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Opalesque Roundtable Series '16

INVESTOR ROUNDTABLE

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Editor's Note

The bigger allocators exiting the hedge fund space will soon return

In the alternative investment industry the rules are constantly changing. We continue to see successful managers, but we also see a lot of managers who used to be successful and who are struggling right now to deliver alpha and raise assets, or even shutting down their funds. They point to increasing regulation, fee pressure, operational requirements, along with challenging global markets, all of which have combined to put extreme pressure on performance. However, not all investors see hedge funds going under.

Peter Tarrant from BTIG, whose firm regularly talks with about 1,300 investors globally, believes that the bigger allocators who are exiting the hedge fund space will soon return, and that the **demand for alternative investments in three to five years will be twice what it is today.** Consultants such as Cliffwater say that the current environment is exactly one where you actually would want hedge funds in your portfolio.

Different roles and return profiles of emerging and mega funds

Steve Simmons, Head of Alternative Investments at Sideris Capital Partners, a family office focusing on emerging managers which has in fact never allocated to a fund in excess of $75mm AUM, says that most critical observers base their opinions on the performance of the largest managers. However, the performance of those household name funds is not representative of the range of sizes, strategies, and opportunities in the global market.

Simmons describes how he is playing in an extremely different sandbox, which is a universe of smaller managers that are usually overlooked by most allocators and industry media. Investing in emerging managers requires a high skill-set and due diligence, but in his experience they also tend to outperform by roughly 200 plus basis points in the first two to three years. At the same time, the institutionalization of large firms has undisputedly been a natural evolution in this industry. Maybe these multi-billion dollar hedge funds won't be making "superior returns" anymore, but they still serve a valuable role in the portfolios of the big institutions.

Investors clearly prefer lower fees, but that preference could be short-sighted

Managers are now forced to spend more time and energy than they ever have before on operational due diligence and regulatory filings which do not contribute to the research of how to generate alpha. When you couple that reality with increased fee pressures, it makes it very hard for management to seek and to hire the next great trader or analyst, and so a question we should ask as an industry is, *"Will downward fees cause great talent to not enter the industry currently or in the future, thereby jeopardizing great ideas and innovation that create alpha?"*

Meanwhile, the teams at all of the large, high profile launches all started out hiring a superstar Chief Operating Officer, Chief Financial Officer, and dedicated marketer at the outset. They understand the value of the investment in building out a strong supporting team. If you look at the top 20 big launches over the last two years, they all have large staffs that are ready to roll and have infrastructure in place from day one. Also smaller emerging managers realize they must have a COO and CFO. However, it is now perfectly acceptable to use the outsourced model to perform those functions. Until they reach approximately $60 million in AUM, a manager can outsource the CFO, COO, or CCO functions. Because of these support functions the industry is now providing to emerging managers, this space today is in a much better position compared to five years ago.

The 2016 Opalesque Investor Roundtable, sponsored by Arthur Bell, united the following experts:

1. Chris Solarz, Managing Director, Cliffwater
2. Corey McLaughlin, Managing Member, Arthur Bell
3. Larry Morgenthal, Managing Member, Soundlink Partners
4. Peter Tarrant, Head of Capital Introduction, BTIG
5. Rob Kaplan, Senior Managing Director, EnTrustPermal
6. Steve Simmons, Head of Alternative Investments, Sideris Capital Partners

The group also discussed:

- What has been the success recipe for the large, high profile launches over the last two years?
- What's the best advice for start up hedge fund managers?
- A neglected responsibility: The issue of succession
- What are the most common errors of managers when launching?
- How is the popularity of quantitative funds shaping the industry?
- What are some of the new creative fee models?
- What type of funds and managers are investors searching right now? In which sectors do they see opportunities?
- Which red flags are investors looking for?
- What do investors suggest to managers to do a better job?
- What is the common trap most investors fall into, missing out to invest in promising early stage managers?
- What's the best way for an investor to review a pitch book?

Enjoy!

Matthias Knab
Knab@Opalesque.com

Participant Profiles

(LEFT TO RIGHT)

Greg de Spoelberch, Chris Solarz, Rob Kaplan, Peter Tarrant, Steve Simmons, Corey McLaughlin, Larry Morgenthal

Opalesque 2016 Investor Roundtable Sponsor

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Cover photo by Sam Valadi: Charging Bull, which is sometimes referred to as the Wall Street Bull or the Bowling Green Bull, is a bronze sculpture, originally guerrilla art, by Arturo Di Modica that stands in Bowling Green Park in the Financial District in Manhattan, New York City.

The 3,200-kilogram (7,100 lb) sculpture stands 11 feet (3.4 m) tall and measures 16 feet (4.9 m) long. The oversize sculpture depicts a bull, the symbol of aggressive financial optimism and prosperity, leaning back on its haunches and with its head lowered as if ready to charge. The sculpture is both a popular tourist destination which draws thousands of people a day, as well as "one of the most iconic images of New York" and a "Wall Street icon" symbolizing Wall Street and the Financial District.

Di Modica spent some $360,000 to create, cast, and install the sculpture following the 1987 stock market crash as a symbol of the "strength and power of the American people." The sculpture was the artist's idea, not the city's. In an act of "guerrilla art," he trucked it to Lower Manhattan and on December 15, 1989, installed it beneath a 60-foot Christmas tree in the middle of Broad Street in front of the New York Stock Exchange as a Christmas gift to the people of New York. That day, crowds came to look at the bull, with hundreds stopping to admire and analyze the gift as Di Modica handed out copies of a flier about his artwork.

