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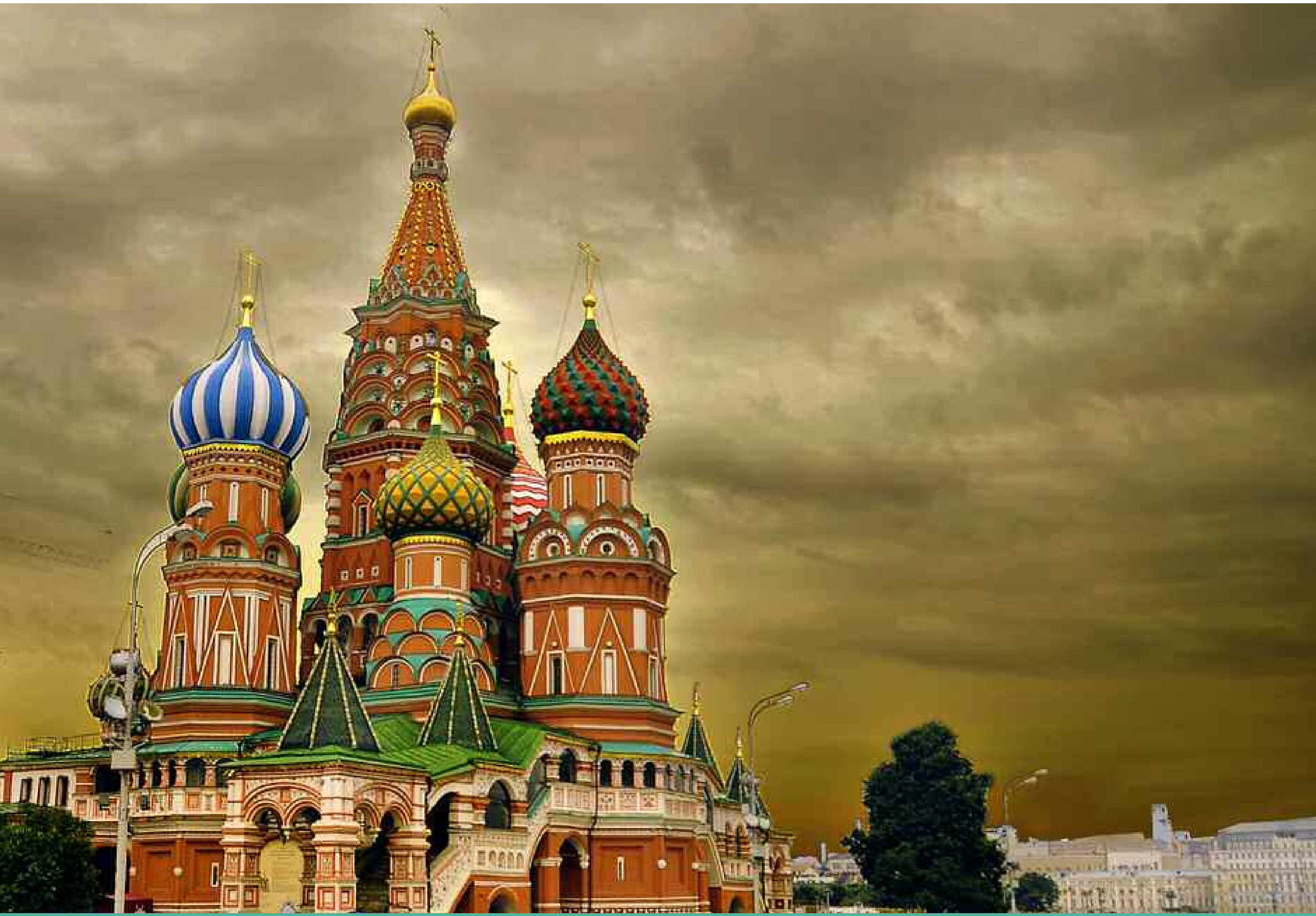

Opalesque Roundtable Series '15

RUSSIA

Opalesque Roundtable Series Sponsor:

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Editor's Note

15 of the 20 top high frequency trading firms are active in Russia

The Russian market is really open and highly technologically advanced, even compared to some of the developed markets, and certainly much more open than other emerging markets like India, China or even Brazil. Particularly for algorithmic funds, Russia is an easy environment to come in and test the market, and that is why the competition is quite high at the moment. The growth, volumes, and market share of HFT algorithmic businesses in the Russian market is constantly growing. Out of the top 20 HFT global firms, around 15 are already in Russia and actively trading. The market is now very dense, especially in the FX market, which has been a theme here over the past year.

On the other side, it is no secret that banking in Russia is in poor shape. Credit risk and operational risks are concerns. Most of the capital is fictitious and nobody really knows what the situation is, even for the bigger banks like Sberbank or VTB, but at least, with those type of institutions, you know that at the end of the day they will be bailed out.

Russia's market one of the least efficient globally

From a fundamental equities perspective, some of the large international managers migrated from Russian local stocks into ETFs not only because liquidity decreased in the key names that they liked, but also because bellwether stocks such as Sberbank or Magnit became less favored on fundamental reasons.

This again makes the Russian market one of the least efficient globally, offering plenty of opportunities for fund managers doing their own proprietary research. So, for alpha-driven funds, the situation is not so bad, because of the high volatility, and the liquidity is still sufficient. Fore example, the Flag Quantitative Strategies Fund hasn't had a single down month since inception and is up around 35%, while the RTS is down by approximately the same amount. Altera Capital has also been doing very well, nearly tripling the AUM of their hedge fund as result of outperformance. Of course, uncertainty around liquidity remains, and it could also be worse next year.

More potential hedge fund launches in Moscow than in London

Still, Stephen Lewis, an executive of fund administrator Maples Fund Services who covers Russia, says that he has seen *"more potential new launches on the hedge fund side in Moscow than I have seen in London over the last two years."* This Roundtable discusses in depth these interesting dynamics in Russia, and the prospects of managers to succeed.

