really stand out against the crowd. For these reasons, in both my capacity as a California-based manager and as the President of the California Hedge Fund Association, I encourage investors to search for opportunity and talent outside of the usual financial centers and come to California and invest with our many talented managers, some of whom are here at this Roundtable today.



**Matthias Knab** Can you tell us more about the California Hedge Fund Association?

**Jason Gerlach** Absolutely Matthias, thanks for asking. The California Hedge Fund Association was founded in 2010 by myself, Chris Ainsworth who is here with us today, and several other intrepid fund managers and



service providers in California. The purpose of our efforts was to try and create a forum for all of those in our industry in California through which we could better educate ourselves, help each other grow our and improve our businesses and ultimately, bring more assets into California. From humble beginnings in which there were just a few of us in a conference room, we're now well over 500 members strong and growing quickly. We have put on dozens of successful events and webinars at this point and have also worked to engage state and federal regulators such that they can better understand and collaborate with our industry, an industry that employs thousands of Californians. We encourage all of the readers of this Roundtable transcript to join the CHFA by visiting [www.calhedgefund.org](http://www.calhedgefund.org) or e-mailing me or [info@calhedgefund.org](mailto:info@calhedgefund.org).

We also have a California Hedge Fund Association group on LinkedIn which has developed into a nice forum for information sharing, job opportunities, and other activities that have further strengthened the bonds of those of us in California's alternative asset management industry. We encourage all readers of this Roundtable transcript to join that group as well and most importantly, find ways to creatively contribute to CHFA in the coming months and years.

**Chris Dopp:** I believe that Jason made a great point about California and I want to expand on that. Our team covers funds across all of the Americas and we definitely see geographical differences in the way market participants think and operate. Chicago, and its proprietary trading culture, has a very different mentality than the New York hedge fund community.

Most people think of the primary financial centers as the center of financial innovation; however those regions can often be the centers of following the herd. Positions aggregate around a general consensus, which causes trades to get overcrowded. In places such as California, the Mid-Atlantic region and Canada, they are separated from that consensus. Traders are more focused on improving their models and discovering what actually works, instead of listening to what other people are doing.

Being in a more remote region allows you to get a clear picture and you are not influenced by what else is going on around you.



**Michael Kao** I have several points I'd like to address regarding the California question.

**Michael Kao:** Coming back to Jason's point on the Californian lifestyle, when I was an Electrical Engineering/Computer Science major at Berkeley and I was getting internship offers in my sophomore year in college from various engineering firms, I wondered why this one firm in Southern California was offering so much less than some of the other offers I got. These were all comparable engineering firms. So I called up HR and I said, so and so is giving me x per hour and you are giving me say 0.7x per hour. How do you justify that? She said, without even the slightest hesitation, "Oh, that's because we pay you in sunshine dollars down here!"

While this is kind of funny, it also leads me to the more important question of taxes. From a tax standpoint, California is one of the highest cost places of doing business and it's just gotten even costlier with the recent legislated taxes. If it weren't for the family ties and lifestyle reasons - my wife is from California, my extended family is in California, and I spent a large part of my life in California - I guess I would have to think twice about starting a business in California today, when I could domicile in Nevada or Texas or Washington or Florida, for example.



**Michael Kao** But because I'm not going anywhere and because so much of our investor base is onshore capital,

we are very aware of tax consequences when we do our trading. So unlike a lot of our peers who just for ease of accounting took the mark-to-market election years ago, we instead choose to be tactical in our trading in order to be tax efficient for our investors.

**Michael Kao:** My last point is about the talent pool in Southern California and LA in particular. I remember when I started my firm a lot of people asked me, “okay, so aren’t you going to have a problem recruiting and retaining talent in your space being on the West Coast?” And I said, actually quite to the contrary, because LA was the home of Drexel, and when Drexel imploded in the early 90s there was a diaspora of credit talent that basically spread out throughout Southern California. That was the talent pool I was looking to recruit from. For what we do - a capital structure long/short strategy which tends to be very debt intensive - I can literally have the pick of the litter in terms of investment talent being here in Southern California.