The police seized the sculpture and placed it into an impound lot. The ensuing public outcry led the New York City Department of Parks and Recreation to install it two blocks south of the Exchange in the plaza at Bowling Green with a ceremony on December 21, 1989.

Introduction

Corey McLaughlin
Arthur Bell CPAs

My name is Corey McLaughlin, and I am the Managing Member of Arthur Bell. We are a CPA and advisory firm that has specialized exclusively in the alternative investment industry for over 40 years, with a commitment to protecting the best interests of clients and investors. Our firm performs tax, audit, consulting, performance reporting, and family office services.

Steve Simmons
Sideris Capital Partners

I am Steve Simmons, the Head of Alternative Investments at Sideris Capital Partners. We are a single family office, and I oversee our hedge fund and venture capital investments. In the hedge fund space we concentrate exclusively on emerging managers, so I spend most of my time analyzing that segment of the alternative investment world. We do not accept outside capital, but we frequently share ideas and co-invest with other family offices.

Larry Morgenthal
Soundlink Partners

I am Larry Morgenthal, Managing Member at Soundlink Partners. My partner and I founded the firm after we both spent many years in the hedge fund and fund of funds industry. We launched Soundlink as a vehicle to give ourselves and like-minded investors the opportunity to continue to invest in hedge funds in a more opportunistic, concentrated way.

Chris Solarz
Cliffwater LLC

My name is Chris Solarz, and I am pleased to be here to discuss the investor landscape in alternative investments. I am a Managing Director from Cliffwater LLC, which is an alternative investment consultant. Our three lines of business are hedge fund advisory, private equity advisory, and real asset advisory. Our clients range from large public pension plans to small private plans, endowments, and foundations.

Cliffwater divides the hedge fund world into five strategies: equity long-short, credit long-short, event-driven, multi-strategy/RV, and global macro. I oversee the global macro hedge fund research and focus on both systematic and discretionary strategies.

Peter Tarrant
BTIG

I am Peter Tarrant, the Head of Capital Introduction at BTIG. We are a global financial services firm with 13 business units including equity sales, options, futures, fixed income, commodities and rates, prime brokerage, and outsource trading. We launched with five people in 2002 and today employ 530 people across six countries. I have been with the firm since inception, and my responsibilities touch all BTIG business services that are related to emerging managers, including their capital raising efforts.

Rob Kaplan
EnTrustPermal

My name is Rob Kaplan. I am a Senior Managing Director at EnTrustPermal, and I also sit on the Investment Committee. EnTrustPermal is one of the top five largest global funds of funds, with $26 billion in assets under management. We monitor and invest into just about every type of hedge fund strategy. We look at global macro, long-short, event-driven, activist, co-investments, and also allocate in many different structural formats. We provide Separately Managed Accounts, daily liquidity funds, and longer duration capital structures for investors, so we touch all ends of the structuring spectrum across all strategies.

Greg de Spoelberch

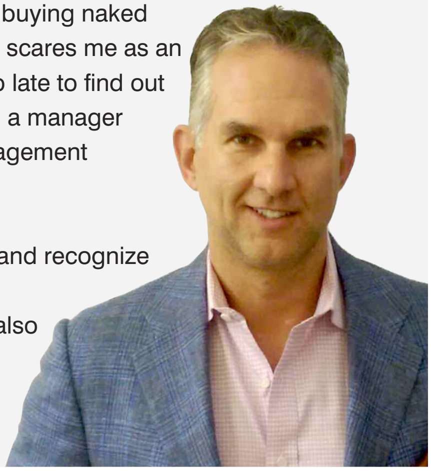
In the alternative investment industry the rules are constantly changing. We continue to see successful managers, but we also see a lot of managers who used to be successful and who are struggling right now to deliver alpha and raise assets. They point to increasing regulation, fee pressure, operational requirements, along with challenging global markets, all of which have combined to put extreme pressure on performance.

A large proportion of managers can figure out how to make money in one set of rules or market conditions, but when the rules change, it seems that not all of them can adapt. The rules have clearly changed and continue to evolve, as managers look for ways to achieve alpha. What do you think the "New Normal" is in alternative investing, and how do you think managers can adapt to survive and once again achieve alpha?

Steve Simmons: Our family office looks at hedge funds all day, every single day, and I find it frustrating when I read press coverage and LinkedIn posts that depict hedge funds as being "dead money." Most critical observers base those opinions on the performance of the largest managers, which is usually comprised of the top five to ten household name brand funds. However, the **performance of those household name funds is not representative** of the range of sizes, strategies, and opportunities in the global market. Our reality is that we are playing in an extremely different sandbox, which is a universe of smaller managers *(we have never allocated to a fund in excess of $75mm AUM)* that are usually overlooked by most allocators and industry media. We believe that the smaller managers have much more of an incentive to outperform and deliver alpha, so that is the sector of managers that we target for our investments.