The Opalesque 2015 Russia Roundtable, sponsored by Maples Fund Services, took place Sept. 30th in Moscow with:

1. Viatcheslav (Slava) Pivovarov, Altera Capital
2. Michael Workman, DG19
3. Grigoriy Isaev, Flag Quantitative Strategies Fund
4. Nikolay Dontsov, ITI Funds
5. Stephen Lewis, Maples Fund Services

The group also discussed:

- What's behind the current wave of new fund launches in Moscow? Where do these start-ups get their initial capital?
- Is due diligence on a Russian fund different? When should you *not* use a managed account in Russia, but preferably have a fund structure?
- Can algorithmic trading be really independent or detached from the market? Why volatility per se doesn't solve anything in the long run, even if it is high.
- Risk management: How to survive when your brokers increase margin requirements *eight times overnight.* Why pure mathematics is not the ultimate risk management.
- Opportunities in Russian real estate: Quality assets at discount prices
- Why are private banks and European investors interested in emerging market fixed income funds?
- Are the Russian markets getting more or less fragmented?
- The evolution of the Russian "mini prime" market

Enjoy!

Matthias Knab
Knab@Opalesque.com

Participant Profiles

(LEFT TO RIGHT)

Matthias Knab, Viatcheslav Pivovarov, Stephen Lewis, Grigoriy Isaev, Nikolai Dontsov, Michael Workman.

Introduction

Stephen Lewis
Maples Fund Services

I represent Maples Fund Services which is an independent fund services provider. We have been around for over a decade and work with a wide range of investment management firms and global financial institutions and currently count more than $50 billion in assets under administration. We're also supported by the leading international law firm, Maples and Calder, as well as our fiduciary group, Maples Fiduciary.

Maples Fund Services is global. We have just opened an office in San Francisco, after opening one in Boston last year. We are also in Hong Kong, Singapore, Dubai, Luxembourg, Dublin, Montreal and London, where I am based. As we are a Cayman Islands headquartered company, we have a large group there as well. Essentially my group provides a full range of fund administration services across multiple onshore and offshore structures and a variety of strategies and asset classes, the key ones being hedge funds, private equity firms and real estate.

Grigoriy Isaev
Znamenka Capital LLC

I work for Znamenka Capital LLC, an advisor for the Flag Quantitative Strategies Fund. We launched a year and a half ago.

My background is mostly in derivatives, on the sell-side. I worked at Sberbank CIB and Troika Dialog for about 10 years, and at Metallinvestbank before that – mostly like a Delta One dealer type of guy.

Right now we have around $20 million in assets under management, and we are growing 5%, 10% each month, because the performance has been good.

We are a multi-strategy fund, but a bit different. A multi-strategy fund typically invests in different assets and different strategies across the board. We are more focused on Russia and Russia-related assets, and only liquid and exchange-traded type of assets, using different strategies, mostly driven by some quantitative models and assumptions. Of course, we have to pay attention to corporate actions, what is going on in the market, micro events, but mostly from a risk standpoint. That is because we believe that you have to make some qualitative judgments about risk even if you are a quant.

Nikolai Dontsov
ITI Funds

I represent a relatively new firm called ITI Funds. We are a multi-manager fund platform set to offer a wide range of strategies across global markets- from beta-driven products to actively managed uncorrelated algorithmic trading strategies.

ITI Funds is based on two teams' joint effort. One is Da Vinci Capital Management Team, a large private equity group based in Russia. The other is IT Invest, a brokerage company, which was bought by the Da Vinci Private Equity Fund at the beginning of 2014.

ITI Funds currently represents the holding companies based in Guernsey. Da Vinci has been in Guernsey for about eight to ten years. And the platform which we are building now and which has already started operations is based in Cayman.

It's a platform for different asset managers, and we also work with clients who want to develop a hedge fund. We also work to create synergy between buy-side and sell-side products. If a trader or a manger is interested in growing a fund over time, we are in the ideal position to help them get started because we have access to the managers' data, their strategies, their track records, and can then add services like capital introductions. The platform is a great vehicle to get started and grow a fund.

We are also working on a few ideas from the development of our own funds, although those are still in the development phase. They will be focused either on Russian strategies or emerging market strategies, and most of them will be focused on quantitative strategies, arbitrage, and will be mostly alpha driven.

My personal background is more on the sell-side. I have been in the Russian financial market since 1995. I worked for a long time at Renaissance Capital, in different segments of the business, developing direct market access services. Then I worked at VTB Capital Group, at the start of its operations in 2008. And 2012, I moved to private equity with Da Vinci. Last year I was working on the development of the new funds platform.

Now, we are focusing more on the sell-side business, with the help of a new CIO, Denis Albert.

Michael Workman
DG19

I represent DG19, a specialist emerging markets investment manager based in Jersey with operations in Moscow. The group has US$650m of assets under management with further commitments for several hundred million US dollars of investment. DG19 has two core asset management products: one focusing on private equity related to real estate, development and management in Russia and the CIS, and the other product is related to fixed income fund management. We manage a bond fund dedicated to emerging market corporate debt. The group has more than 60 people working in the real estate and the fund businesses.

The private equity business was launched in 2004 with initial investments in the development of logistics centers and industrial warehousing. Today, we also have a number of retail shopping centers that include both development projects and operating assets.

On the fixed income side, we focus on global emerging markets with core strategies in Eastern Europe, Middle East and Africa, primarily investing in dollar securities of corporates and sovereign Eurobonds.

Traditionally, our client base includes European private banks, family offices, institutional investment funds and high-net-worth individuals. We also work with sovereign wealth funds, in particular those that look at the Russian real estate market for acquisition and development opportunities.

My background is in principal investing and fixed income trading. I manage our fixed income products and help develop our overall asset management business. I have been working in Moscow since the mid-90s in Russian and international banks including, Goldman Sachs, UBS, and Renaissance Capital. I graduated from the University of Notre Dame with degrees in Finance and Russian.

Viatcheslav Pivovarov
Altera Capital

I am from Altera Capital. Our group was founded in 2011. It manages three types of fund families; private equity, both Russian and global; real estate development primarily in Russia; and a hedge fund, which was initially Russia-focused, but this year started covering all emerging markets.

The funds have been doing well. We have more than $700 million in assets under management. On the public side, the fund runs about $140 million. It was launched with $50 million in 2011. **We have been up around 30% since inception, in a market that has been down about 50% since then.** So since launch, we outperformed the Russian market by 80% and the emerging markets index by about 40%.

Our strategy is fundamental event-driven. We don't do technical analysis, but primarily focus on top down market, sector and bottom up company research. We invest in both equities and debt; as well as derivative instruments, currencies and commodities.