#### Kimberly Mounts

Regarding why we chose to locate MAP here in Southern California, it was mainly based on the tremendous fixed income talent. Given MAP’s focus on risk management and fixed income hedge funds, Southern California and especially Newport Beach made the most sense. I should note we also look to move out to California the best fixed income specialists from around the world. Our newest star team member is from New York with over 15 years of experience trading derivatives.

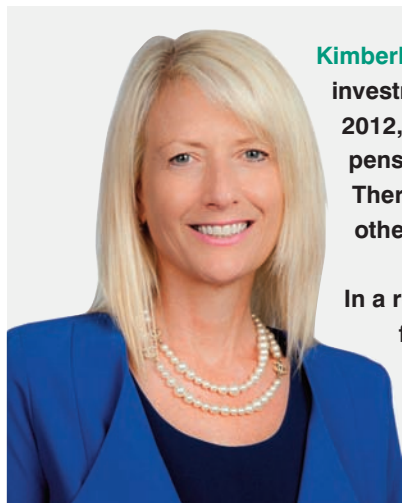
Secondly, our access as a hedge fund consultant to managers is more focused. With the two largest public pensions in the United States with over \$400bn in assets in California, every manager comes here. Both large and small managers come to Southern California and specifically Newport Beach as there is a tremendous amount of wealth here.

Finally, we are California based because it is the Pacific gateway to Asia and provides the best access to the region. MAP believes there is tremendous opportunity there, and from Southern California it is relatively easy to fly to Asia. With John Wayne Airport, we still maintain the ability to travel non-stop to New York in five hours.

If I may go back to the public pensions in California, what’s interesting to note is that when I wrote MAP’s business plan in 2005, CalPERS had been allocating to hedge funds for several years but had less than a 2½% allocation to the space. Conversely, CalSTRS hadn’t allocated any money to hedge funds at the time. Similarly, New York State had been allocating to hedge funds, but New York City hadn’t invested in hedge funds at all.

#### Matthias Knab

Will those institutions make more use of hedge funds and alternative investments going forward? What trends and developments do you notice?



**Kimberly Mounts:** Yes, interest among pensions is certainly rising. A recent article cited that investments in hedge funds among the 200 largest U.S. retirement funds increased by 20% in 2012, representing a five-year growth of approximately 67%. Moreover, the average public pension is anticipated to maintain allocations to hedge funds of anywhere from 5% to 10%. There are some public pensions that have no allocation to hedge funds whatsoever while others that have up to 27% in hedge funds.

In a recent panel I moderated, we were fortunate to have senior investment representatives for a large public pension, foundation, and university endowment. What stood out and what I find most fascinating is the similarity in the real return (after-inflation) objectives, but the large differences in the compositions of the portfolios (pension, endowment, and foundation). The average percentage allocation to hedge funds and alternatives varies widely between investor segments. Endowments and foundations

have an average 25% of their portfolios invested in hedge funds, compared to pension funds at 5%. They all have similar expected returns but wide variation in allocations to hedge funds.

Finally, a trend that we are delighted to see at MAP is that there are growing discussions and interest expressed by Institutional Investors, particularly public pensions regarding the development of minority and women-owned emerging manager hedge funds programs.

**Matthias Knab**

Let's look at risk management. Has risk management advanced in our industry?

**Chris Ainsworth**

I think the state of risk management and advances in it is partially an oxymoron. Everything is backward looking and when the world runs into trouble all correlations go to 1.

**Christian Dopp**

I disagree. The amount of information and the speed at which a risk manager can obtain it has improved exponentially. At least in the exchange traded world, the most sophisticated systems can now manage risk in millisecond increments. Now, not all fund managers have this level of sophistication yet, but the financial crisis has made risk management a primary focus and the knowledge gap is closing rapidly.