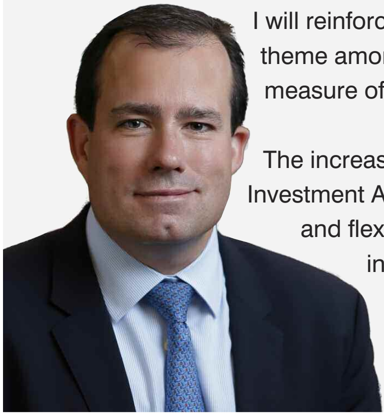
However, regarding the "New Normal" environment that managers are now facing, those emerging managers do need to learn to be more flexible to tailor their offerings to meet the needs of investors. For example, all of our family office allocations are implemented via a **managed account** structure. I am still surprised when I see a number of managers (and investors for that matter) who still do not understand or appreciate the value that managed accounts can provide, particularly in this post-Madoff environment where the need for transparency is of utmost importance. We do not use managed accounts for the purpose of liquidity; we use them purely **for transparency.**

Our motivation for that is to not only allow us to run hedges or overlays against the underlying managers if needed, but most important, we want to know that a manager is sticking to their specialty and strategy. When we have a manager focusing on the biotech sector, for example, we need to know that he or she is trading biotech and not buying naked Google options, which we have seen happen before. Style drift is definitely something that scares me as an investor, so I need full transparency; and waiting until the 15th of the following month is too late to find out when your manager has dropped the ball. As an investor, the worst phrase I can hear from a manager after an unforeseen drawdown is.. "As a result of this, we have implemented new risk management procedures"…



My advice for managers is to make a concerted effort to adapt to the current environment and recognize that in order to raise assets, you have to look at every opportunity to really build out your offerings to suit investors. The managed account offering is a good first step, and I would also like to see that structure become somewhat more standardized and streamlined for the benefit of allocators and asset managers.

Peter Tarrant: The managed account discussion has been gaining momentum for the last five or six years, but has peaked this year, as you would expect in any difficult asset-raising environment. Whenever you see a low point in the fundraising cycle, you see a spike in opportunities that are more beneficial to the investor. This year you are seeing major allocators who have never used separate accounts in the past, now moving in that direction.



I will reinforce Steve's point about the value of structures which provide transparency, because it is a major theme among investors. The investor does not look for separately managed accounts in order to have a measure of control over a manager. The significance is to help allocators achieve full transparency.

The increasing burden of more onerous compliance requirements now applies to all Registered Investment Advisors (RIAs), and that includes funds of funds. Technology has also delivered accessibility and flexibility for investors, particularly the larger institutional investors who can now customize their investments. There are a number of factors coming together all at once that are driving the separately managed account movement. Investor requirements for this level of transparency are only going to become more commonplace going forward.

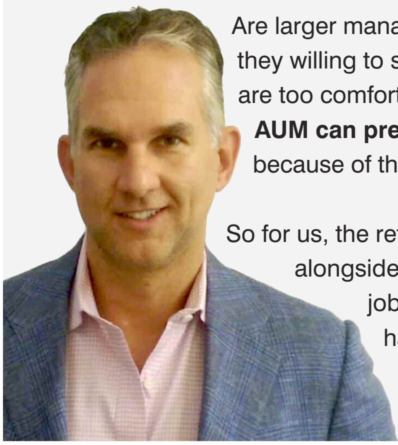
Rob Kaplan: A component of Greg's question concerns the "secret sauce" that will help these managers to start generating alpha again, because clearly the hedge fund industry's performance has been lackluster for the last few years. My position from the allocation perspective of a fund of funds is that managers have to get back to a nuts and bolts approach, where they focus more on performance and delivering returns.

The market throws up opportunities every day. *Do not tell us that there are not opportunities to deliver returns in the markets, because there most certainly are.* If the S&P 500 is up 7% year to date, that is a weighted average index. That means that a certain percentage of stocks are doing much better than 7%, and managers should be long those stocks, and a certain percentage are underperforming, so managers also have plenty of shorting opportunities. There are plenty of entry points in the market where talented funds can capitalize, so I do not want to hear excuses from managers as to why they cannot deliver returns. We are experiencing difficult market conditions right now, but talented managers should still be able to deliver the returns that we need.

Peter mentioned the increased growth of compliance and the added regulatory burden on managers. Managers have to adapt to this new environment, because those requirements are not going to abate. In order to adapt successfully, funds must hire effective professionals to handle all compliance-related issues, because that division of labor allows managers to return to focusing on the most important element to their survival and growth, which is actually making money.

Some managers have gotten away from that core principle and are far too focused on the sales component of the business and on raising assets, when the most important element is and always will be delivering solid returns. I think a lot of them are missing the ball, because if they do not return their focus to making money, their business is doomed. I do think they will return to form in delivering alpha, which is what the hedge fund industry has done so well historically.

Steve Simmons: I agree with Rob that managers need to return their focus to the core principle of driving returns. We look at early stage managers exclusively because of their return potential in comparison to the bigger funds, and because those managers are often willing to take more risk to outperform. A fund running $5 billion AUM wakes up on January 1 with the knowledge that the firm is theoretically receiving a 2% management fee simply for showing up to work; and a moderately decent annual return of 5% - 7% may be beneficial for that firm's well-being; however, that modest number may not provide enough value to the end investor.



Are larger managers more willing to provide an adequate risk profile to meet my needs as an investor? Are they willing to shake things up in their portfolio, or do they take most of the risk off of the table because they are too comfortable with "safe returns"? There is also the question of flexibility in their trades; **excessive AUM can present a vicious cycle** for the larger firms, where they cannot deliver adequate returns because of the inability to effectively size trades.

So for us, the return potential of these smaller stage participants who are willing to target higher performance alongside suitable risk is far more beneficial. Many emerging managers will leave a six or seven-figure job to start a business, so risk is built into in their DNA and their investment philosophy. I am happy to back those managers who have their own skin in the game, and take the professional risk in starting their own fund.