My background is primarily on the buy-side. In the United States, I was special situations portfolio manager at Third Point, which is shareholder activist fund. Then I was a partner at Old Lane Partners. After Old Lane was sold to Citigroup in 2007, I was managing director at Citigroup in New York. During the global financial crisis I advised the Russian ministry of economy on setting up a number of initiatives: improvement of investment climate, macroeconomic policy, and the launch of the Russian Direct Investment Fund. In 2011 my partners and I decided to set up Altera.

Matthias Knab Let's look at your activities. What are you doing right now? How are the products doing? And what is your outlook?

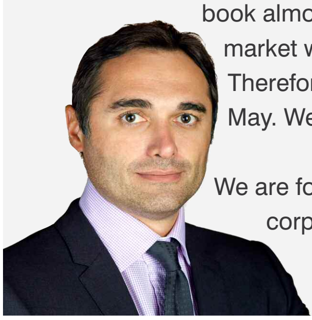
Viatcheslav Pivovarov: Let me start with telling you that at the moment we are not actively marketing our funds, not because they are closed, but because we think that the asset classes have not been on the investors' radar screen. **We have however nearly tripled our assets under management in our hedge fund as result of our outperformance.** Anybody who is really interested in our products can find us through various databases, and our results are available on Bloomberg on a monthly basis as well.

What we focus on is performance and performance only. We have substantial proprietary capital in our funds. In today's environment, our strategy is to grow through capital appreciation and if foreign institutional investors who would like to come in, which we do see at times, we are happy to have them.

Matthias Knab You mentioned that you have broadened the mandate of your hedge fund from Russian only to other markets. Can you please talk about the opportunities that you see for the strategy, now and going forward?

Viatcheslav Pivovarov: We are very opportunistic; our only goal is to produce returns to our investors.

As I explained, we are not running this business to be limited to any particular silo, be it Russian fixed income or equities. Our goal is to generate returns in different market environments. That is why we have been a long/short fund from inception. And we are moving to where we see the opportunities.



For example, as the Russian fixed income markets sold off in 2013 and were offering equity-like returns, we shifted the equity book almost entirely into Russian euro bonds in December through February. At the end of April, when Russian market went up, we saw lack of fundamental growth drivers neither macro-economic, nor company specific. Therefore we decided to diversify out of Russia, and that is what we have been doing since the beginning of May. We were not in a rush redeploying capital as we saw very limited set of opportunities globally.

We are focused on key markets where we find top line growth, including the U.S, China, India and EU, where corporate earnings should be driven by expanding QE.

Grigoriy Isaev: We are more in the startup phase; we launched a bit more than a year ago, with capital coming from some anchor investors. Since then, our assets under management have quadrupled, but it is still a relatively small sum.

We are also now looking to diversify out of Russia. Our trading is not mainly focused on fundamentals per se, but we are still very sensitive to the overall level of market activity, liquidity flows, etc. All those paremeters have been down substantially, and it is becoming more difficult to make money. **We still haven't had a single down month**, but the returns have been going down.

The fund is up around 35% since inception, while the RTS is down by approximately the same amount.

Although I have to add that the RTS is not really comparable because we are a pure alpha fund, we don't have any beta at all, so it would be difficult to find a suitable benchmark, maybe more a global, quantitative one.

Right now we are looking at markets like India. China was very promising, but as you know, with the recent crackdown on any trading activity by Chinese authorities, some people have suffered a lot there. I personally know some people whose assets have been frozen, even though they were not doing anything wrong, just pure trading. That is actually one of the biggest problems in emerging markets: the rise of protectionism and general regulation.

You might say our fund is part of the movement of proprietary trading activities going from the sell-side to the buy-side that are caused by the increase in regulation and bank capital requirements, etc. So while we were running away from regulation and bureaucracy on the sell-side, the biggest threat now on the buy-side is actually the same: more regulation and more interference from the government.

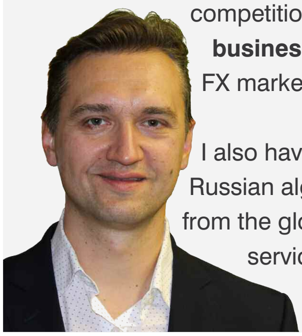
At the moment, we are not doing any active public marketing for the fund; we are known through word-of-mouth, acquaintances, connections. Another reason for us holding back is the fact that since we started, as I mentioned, activity and volumes have been going down quite rapidly. It is now difficult to pinpoint where the liquidity frontier is the optimal one for us.

The biggest trend in Russia for people like us, hedge funds or proprietary trading firms – it actually seems like 90% of the people in this business are prop traders – is that everyone wants to go away from Russia. This is because **Russia is becoming too competitive.** And it is becoming so because, despite all the talk of isolation and political uncertainty, the actual market in Russia is very open. It is much more open than in India or in China or even Brazil. So it is **very easy for some of the biggest algorithmic or high frequency trading (HFT) firms to come to Russia and to set up their type of trading**, if they are comfortable with local counterparty risks, because they would be trading with two or three Russian brokers. The likes of Sberbank or VTB don't provide the necessary services, so they would go to the likes of BCS, Rencap or Otkrytije, which have a completely different credit risk. I would say that out of the top 20 HFT global firms, around 15 are already in Russia and actively **trading.**

This means the market has become more and more competitive, and more people are looking to diversify and look at new opportunities, mostly in emerging markets, because of course, in developed markets, the cost of infrastructure and also the competition are very high. People are looking at places like India, China, Taiwan, so in general all over Asia, because there is some economic growth and the volumes have been rising. For example, in India, the volume of derivative trading increased by around 30-40% last year. In China, it also increased quite rapidly before the latest authority crackdown. Unfortunately, China has essentially killed trading in index futures and other derivative products. They introduced draconian margin requirements and also prohibited any shorting activity. Furthermore, the minimal commission on index futures in China, only the exchange fees without the broker part, is now 25 basis points. So that effectively killed any opportunity for algorithmic trading from the start.

Nikolai Dontsov: I agree with what Grigoriy was saying, because the niche we are in is quite similar to what he was describing.

The Russian market is really open and highly technologically advanced, even compared to some of the developed markets. Russia is an easy environment for international algorithmic funds to come in and test the market, and that is why the competition is quite high at the moment. The **growth, volumes, and market share of HFT algorithmic businesses in the Russian market is constantly growing**. The market is now very dense, especially in the FX market, which has been a theme here over the past year.