**Kimberly Mounts:** What we see and hear from working with our clients is that they are very concerned with risk management and wish to examine risks by running various stress tests, historical analyses, and what-ifs. Also our clients are taking a more holistic view of the portfolio when thinking about asset allocation. They are weighing the risk of making new incremental investments in alternative asset classes (such as hedge funds) by considering the correlations of returns to the existing assets within the portfolio and not on the individual risk of the new investment asset class alone. Risk managers can add value by running stress tests and scenario analysis to identify the risks within portfolios, hedging risks exposures for which they do not have the tolerance or ability to bear, and by adding return enhancing diversifiers.



**Kimberly Mounts**

Moreover, in our opinion it is extremely important to look at portfolios from a very granular level and to evaluate individual securities, their classifications and their risk characteristics. Security level analysis also allows us to provide extensive decompositions of the contributing risk factors within our client's portfolios.

**Matthias Knab**

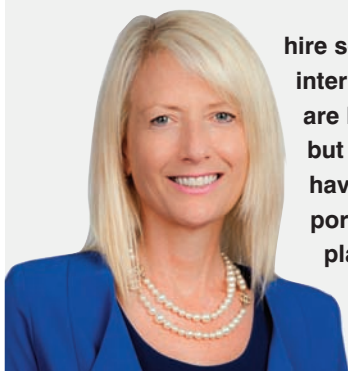
I sometimes hear the point that most risk managers and most organizations have more data than they could have ever wanted, and they have no idea what to do with it.

**Kimberly Mounts**

That's a good point, but also one of the reasons why MAP chose to invest so heavily in our infrastructure and our team. As a result, MAP Alternative just won another Public Pension Request for Proposal for Investment Risk Analysis of a \$20bn portfolio. We also have three of the largest corporate pensions in the State of California as our clients. For our risk management consulting clients, we do position-level risk management and aggregate it up to the entire portfolio. The position level analysis has been on portfolios ranging from 1,000 to 40,000 positions.

**Kimberly Mounts:** Post-2008 hedge funds are providing more and more transparency. We at MAP have always demanded it from our recommended funds. The question is what do you do with the data? That's exactly why institutional investors go to a fund of hedge funds, or a risk management consultant. My point here is for investors: to





hire somebody as a risk management consultant who knows how to measure, monitor and interpret the risks. It is not just a matter of buying the latest risk software. The savvy pensions are hiring risk consultants as they have already tried to implement a risk system on their own, but quickly found out that can be very time and labor intensive, and can take over one year to have tangible results. When clients come to MAP for risk consulting, we can typically get their portfolios up and running in a couple of months. That is because we have all the systems in place and have them automated. We have been analyzing these portfolios and can actually handle full position-level transparency.

**Kimberly Mounts**

MAP also invested in developing our own customized risk software solutions using a combination of internal and external tools. We believe we have the best solution for analyzing risks across investors' entire portfolios, especially those with complex derivatives and hedge funds.

**Joe Childrey:** When it comes to risk, it's really your definition of risk, and I happen to agree that information does not equal knowledge. The only way you are really going to get wisdom is from being in the game over time. But definitely, doubt and verify, trust and verify.

Our fund, for instance, is cash 30-35% of the time, or a riskless position. How do you look at risk when you are in cash 35% of the time, yet we are leveraged about 20% of the time? So it's all how you define and look at risk. And to us at this table, volatility is not a bad word. If it's volatile on the upside, that's great. You want to be volatile on the right side. So my point here is to that it is important to define risk, then use volatility to your advantage, if possible by forced rebalancing.



**Michael Kao:** What you often see in the risk measurement game is "garbage in, garbage out." We offer full transparency; we will give you whatever you want as we have nothing to hide. But I would caution anybody who gets real-time transparency: be careful running it through VAR-based platforms because it will tell you nothing about the underlying positions that we have if you don't know what hedges go with what.