Larry Morgenthal: All of the points that have been made by my fellow panelists accurately reflect a major divergence in the industry between the role of the largest asset managers and that of the smaller, emerging managers. Conceptually, smaller shops should find it easier to generate high returns. While the statistics do go back and forth on whether or not that is true, I do agree that emerging managers are more nimble and can generally make money more easily, so family offices like Steve and Sideris Capital are backing those funds to drive higher returns. At the other end of the spectrum, the big behemoth asset managers have really become asset gatherers and client service engines, which are catering to the very large asset pools of institutional investors.

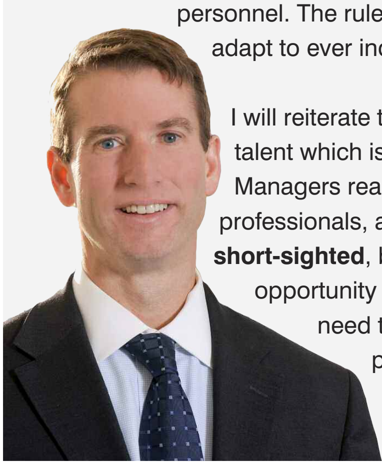
The institutionalization of large firms has been a natural evolution in this industry. When I began in this business roughly 25 years ago, the industry was very successful. Managers and investors both made a lot of money, but there were only a few hundred hedge funds that existed globally. Now there are over 10,000 hedge funds in existence. Institutional investors often do not have the bandwidth or staff to support research and investments into this broad range of managers, so they look to the larger shops which can handle large allocations to employ their capital into alternative strategies. *I do not see the day in the future when these multi-billion dollar hedge funds are making "superior returns" anymore, but they can still serve a valuable role in the portfolios of the big institutions.* Going forward, both small and large managers will continue to provide value for specific investor classes who have a wide variety of investment mandates.

Corey McLaughlin: When you take a step back and look at the industry, there are a lot of factors that are shaping this "New Normal" environment for managers, and we see the effect on our client base every day. Specifically, regulatory pressure and fee pressure have become the biggest challenge on the most important resource that a hedge fund has, and that is focus of its human resources. Regulatory pressures can take time and focus away from the core of a manager's business.

Managers are now forced to spend more time and energy than they ever have before on operational due diligence (ODD) and regulatory filings. These elements are important, because funds must be fully compliant, but these same elements do not contribute to the research of how to generate alpha as the markets change, and do not aid in improving fund returns.

When you couple that reality with increased fee pressures, it makes it very hard for management to seek and to hire the next great trader or analyst who can generate innovative ideas that may help to catapult the firm to the next level of alpha generation. A question we should ask as an industry is, *"Will downward fees cause great talent to not enter the industry currently or in the future, thereby jeopardizing great ideas and innovation that create alpha?"* In addition, a manager may face the challenging choice of hiring someone with the talent to digest all of those regulatory issues instead of making the investment in a new analyst or trader, which draws resources away from the trading operations and the bottom line.

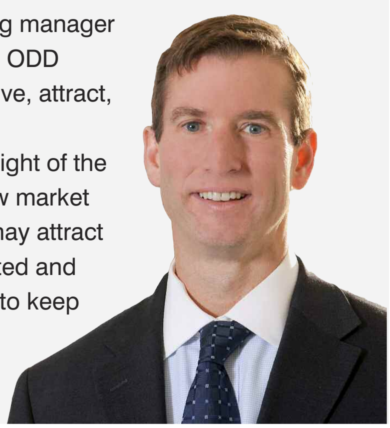
The regulatory pressures continue to pile up. For example, the SEC has recently come out with a proposed rule that would require written business continuity plans which would need to be tested annually. Disaster recovery and cyber-threats are included in that proposed regulation, but managers will also need to define protocols in the case of the departure of key personnel. The rules are constantly changing and presenting new challenges, so managers need to continually adapt to ever increasing regulatory rules and standards.



I will reiterate that the most important resource a fund can have is investment talent, and I feel as though the talent which is commonly associated with the hedge fund industry has been hard to find in recent years. Managers really need to think long and hard about the issues of performance and the cultivation of talented professionals, and so do investors. **Investors clearly prefer lower fees, but that preference could be short-sighted**, because there is a potential that the long-term effect is to put constraints on a manager's opportunity to generate alpha. I am interested in the investors' perspectives, because as an industry we need to make sure that we are doing the right things to recruit and encourage the most gifted people, who will become the next generation of managers and traders.

Greg de Spoelberch Steve Cohen of Point72 recently went so far as to say that he is "blown away by the lack of a talent" in the hedge fund industry right now.

Corey McLaughlin: It is a very real concern. Personally, I was very worried about the emerging manager sector for a while because the bar of entry was so high in terms of compliance, capital raising, ODD requirements, and fee pressure. With all of these pressures, how do emerging managers survive, attract, and retain talent? The landscape has improved a bit, but the ability to innovate and hire great professionals remains difficult with the added pressures we have discussed. We cannot lose sight of the greatest asset that this industry has, which is the people, and must continue to encourage new market entrants and provide opportunities for them to have lucrative financial situations so that they may attract great talent which will assist with generating great returns for investors. The industry was created and expanded through innovation and creative thinking, so we all have to remain creative in order to keep this industry on the cutting edge.