I also have to point out that **international funds have more advantages** when trading FX strategies than Russian algorithmic funds, because of their easy access to cheap capital. And the brokers have cut off the limits from the global banks like Citibank, ABN AMRO Bank, and there is no possibility to offer to the clients two extra services at the same time.

So if clients make an arbitrage trade between, let's say, EBS or Currenex and the Russian currency section of the Moscow exchange, then Russian brokers can only offer the local part, while global buy-side firms will be making an arbitrage and finance both sides at the same place. That's why for local clients, be they arbitrage traders or hedge funds, it's much more difficult than for global ones.

In terms of our buy-side platform at ITI Funds, at the moment we have managers who are alpha-driven, and mainly with a focus on Russia, but they are expanding globally and are testing different strategies in the U.S. markets; Chicago, the New York Stock Exchange, NASDAQ.

We are also constantly looking for opportunities in different emerging markets. For the next two or three years, we see the opportunity to become a dedicated emerging market funds platform, with a focus on high technology, alpha-driven funds, and in finding niches in the markets that offer competitive advantages.

We are looking into Turkey and India. China is highly restrictive, so inaccessible for these sort of strategies at the moment. Brazil, Taiwan, and a few more countries may also be considered.

We will focus on helping the existing managers to develop their own business, because they constantly look for new opportunities. We have a few managers in the pipeline which should come out shortly on our fund platform. So we hope that in first quarter of 2016, there will be more volume than now.

The other thing which we are working on is our beta strategies,. The **Russian market is definitely in a difficult situation, probably the most difficult since the start of operations in mid-90s, and the environment is tough. But actually, for alpha-driven funds, it is not so bad, because of the high volatility, and the liquidity is still sufficient. But it could also be worse next year.** However, for traditional funds, there could be good opportunity once the market reverses and some sanctions are lifted. The current levels could be a good entry point, and we hope for the better. So we are working traditional fundamental fund, and the right way to structure it at the moment.

In terms of the synergy between the buy-side and sell-side platforms, we have a lot of small algorithmic trading clients, and we are working on the idea of combining them into a multi-manager fund with asset allocation across different asset managers, and tracking their individual investment performance. We have seen this model elsewhere and think it is highly applicable to Russia. Russia has a deep talent pool of technology-driven experts who are looking to create different algorithms and program training models, and with our fund they will be able to compete. Sometimes it is just one or two individuals, but they can develop something really smart, and they deserve a chance to be on a proper fund platform and be allocated some capital. Meanwhile, we can work on marketing and capital introduction. With a proper infrastructure, managers can just trade and our chief investment officer will get capital for them.

Grigoriy Isaev: Despite the notion that algorithmic trading should provide pure alpha, etc., we should not pretend that it is completely independent from the market. There is still a strong link between the overall level of economic activity with the overall level of market activity, the volumes and the opportunities in the market.

Volatility per se doesn't solve anything in the long run, even if it is high. My favorite example would be the situation in Ukraine, where in 2014, there was a lot of volatility, but the volume in the market was maybe $1 million per day on the whole for equities and derivatives. So what would you do if you were a fund trying to trade that, even if there was a lot of volatility? I guess not much. Most asset managers, the traditional ones and the algorithmic ones, are in the same boat when it comes to the reality of the market. Some of them may think they are not, but in reality they are.

The other trend we have seen is that, as Nikolai has mentioned, there are a lot of small fund management teams. But with fixed costs rising and margins going down, my view is that most of the small, two to three-person teams will have a hard time surviving this market.

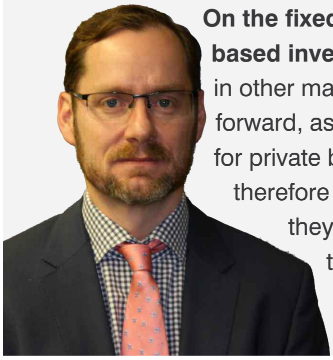
Matthias Knab Could you comment on the current liquidity level, the factors that affect liquidity and your strategies?

Michael Workman: We see challenges in bringing in new investment into less liquid assets, and to reiterate what Slava was saying, as far as marketing or trying to attract new investors, I think that right now it is a challenging environment.

When it comes to Russia, we see different behavior among investor groups that have existing exposure or current positions, especially in real estate. Some investors have decided that they want to exit the market and are looking to divest. This may be related to a change in strategy or for more political reasons rather than commercial. While for the other group – those with a longer investment horizon and current exposure, they are more comfortable with looking to be opportunistic and **acquire quality assets at a discount**. It is an easier conversation with this group of investors and we see them trying to take out some of the weak hands in the market.

Real estate is interesting because we are starting to see a bit of consolidation in shopping centers and retail. In particular, high street retailers and brand names are cutting back on their inventories and scaling back their new store openings going forward. So this has put some pressure on underlying cash flows and hurt owners. We feel, the best strategy is to cherry-pick some of the better assets help provide liquidity to shareholders that want to exit. In particular in Moscow and St. Petersburg markets.

Another factor that is giving **cash rich investors** an edge is that there is little bank financing available. In most cases, Russian banks are not willing to lend into new projects or even existing assets that need to be refinanced. Financing in rubles is very expensive; in dollars it is almost nonexistent, unless you have a strong relationship with the bank and have the ability to arrange financing for existing assets that have cash flow. So until we see a change in bank financing, a reduction in rates and attitudes towards new lending, new real estate development will remain below trend compared to the last few years.



On the fixed income side though, we see constant interest from private banks, especially European based investors. The negative interest rate environment in Europe has forced private clients to look for yield in other markets. So while Russia and EM in general have not been high priority for them historically, going forward, as political risk and the macro environment stabilizes, the Russian market will outperform. It is hard for private bankers to convince their clients to be excited with a negative 25 basis points on their deposits; therefore it makes sense to look at Russia or other emerging markets in order to get a much better yield than they are getting in the current environment in Europe. And quite frankly, in many cases they are actually taking less credit risk because of the rating agencies' tendency to rate emerging market corporate borrowers lower than their credit ratios suggest.

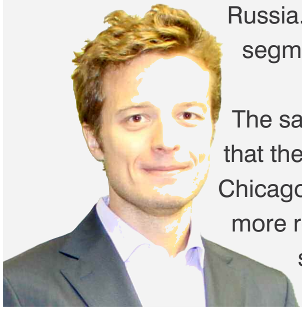
Nikolai Dontsov: Liquidity has definitely worsened in the last year in the local Russian market. When the market is in a good shape, then we will see more liquidity on traditional spot equity and bond markets; but it is not there now.