Our strategy is measurably different from equity long/short or CTAs. For example, we might have five or six securities representing different parts of the capital structure of the same issuer all serving a deliberate purpose in our trade construction. You can't model these things in a traditional check the box format.

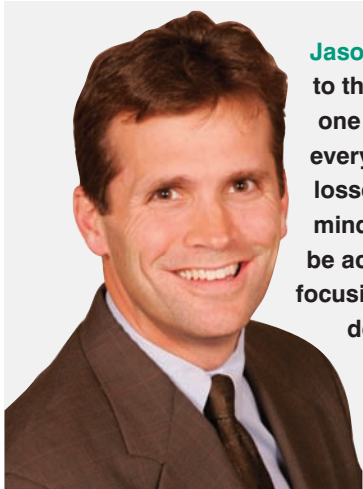
We model our risk and our downside through scenario-based outcomes that are not VaR based, because in my experience the problem with the VaR based models always is that they tend to underestimate the tails. When you are as involved as we are in event-driven outcomes, traditional risk management models based on smooth distributions simply don't make a lot of sense. That said, one of the key investment criteria for us regardless of theme is the reward-to-risk ratio. Simply put, "how much can I make versus how much I'm risking."

**Kimberly Mounts:** We think about and look at risk like a mosaic – you need to view it from different angles. We do extensive analysis and stress testing at MAP. We stress portfolios by shocking various risk factors, over specific dates, by our specified fields and using a combination of stress tests. We run over 75 historical scenario analyses and analyze the best case, worst case and what-if. We look at VaR as a numerical approximation of risk, but realize that by no means does it capture or quantify all of the portfolio's risk.



**Kimberly Mounts**

At MAP, we invested heavily in our technology, infrastructure and risk systems. Therefore, we have the tools available to measure, monitor, evaluate and control the risks in large institutional investors' portfolios consisting of thousands of positions. Combine that with our team's knowledge from working on trading floors to interpret the risks and then you have solved the problem of data overkill.



**Jason Gerlach:** My colleagues and I at Sunrise like to keep things fairly simple when it comes to thinking about risk. On the investment side, we live, breathe and die by one number and one number only – the amount of our investors' money we stand to lose should, in an instant, every trade we have on go against us and force us out of our positions at our various stop losses. Everything we do – model building, trade execution, etc. – is done with that number in mind and that number is monitored religiously to ensure that it stays within what we believe to be acceptable tolerances and more importantly, within the tolerances our investors expect. By focusing on these simple concepts, we have managed to stay in business for over three decades and only lose money for our investors in a small few of our 32 calendar years of trading. There is nothing that makes us more proud as an organization than this achievement and a desire to maintain this standard of excellence will keep us focused on the all-important task of investment risk management.

**Jason Gerlach**

On the operational side of our business, our view on risk is equally simple: take every reasonable step necessary to ensure that operation risk is mitigated as close to zero as possible. Specifically, we respect the fact that by entrusting assets to us, our investors signed up for only one risk, the risk of our investment strategy not succeeding. They did not sign up for information technology risk, regulatory compliance risk, human resources risk, or any of the numerous other operational risks facing today's asset management businesses. Accordingly, our job at Sunrise is to vigilantly identify and reduce operational risks wherever we find them and continually improve our business to ensure that we keep up with the ever-changing business landscape of our industry. Again, our three decades in business suggest that our philosophy has paid dividends and thus we have no plans to deviate from this approach in the future.

# OPALESQUE'S GOT TALENT

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

Emerging Manager  
Fund Database

A SQUARE (Alternative Alternatives)  
Fund Database

- ✓ Performance
- ✓ Diversification
- ✓ Uncorrelated
- ✓ Alternative
- ✓ Alpha

Logon now at [www.opalesquesolutions.com](http://www.opalesquesolutions.com)

Opalesque subscribers get free access!



# accurate

## professional reporting service

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



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

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

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

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

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

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

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

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

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

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

**OPALESQUE**

[www.opalesque.com](http://www.opalesque.com)