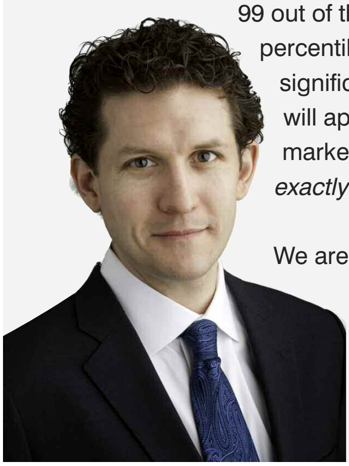
Chris Solarz: As a consultant, we look at all strategies and hedge fund sizes across the hedge fund industry. In order to best inform our institutional investor clients, we keep a pulse on all aspects of the current hedge fund environment, including investor inflows and outflows. There were roughly 10,000 hedge funds in existence and $3 trillion invested in the industry at the start of 2016, but this is the first year since 2009 that the rate of hedge fund liquidations is exceeding the rate of hedge fund launches. So we are indeed seeing a **consolidation** of the industry.

That industry consolidation and poor performance has led to an overwhelming amount of media attention which focuses on the failure of hedge funds. I am not going to present a full defense of the performance of hedge funds, because returns have been underwhelming in recent years, but I do think that the media coverage of the industry has been far too critical and is largely uninformed. We hear about many hedge funds closing, but of the $3 trillion invested in hedge funds at the start of 2016, only $20 billion has left the industry through the first half of this year. That equates to less than one percentage point. The media hype and negative attention have been wildly overblown.

As Steve talked about earlier, if you simply read the headlines or listen to casual observers, you would think that the industry is collapsing. Despite a marginal amount of consolidation, the industry as a whole is doing very well, so I think there is far too much criticism from outsiders. On the other hand, speaking from the perspective of a consultant to large investors, I do believe *allocators can fall into the trap of an overreliance on hedge funds to truly be all weather investment vehicles* that are capable of holding up in volatile markets, because a lot of strategies are not, and we are now going through an extraordinarily volatile period in the markets.

Investors must evaluate the proposition of a hedge fund investment in light of their expectations for future market environments. Hedge fund returns are composed of cash plus beta plus alpha. In this zero interest rate environment, cash returns nothing. With $12 trillion invested in negative interest rates around the world and simultaneous all-time highs in fixed income and equity markets, beta is looking stretched, too. Hedge fund alpha can be 4% per year annualized, but that is over time and alpha is not consistent.

This is the challenging return environment that I would call the “New Normal” in which managers have to develop their businesses. We now live in a depressed lower return environment where we have Swiss bond yields negative out to 50 years and you have negative yields throughout Europe and Japan. We have been in a bull market for eight years now, and investors need to consider where we are going to be five years from now. The S&P and the US Treasury Market have performed in the 99th percentile of five-year trailing returns for the past century. This means that this trailing 5 year period has done better than 99 out of the past 100 years for stocks and bonds. Sure, five years from now we could also be in the 99th percentile, but I think that prospect is highly unlikely and that the return environment will change significantly. If and when the market landscape shifts, the overfed beta in the bond and equity markets will appear far less favorable. While alpha certainly has been compressed over these past five years, as markets stabilize I think that trend will change, and managers will get back to delivering alpha. *This is exactly the environment when you want hedge funds in your portfolio.*



We are in a shallow trough of hedge fund launches right now due to recent poor alpha production and the outperformance of long only markets, but historically hedge funds have stood the test of time and they have been able to deliver strong alpha for clients. The contraction in the industry can be a good thing, too. Half of the 10,000 managers are below average by definition, so some attrition can be a positive thing to “trim the fat” from the industry.

Greg de Spoelberch What advice would you give managers regarding expectations for performance and success in this new environment? Rob, you indicated that managers should focus more heavily on producing returns, and if they do that, then the investor capital will eventually find them.

Rob Kaplan: My strongest piece of advice to any manager who is starting out is that **your first hire should be a President or CEO-level professional** who can talk intelligently with clients about the book and understands the complexities of the regulatory environment. You need a dedicated professional to run the business, because a manager's time is best served by focusing on the portfolio.

My advice is to hire a partner who handles every other operational element of the business, which frees you up to simply trade and invest. That will help you to drive performance, which was the point I made earlier, and which is paramount to the survival of your business. *This person should not be one of your analysts, but should be a dedicated, experienced partner.* I frequently tell managers to take that step, but there is a psychological challenge for many managers who do not want to accept that reality, because they want to have full control in running their own business. A manager has to realize that they have limited brain capacity and time to dedicate to operations.

Larry Morgenthal

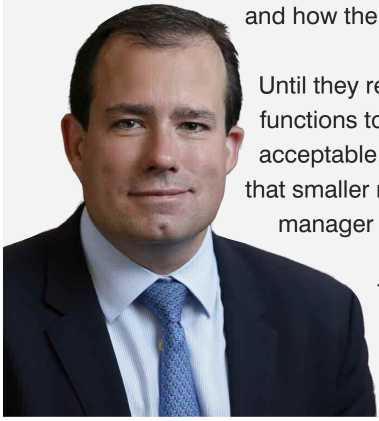
I agree with Rob, but what I have found in my experience in allocating to managers is that the psychological component of what drives a person to want to be a hedge fund manager also makes them very reticent to give up any level of control. So I agree wholeheartedly with Rob, but my question is how do managers react when you communicate that message to them? Do people actually listen to you and take action accordingly?