There is more liquidity, from my perspective, on the derivatives side and in FX market. Until the fundamentals and macro factors shift, I don't see change coming in the short term. The overall situation is moderately negative.

Grigoriy Isaev: Liquidity in the Russian market in general has historically been very fractured. That has been a key advantage for the local sell-side shops that offered better liquidity. We have seen derivatives in MICEX versus derivatives on RTS, and then LLC versus the local market, etc.

Before the recent crisis, the general trend was that with the opening up of the Russian local market, the liquidity gradually migrated to the local venues and became more centralized. The RTS spot market completely died off, and MICEX bought what was left of RTS, mainly the derivatives business, and then killed their own project. The general assumption was that liquidity would become more and more concentrated and more and more listed. Meanwhile, the OTC business had been doing very poorly in sell-side firms as well.

But last year, with the sanctions and other factors, a curious thing happened. The assumption of Russian risk and Russian credit risk forced some of the global players to reassess whether they wanted to be in the local market or not. For example, an interesting development was seen in the RDX Index futures, which are futures on the Russian Equity Index, created by the Wiener (Vienna) Exchange. They trade both on Wiener Börse and on Eurex. While the volumes there are quite low, as they have always been, the notional interest of contracts outstanding is now equivalent to RTS's and sometimes even higher. It shows that the global fund managers and even some Russian fund managers are cautious of Russia in general and use any opportunity to find a **foreign venue just for clearing purposes**, because there is a fear of capital controls in Russia. So people are migrating from Russian to the global trading venues, officially making it even more segmented.



The same thing happened with FX last year; there was a big move in FX and everybody was pretty certain that the rubble was going one way, but the smarter guys opened up their positions not in local markets, but in Chicago, OTC and other venues. This type of risk really exists in Russia and it does not go away. That is one more reason why people are looking to diversify geographically; they are looking to clear their trades somewhere outside of Russia just in case, and they are willing to pay up a little premium for that.

Viatcheslav Pivovarov

From a fundamental perspective, some of the large international managers migrated from Russian local stocks into ETFs not only because liquidity dried up in the key names that they liked, but also because bellwether stocks such as Sberbank or Magnit became less favored on fundamental reasons.

Matthias Knab

Steve, you have been covering Russia for some time, what has been going on here from your perspective lately?

Stephen Lewis: I will follow on the diversification theme. We have clients who manage private equity funds, real estate funds, and hedge funds. Up until about 12-18 months ago, the focus was inward, it was all Russia. That has completely changed for exactly the same reasons you have all been alluding to.

On the real estate side, the focus has shifted to Europe and there seems to have been some success there. On the private equity side, the firms that we deal with have moved to the UK and the US, as has the hedge fund side, exactly as Slava was saying.

These changes do not really impact us. We are almost agnostic in terms of where those investments are. Frankly, the more liquid, the better, but clearly if it is a PE or a real estate fund, that is not necessarily going to be the case.

Another key observation is the sheer quantity of new funds coming out of Russia, specifically Moscow. I am genuinely staggered by that. Even more interesting is that I have seen more potential new launches on the hedge fund side in Moscow than I have seen in London over the last two years.

London is a different market at the moment with its own issues, particularly coming from the counterparties. The average hedge fund manager in London may be facing quite a few lines drawn in the same by prime brokers, investment banks and others who are becoming more selective about who they will work with and that has certainly impacted our client base.

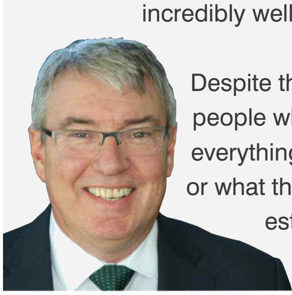
That trend has also moved across into the fund administration arena. That same line in the sand is also applied here, and as a result, we are getting quite a bit of **transition business** from hedge funds that are being forced to find new service providers. I also find it quite extraordinary that some of the larger administrators that are owned by universal banks or are an investment bank with a fund administration arm have been getting out of the business, the most recent example being SS&C buying Citigroup's Alternative Investor Services unit.

As a growing mid-sized fund administrator, we've benefited hugely from the terminations and the transitions on the service provider side. That is because some of these larger firms just don't want to deal with the smaller hedge funds, those that have up to a billion dollars in assets.

Coming back to Russia, for me it is great coming here. There are only half a dozen or so firms that offer our types of services in Russia, and we are one of the bigger ones, which is terrific and certainly presents a significant opportunity for us to grow our business in the region.

Matthias Knab Why do you think there are more fund launches in Moscow than in London?

Stephen Lewis: It is in part because of Moscow's entrepreneurial culture and the presence of a lot of youthful dynamism. There are many young people who have been very well-trained. They have worked for various finance groups and are incredibly well-qualified and launching a fund may be a natural next step.



Despite this ambition and pedigree, there is still a need for education in the market. I get phone calls from people who say, "I have a million dollars, I need a fund administrator." I then will meet with them and tell them everything I know about fund administration because, in many cases, they have no idea what they are asking for or what they really need. This has been a significant part of my job over the last 12-18 months and has helped us establish strong relationships with some of these emerging managers.

Nikolai Donstov I see the same, and in my view these people are going in exactly the right direction right now. I would not call them small, but micro funds. From a global perspective, a sub-$50 million fund is a micro fund, but here those people are just too small for most of the brokers to take a look at. And this niche is completely empty globally – not just in Russia, but in Asia as well.

Do you think that at some point some big firms will focus on this segment, or will be just seen as uneconomical?

Stephen Lewis On the prime broker side in the UK, there have been a number of relationship changes and this has given rise to the so-called "mini primes." Whereas a couple years ago, there were probably one or two mini prime brokers, now we have half a dozen. This is the group that is providing services to those hedge funds that may have had their relationship terminated with one of the bigger players and while it's not a full-service offering, they seem to have captured a lot of that business.

Nikolai Dontsov: Actually, we are in this niche and we see it growing globally. There is opportunity to be in the **mini prime** space, particularly for algorithmic and quantitative funds in emerging markets. The competition on this niche is still tiny. We set up our connections as a broker to different markets last and this year, and saw how the market is structured.

The demand for mini prime services can be partially explained by the growth of the hedge fund segment. The number of small and mid-sized hedge funds has grown significantly in the last few years driven by the growth of different products and platforms on which you can build your own fund. You can even lease or rent a particular fund platform, or you can buy just one of the cells from the platform as well. For example, our clients can build their own independent funds structured as a segregated portfolio of ITI Funds SPC, the cost of such a structure will be much lower versus a stand alone fund, and this set up is justified from let's say $5m assets under management. So if you have a strategy which gives you about 30%-40% return p.a., if you have $5m, you could pay off administrations fees, audit fees and different types of fees on the platform.

As for the number of new funds entering the Russian market at the moment, we have to keep in mind that this is a cyclical development based on the cycles of technology and market developments. After the 2008 market crash, many people started developing their own algorithmic strategies. Then, after going through five or six years of evolution, if they have been *successful in their returns, they reach a stage where it makes sense to launch a hedge fund. This wave is coming to the surface right now and should stay around for maybe another three years.* I am actually not sure if there is another wave coming, so we are focused on helping this wave come forward through our many small clients.

But still, as we discussed, launching now it is much more difficult and expensive, and the regulation is not in our favor. So we also see that hedge funds are leaving Russia; people are looking elsewhere and they see more opportunities in different emerging markets and in the States.

Grigoriy Isaev

The cost of maintaining a small fund relative to the assets has gone up a lot in last two years. That partially has to do with compliance issues, because compliance at banks and brokers has become very strict.

And we are in fact a small fund, not a micro fund. Micro funds could be completely killed off by those types of costs. The only option for micro funds is to find a mini prime, ideally paired with some kind of fund service platform, and to do everything as centralized and as cheaply as possible. It is their only chance for survival.

Michael Workman: There has been a change in the local regulation regarding the whole **de-offshorization process.** It is forcing people to change their corporate structures if they hold assets or securities and manage those portfolios from Russia. So now, the fund structure is actually quite attractive for this. To optimize cost structure, we are seeing people willing to pool assets together, putting them into a fund structure, where as before, these businesses could have been held through multiple offshore structures for the beneficial owner.

This in the end will make the market more transparent and will reduce the potential tax and perceived political risks when holding assets offshore. That also works in favor of the fund administrators whose services will become more important.

Matthias Knab

Where do the startups we have been talking about get their initial capital from, if banks won't finance them?

Nikolai Dontsov: The initial capital is proprietary capital in most of the cases, some could be from friends. When they grow, fund managers make an effort to attract capital from elsewhere. But the truth is that we often see good quant managers who don't have sales capabilities and therefore have difficulty in attracting capital.

Attracting the local investor base is also quite difficult, because you have to apply for a license, and the license here imposes certain limitations on your investment strategy.

But some of them are quite successful; we know some people in this market who have grown from nothing and have built a proper hedge fund structure at an international level and also attracted investors. They work with professional capital introduction teams and are marketing themselves directly, and have been quite successful.

Grigoriy Isaev: We should also mention that unfortunately Russia has had some high profile industry scandals. In the last two years, we have had two or three cases in which people claiming to be hedge fund managers were actually building Ponzi schemes. There were cases such as Blackfield Capital, where the founder disappeared with investor funds, or scammers claiming to be hedge fund managers, advertising on YouTube, collecting money from people, without any proper fund structure. This is all very concerning, because it creates a poor image for the industry in general. The Russian public is not really sophisticated in financial terms and it is difficult to explain to them what a proper hedge fund is.

That is definitely one of the reasons why people are moving globally, building up a proper global franchise in order to have access to global capital. Local capital in Russia has dried up a little bit not only because people have moved offshore, but also because the industry gets a very bad publicity, especially small funds. Even if you have good track record, it doesn't really matter because everyone is asking, 'Well, how can you prove that you are not another scammer?'

So with this level of trust in Russia it's quite a **challenge to attract capital.** And, of course, it's all about size. For example, we had discussions with some people on the sell side who typically should be cross-selling products like our fund and find investors for us, etc. These people have known us personally for 10 years or 15 years. They know that we are not scammers, but the challenge for us still remains the same. They say, "No chance we will be selling any fund under $50, million because our clients won't just buy it. It doesn't matter if it is good or not, it's just not our focus right now.", so that is also one of the realities in Russia at the moment.

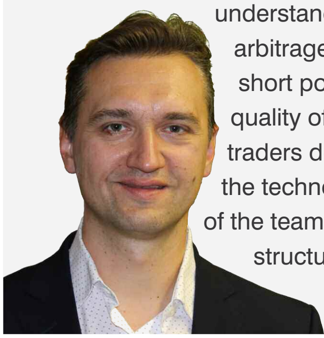
Matthias Knab Grigoriy, how should due diligence on a Russian fund be done? What should people do?

Grigoriy Isaev: Due diligence in general is a tricky thing. **No amount of due diligence will substitute for common sense.** You have to know people, speak with them, and understand what exactly they are doing. Then also, you have the risk of something blowing up when people make some stupid decisions. *Generally, most people start out with good intentions and try to make money as best as they can. But then sometime down the road, they may get in a difficult situation, and that can happen a lot in Russia, and some make the wrong choices and end up digging even bigger holes for themselves.*

It would be very difficult for anyone to spot a situation like this from the outside if people were doing proper business from the beginning and then at some point starting to go wayside. That is why we are telling people that a proper hedge fund structure is a must, and I personally say that **you shouldn't invest a single ruble with anyone who id offering you a managed account in Russia if you don't know him personally for ten years or so.**

But people in Russia still like managed accounts. They think it gives them control, and managed accounts in general are also one of the reasons for the lack of growth of hedge funds. For investors, in my opinion the best way is to go with a proper hedge fund structure, meaning with an independent business administrator; the ability to play tricks with that kind of structure is limited.