Rob Kaplan

Some do listen, but also a lot of managers are wary of giving up an ownership stake in their business. A manager is not going to give away 50% of their business, but they should give a meaningful stake to a qualified professional to handle all responsibilities which are external to investing. Find someone outstanding and accept that reality, because in the long run it will make your business better.

Peter Tarrant: The teams at all of the large, **high profile launches** over the last two years exemplify Rob and Larry's perspective. *They hire a superstar Chief Operating Officer (COO), Chief Financial Officer (CFO), and dedicated marketer at the outset*. They understand the value of the investment in building out a strong supporting team. If you look at the top 20 big launches over the last two years, they all have large staffs that are ready to roll and have **infrastructure in place from day one.**

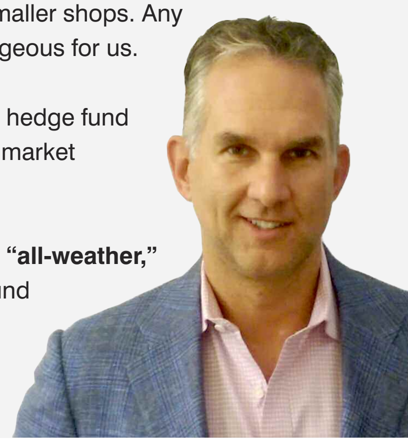
Among emerging managers, there is recognition that you must have a COO and CFO. However, it is now perfectly acceptable to use the **outsourced model** to perform those functions. The industry has filled that gap for emerging managers in a very innovative and economical way. That goes back to Corey's point about his concern for the emerging managers, and how the industry can facilitate their survival and growth, and remain innovative in order to help them.



Until they reach approximately $60 million in AUM, a manager can outsource the CFO, COO, or CCO functions to a firm like Constellation Advisors or Agile Fund Solutions. That practice is perfectly acceptable, because emerging manager investors understand the cost structure and regulatory burden that smaller managers face, and they recognize the value that those third parties provide. When the manager raises money, investors will often want to see those functions brought in-house.

This is just one example of the adaptations happening in the industry that are fruitful for all parties. Service providers are stepping in and standardizing operational services in ways that are satisfactory to the organizations that will invest early in emerging funds.

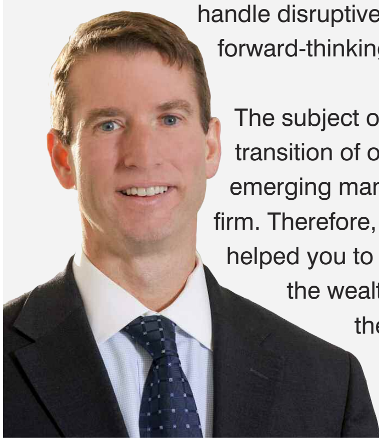
Steve Simmons: I agree with Peter that having the ability to outsource is fantastic for both investors and managers. It facilitates our family's mandate, which is to invest early in those shops that may not yet be fully institutionalized, but who we believe can drive the best returns. *The prevailing argument for emerging managers is that they tend to outperform by roughly 200 plus basis points in the first two to three years.* Those numbers are skewed somewhat as funds that have shut down in that time period are not included, but the performance advantage definitely exists for the smaller shops. Any industry adaptation that allows them to focus on their core business of investing is advantageous for us.



Revisiting the concept of performance for a moment, we believe in diversification within the hedge fund space, as we don't believe any single fund is "all-weather," and able to outperform in every market environment. I think that type of fund, with a few exceptions, is very hard to find.

However, **that does not mean that an investor's hedge fund portfolio in total cannot be "all-weather,"** and should not deliver alpha in all market cycles. I believe successful utilization of hedge fund investing comes down to proper capital deployment and portfolio construction without needing a crystal ball to determine market movements.

Corey McLaughlin: Regarding Greg's question about advice for managers, in my 18 years in the industry, I have seen a lot of **managers neglect the concept of succession** until it is too late. So my suggestion would be to check and ensure that a manager can continue to be effective with his trading activities, research, and regulatory filings if there are key personnel departures. Managers should ask themselves questions like, *"Are the investment processes repeatable, or do they rely on a single person? Is someone of such a significant influence that if that person were to leave, there would be no one to fill that void?"* A succession plan is vital for a fund manager and their investors, because it ensures the ability of the organization to handle disruptive or catastrophic events, which makes the business far more sustainable in the long term. A forward-thinking approach from day one is critical in order to protect your business and your employees.



The subject of a succession plan applies to emerging managers in particular, who should consider how the transition of ownership will function in the future from a financial standpoint. For example, if you are an emerging manager and you become ultra-successful, that will create a tremendous amount of value in your firm. Therefore, you need to ask yourself how do you transition the organization to the professionals that have helped you to create the success of the manager and been a catalyst of growth? Do these personnel have the wealth to purchase equity in the manager once it has become ultra-successful or has the value of the equity surpassed their ability to buy-in? Succession is very often overlooked, but a manager has to plan to make sure it can continue for the long-term.

Peter Tarrant

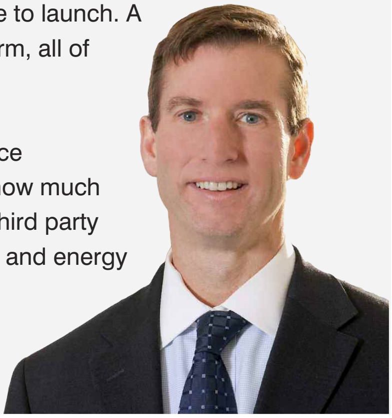
Corey makes a valid point, which feeds into the topic of the distribution of equity to employees. I do not think that managers think hard enough about how to distribute ownership of their fund, including the distribution of points, whether real or phantom, to employees. If you look at the largest funds, in many cases their staffs today are far different from the teams they started with. Funds of any size should consider the timing and percentage points of the distribution of hard equity employees, and how to align incentives correctly as the fund grows. I do not hear a lot of managers discuss or consider succession plans, but they absolutely should.

Chris Solarz

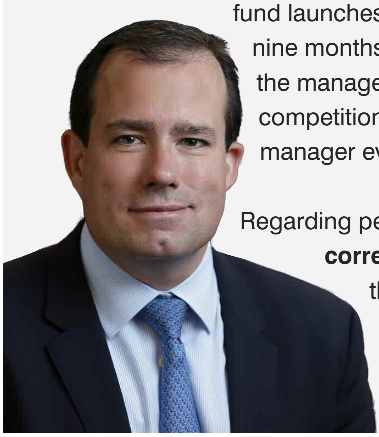
This may sound glib, but my best advice for start up hedge fund managers is to deliver positive double digit returns in your first year. Performance stands alone as the single, top priority. You need to perform in year one, it is as simple as that. Marketing and business building can wait for a few years because it won't be possible without a solid track record to pique allocators' interest.

Corey McLaughlin: Another piece of advice for managers is to recognize how long it can take to launch. A manager has to pick a legal adviser, a prime broker, a third party administrator, and an audit firm, all of which can take significant time and effort.

I agree with Rob's recommendation about hiring a partner or CEO, as a search for these service providers could take months of work before a fund gets to launch. Managers need to realize how much time and energy goes into launching a fund, and the challenge of picking the right team and third party service providers. Third party service providers are critical partners in your business, and time and energy should be spent to make sure you are hiring firms that will act in that way as it will make your business much stronger.



Peter Tarrant: We also see managers looking for an **unrealistic amount of capital** before they get started, which often delays fund launches. Let's say that a manager has $10 million of friends and family money, but they waste six to nine months trying to raise another $90 million and reach that $100 million AUM mark. The reality is that the manager will probably never reach that level before he actually launches, and in the meantime, the competition has already launched and has begun establishing a track record, which puts the delayed manager even further behind.



Regarding performance, I can tell you from personal experience in watching allocation trends that the **correlation of performance to actual allocations is ultra-high** right now, so I agree with Chris that the fund has to perform well in the first year. However, before they even start running the fund, they have to be realistic about their capital raising expectations, or they can waste a lot of time trying to reach an asset level that is not achievable.

Greg de Spoelberch

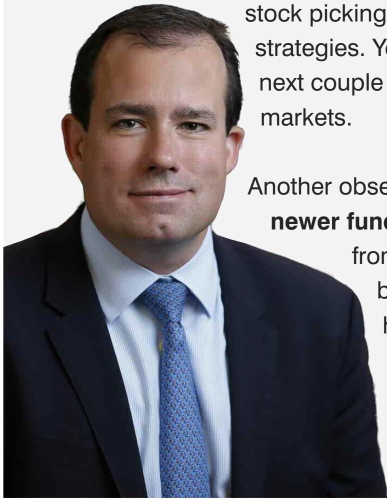
A number of you have referred to the overwhelming wave of media attention which has been critical of hedge funds and their recent performance, and would seem to indicate that investors are fleeing the industry. Certain large institutional investors such as CalPERS and NYCERS have actually taken steps to eliminate their portfolios.

Have those decisions impacted investor perceptions and caused further outflows? Chris's point from earlier was that when you look at the numbers, less than 1% of the total assets invested in the industry have exited the sector this year. I'm curious about the myth vs. reality of investor outflows. Are investors redeeming?

Peter Tarrant: The CalPERS decision to exit the space is a headline that sounds very impactful, but in actuality has very little effect on the emerging managers that we work with, since those large organizations do not traditionally invest in smaller firms.

I also believe that those bigger allocators who are exiting the hedge fund space will soon return. Although there has been a small contraction this year, if you look at the historical timeline, the industry has performed very well and has grown consistently. I think the **demand for alternative investments in three to five years will be twice what it is today.**

Steve Simmons Peter, do you see large institutional exits from the hedge fund space as part of a strategy to reduce the fees?

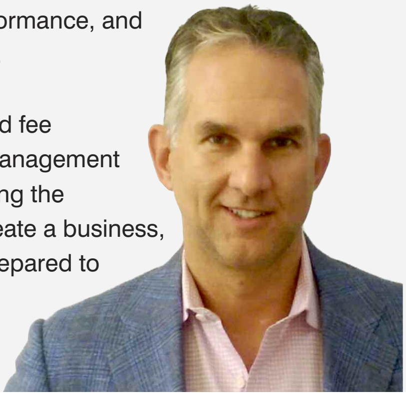


Peter Tarrant: I understand your perspective, but I do not think that is the case. What I observe is a genuine lack of appreciation for stock-specific alpha generation at certain levels within these large organizations. The recent market volatility is probably a huge driver of that mentality among large investors, because in such a challenging environment, stock picking has become very difficult. That is why we are seeing a significant move towards quantitative strategies. You are going to continue to hear a great deal of investor buzz around quantitative funds for the next couple of years, because investors are wary of some of the more traditional strategies in these markets.