Nikolai Dontsov: Small funds should be backed up by a stronger player, also in the case of managed accounts. *If it is a brokerage company which has been the market for more than 10 years, with a good reputation, good volumes and good rating, that helps a little bit. But* ***if the managed account is with a small brokerage firm, for example, a new name with a new license, I would discourage people to work with them until they have five, six years of history, good assets under management, and you personally know the people and their backgrounds****, you could try using them, but it is still a more risky situation.*



On the due diligence of quantitative funds, it becomes trickier because it is difficult to test the strategies and understand their depth. And very complex, because the funds may combine up to 10 or 15 different types of arbitrage strategies. Some of them are determined arbitrage strategies, where they take small risks, long or short positions on an intra-day basis for say a few minutes. The quality of the algorithms and the technical quality of strategies is not disclosed because they consider this as their know-how obviously, and those traders don't want to show the depth of the systems. But without actually understanding the alpha strategies, the technology and the algorithm, it is difficult to assess such a firm. So eventually, it comes down to the trust of the team and their track record, whether they have a proper hedge fund structure, the maintenance of this structure, and whether they are backed up by some large group or not.

Viatcheslav Pivovarov

We were approached this year by a high frequency fund, proposing to add their strategy to our platform so they could access to our first class infrastructure.

We thought it was worth exploring, but we could not get the data for our due diligence as they thought we would replicate their strategy.

Stephen Lewis: Just to pick up on Slava's point about checking data and due diligence, I think it is right and it has also been a big trend for us. We've actually had to allocate space in our operations offices to accommodate the number of operational due diligence people who come to see us. It is all about credibility and the scrutiny trickles down to all service providers, not just administrators. There are now full teams in the largest institutions that will meet with each service provider and perform deep due diligence.

Coming back to the regulatory and compliance points, we've seen additional effort from a number of our fund managers to set up the necessary infrastructure, despite the expense, because it is what their investors are demanding. Even the most naïve investor, if there is such a thing these days, will expect this. From the fund's perspective, it is all about the investor, and about choosing the right administrator, auditor and prime broker to meet their demands.

Grigoriy Isaev: The recent growth of hedge funds in Russia can also partially be explained by the crisis of the Russian financial industry on the sell side as well. It is no secret that employment and salaries on the Russian sell side have plunged in recent years. Even leading investment banks have frozen ruble salaries to the 2014 exchange rate. *So for people who are confident that they can do something, starting a hedge fund is now their only option. Indeed, the Russian financial industry has overgrown the size of economy for years and right now, the industry is going through a painful period of restructuring.*

In my opinion, many of those new funds that have launched not because the founder has some kind of elaborate plan or great expertise, but mostly because there is not much else to do. They say, 'let's try this as a startup, maybe it will work out.' It is like an option. 'We have some money, let's spend it.' Of course some of them will survive but **the general 20/80 rule will apply**. I don't see most of those funds surviving in five years.

Sometimes, you can have a crazy encounter in the hedge fund space or in those managed account type offerings, where someone tells you, 'I have a fund manager. He is very successful, he's been trading in the U.S. stock market and making good returns.' When you ask about his background, they say, 'He is just an ordinary guy, he is up here from around Moscow.' 'What does he do?' 'Well, he trades options on the S&P 500.' And when you ask, 'Why do you think this particular guy should have a niche in the S&P options?', he goes into some long story, saying this manager is mostly selling volatility, and there is an insurance premium, and it all sounds very sensible. But then you ask, *'Do you know that most of those type of guys either completely blow up at some point or have some huge drawdown, like 50-plus percent?'* And they just give you a blank stare.

This is another major issue among startup managers, especially those who have been focusing on volatility, which has been going down across the board. Sure, there have been very profitable strategies, either selling volatility directly or synthetically. But I know lots of people who advertise now based on a five-year track record which started exactly at the bottom, in March 2009. Some of them have had huge results, but unfortunately most of them don't think about what will happen going forward. That is probably the area where you will see lots of surprises for investors as well in the next two years or maybe even sooner.

Michael Workman: If you calculate the cost the private banks may charge their clients, from custody fees, transaction costs, buying and selling a bond, fees add up quickly. Plus, the execution might not be great. But when instead you strip those services out and look at the cost of putting assets into a fund structure, you are not losing much and actually might gain in some cases. A fund structure is scalable because you can always add other assets to it.

That is one of the things that we have done. When we look at our analysis from dealing with managed accounts, of course there may be added psychological comfort to some investors to have a managed account, but when you look at the cost of the execution and the day-to-day maintenance of it, you are many times actually better off putting the assets in a fund structure, even a scaled down one. That also is also a factor in helping explain the move in Moscow to funds versus traditional private banking, which is becoming less attractive due to the reduced value added and higher regulatory requirements.

Viatcheslav Pivovarov

Grigoriy just reminded me a story where we met a fund manager with a track record of a couple percent up monthly, and then an empty space in May after which it continued again. When asked what happened there, the manager explained: "Well there was an adverse event; and investor took all the money out so we had to restart." That reminded me of a saying, "Eat like chicken, shit like elephant."

Matthias Knab Let's look at risk management, hedging, absolute return. Slava mentioned before in the introduction that his returns were higher than the market, and at the same time, the volatility was lower. So that's actually a result of skill and of your risk management. How do you do your risk management? How do you excel there?

Viatcheslav Pivovarov: Our portfolio performance attribution is primarily driven by the fundamental decisions rather than the beta hedges.

First, we try to buy deep value with margin of safety. Second, our portfolio construction is long/short. So our exposure is sometimes negative but we do have a longer bias somewhere around 20% to 40% net. The third factor is proactive portfolio management. We compare our track records on specific positions as if they were buy-and-hold versus the way they have been managed and it looks more favorable both from return and volatility perspective. We believe that the Russian market is one of the least efficient globally and offers proprietary research opportunities.

In addition, we compute al key risk metrics, such as VAR, liquidity, exposure and stress tests.

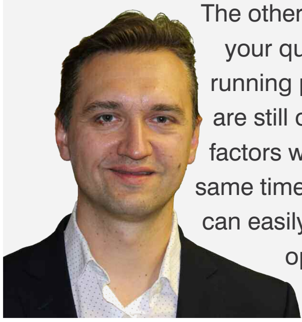
Grigoriy Isaev: We have a risk management framework which we mostly transferred from our previous sell side structure. We have different types of strategies and different types of limits.

We are proud that we went through last December pretty well. Our margin requirements with **our main brokers went up eight times overnight, and we still managed to survive that.** The last year and-a-half was a very tough environment but you could deliver decent returns if you did everything right.

I think it is impossible to solve the risk management riddle from a purely quantitative standpoint. No matter what kind of model you take, no matter which advanced data you have, you won't be able to get from the model's set of single numbers, what kind of exposures and what kind of risk levels you should have at any moment. *There should be some qualitative and macro-based judgments overall on top of this. No amount of time series could have predicted the market reactions at the time the central bank raised interest rates by 6.5 percentage point; the ruble fell 30% and the margin requirements went up eight folds across the board.* So you are either conscious of those types of risks or you are not. And if the strategy is built in such a way that it won't survive those types of events, you will be out of business sooner or later.

Having said that, we do have a quantitative framework. We look at all the numbers. Between the founders, we have some 60 years of experience in the markets. But we still discuss the situation, the environment, the macro risks which we may not be able to quantify exactly. Can we trade a little bit more or little less, what are the potential negative triggers like in terms of regulation which can catch us, etc. **I think such considerations are really key because, despite being a quantitative fund, and being proud of that, and using a lot of technology, we don't think that pure mathematics is an answer to risk management.** You also have to understand the market environment.

Nikolai Dontsov: Funds also need to consider other risks. Even if you ran only arbitrage strategies and you open just a few positions during short periods intra-day, you would still have issues with **credit risk**. And you need to be really careful about choosing the providers, the banks and the prime brokers through which you are entering a particular market segment. The question of credit risk has been highly important. We saw a situation where a brokerage company had gone down due to some internal or external factors, maybe even while they were waiting on a clarification of a regulatory framework rule. We are now in a much better situation, but still, even if you have a relatively small fund, you need to be backed up by a large brokerage and banking firm. *If you are going through mini prime, this mini prime should be backed up by a large banking and brokerage company, where you don't have to be concerned about the credit risk.*



The other thing is **operational risk management.** If you pretend that you control market risk more or less in your quantitative model, you still have huge issues around operational and technical risks. All the aspects running particular strategies or set of strategies are never fully automated from a technology standpoint. There are still one, two, maybe three people who sit there and control how these robots work and monitor multiple factors which were built inside the model. So there is a human factor behind it. It is a plus and a minus at the same time. It is a plus because you need to control it and it gives you more comfort. And a minus because you can easily make a mistake, and in this particular world, a mistake can cost you quite a lot. Therefore, operational risk management is an important thing.

Grigoriy Isaev: That is true, also for our fund, the main risk is credit risk. It is not only the Russian country risk per se, but the particular configuration of the sell side industry right now. In the last five years, independent brokerages in general have suffered hard. The state-owned banks took lots of high margin business from them on the IB side, because they were able to provide some financing to those players that didn't have access to it. As a result, some of the brokerages have taken on more risk; not necessarily market risk, because everybody is now allergic to market risk, but brokerages and banks have been loading up on credit risk as well.

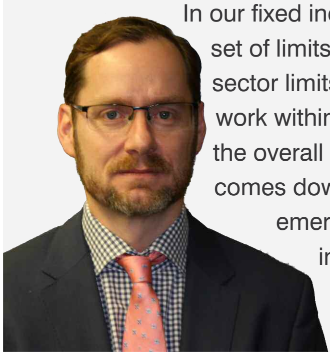
In general, **banking in Russia is in poor shape**. Most of the capital is fictitious and nobody really knows what the situation is, even for the bigger banks like Sberbank or VTB, but at least, with those type of institutions, you know that at the end of the day they will be bailed out.

But for us, the problem is that in general, the large banks won't deal with small funds either. If you are, for example, an emerging hedge fund manager and you have a quantitative strategy and you want to trade in Russia, there is no smart choice for you because the global banks have been closing up limits on anything Russia-related in the recent years, and the big local banks which are safer are not doing that business. So you are basically left with big brokerages, but they have quite high levels of credit risk in general. But not all, so there is still some opportunity.

This is the situation we find ourselves in our corner of the industry. It is not like you have a choice; 'this one is more expensive but it has country risk, this one is a little bit cheaper but it is dodgy.' You just have to trade with a subset of brokers which don't have much to show for in terms of balance sheet quality or credit ratings, for us, this whole issue of credit risk is a very important one.

Michael Workman: In the real estate sector, risk management is a little bit difficult once you have made your investment. But we see that the biggest risk now is the currency risk. For example, assets traditionally were financed in dollars and investors and owners thought they had dollar revenue streams coming from their tenants. But in many cases, now, those tenants have asked to switch to ruble contracts, or to switch out at different exchange rates to pay their rents..

We are seeing a number of cases of that now. There is more interest to negotiate ruble contracts, as they match better with ruble rent streams. This will probably be a short-term to medium-term trend though. Ultimately, once things stabilize, people will likely go back to dollar or euro contracts, because that is where their financing costs will ultimately be. Long term construction financing and construction costs will be denominated in US dollars or euros. So in real estate, the main thing is trying to manage the potential mis-match between current liabilities compared to the expected cash flows from the underlying assets.



In our fixed income portfolios, we use much more proactive risk management techniques - we have a detailed set of limits and guidelines that we use to manage our exposure. We look at single issuer limits, country limits, sector limits among others. Of course, we concentrate on our duration and the maturity of the portfolio and work within pretty comprehensive Var and DV01 limits. When we need to be defensive, we will try to shorten the overall maturity profile of the portfolio and make sure we are in higher credit quality name. But ultimately, it comes down to having a proper investment strategy that fits with the risk you are prepared to take. In emerging markets, there will always be headline risk and some volatility not related to your underlying investments. So we really focus on single issuer credit research and make sure that each trade matches up with what we feel is acceptable risk vs return.

Stephen Lewis: We have a robust risk framework to ensure our processes and policies mitigate risk and comply with all relevant regulatory standards and best practices. We have taken this philosophy one step further and a few years ago we developed **risk management technology** alongside a number of medium-sized to large fund managers in various markets. Over time investors have begun using it as well, so in some ways we sit on both sides of the fence.

Some of those sophisticated risk management approaches are actually just technology. Coming back to what Grigoriy was saying about choosing the type of fund you want to allocate to, some of those allocation models are becoming ever more sophisticated, and there is genuinely an opportunity there for some of the smaller funds.

We have two continuums now. We have the very large investors dealing with the very large funds. And then there is a substrata of high net worth individuals, family offices, etc. dealing with the smaller funds. And the level of risk management in that substrata is ever increasing.

For example, the last client who implemented our risk management technology was a family office. They now have many of the same models and are looking at similar variables. Obviously, they are looking at it in a portfolio sense, but because we enabled them to drill down effectively, they have access to more information and can make better decisions and this offers more comfort for both the managers and the investors.