Another observation I have is that the **bigger players are moving downstream to look at smaller and newer funds**. Industry-wide fee pressure allows investors to secure extremely low fee structures, even from talented teams who have spectacular pedigrees. If an investor is willing to take the risk and be an **early stage allocator,** they can potentially access a fee free environment once that fund hits $300 to $500 million in AUM. If you are a day one investor, you may have to pay fees for the first year, but going forward you will be rewarded for your early support. I am even seeing pension funds act as anchor investors to help funds launch. I have never seen that before, and it is an exciting development.

Steve Simmons: We are also seeing a great deal of **creativity with fee structures.** Some managers are even waiving the management fee, but raising the performance fee while setting a hurdle rate that is higher than normal. We have invested with a number of managers who agree to a 0% management fee and a 30% performance fee with a high initial hurdle rate. We love to incentivize managers who recognize that they will be rewarded for their performance, and who really believe that they can surpass their hurdles without taking undue or excessive risk.

There is a significant due diligence responsibility on our side before we invest in any modified fee structures, as we need to ensure the manager can survive without the revenue from those management fees. Corey's point about succession plans and day one planning is spot on, because building the business from day one is the key to success. Everyone wants to "be their own boss" and create a business, but is that business built to last, and for that matter, when money starts coming in are you prepared to deal with a myriad of operational, infrastructure, HR, and all such issues that come with success?



Greg de Spoelberch As investors, what you are looking for in your portfolios right now, and what kind of funds are you looking for in your businesses?

Larry Morgenthal: I would like to add a point of advice for managers, which is that they should appreciate the importance of **effective communication**. Hedge funds, surprisingly even the smaller startup managers, do not always treat their investors as partners. I have found that if you communicate well with people, when times turn bad and your performance is not there, they are more likely to stand by you. *If you do not communicate well with your investors when times are good, they will have far less leeway and patience when your fund endures a difficult performance period.* View your investors as true partners, and be open with them about your outlooks and concerns beyond simply the reporting of your performance numbers. An active dialogue carries a lot of weight with me.

Regarding areas of interest for our portfolio, we are trying to find **dislocations** in the markets that create opportunities. Our method for pinpointing specific managers that can capitalize on those opportunities ties into that same theme of the value of a manager's effective communication. A manager must have a distinct and succinct way of describing what they do and why there is an edge to their strategy or investment approach. If a manager can effectively communicate a very distinct reason why they should exist and how they execute their trades to take money out of the market, it creates an optimal starting point for your dialogue with investors.

Recently, we have been looking for managers who fill a need that was recently vacated in the markets, where hedge funds can step in and fill a void. That void might be created by the exit of the big banks from a certain market or trading activity, such as proprietary trading, where hedge funds have now stepped into fill certain roles. Right now we are looking at market-makers at various shops who have experience in proprietary trading and are now running their own shop. These managers are typically capital-constrained, which we tend to like, because there is no real benefit to being small unless you can take advantage of things that the biggest organizations cannot do. We are focusing on those type of niche opportunities.

Rob Kaplan: We look for smart investors, plain and simple. Over the past 20 years I have interviewed and met enough managers that I am able to tell very quickly if someone is thoughtful, intelligent, and has done the research that puts them in a position to succeed. We also look for someone who thinks independently. We are very much drawn to **innovative and creative managers,** because they are able to think outside the box and invest uniquely. A manager who comes in to meet us with a stock idea that we have heard from a dozen other managers with the same underlying thesis is not intriguing to us. We want to hear unique ideas or insights from someone whom we perceive as genuinely smart, savvy, and original.

The next thing we look for is a manager who thinks holistically about his business, which applies to my earlier point about the benefit of a manager hiring a President or CEO. We want a manager who recognizes that he cannot do everything himself or herself, and so puts the infrastructure in place to support a strong culture of compliance and effective operational support. Strong infrastructure and a talented supporting staff always carry a lot of weight with us as an investor.

Corey McLaughlin I am curious to hear a bit more from the investors about their investment process and approach. When you think about generating alpha, do you look at managers first, or is your process driven by looking at market opportunities? Do you utilize a top-down or a bottom-up approach, or is it a combination of the two?

Rob Kaplan: Our approach is a combination of those two philosophies. At times our investing approach is to find the areas where we think there is going to be an opportunity for both beta (either positively or negatively) and alpha (i.e., lots of dispersion). Then we try to drill down in that area in order to find the best manager to fill that space. We look for unique situations where we think there is a market dislocation, just as Larry mentioned. Earlier in the year we saw a dislocation in high-yield energy bonds and also in the Master Limited Partnership (MLP) space, so we invested with managers in both of those sectors. But at other times, we are looking for the best athlete in the room, someone who is adaptable and will take us to new regions or spaces or opportunities.

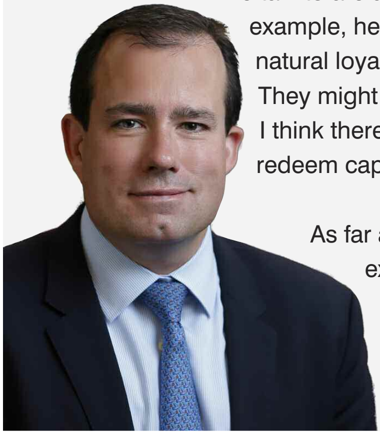
When we look at the markets thematically and try to find opportunities, we have to take both alpha and beta into account. Beta is not just limited to the S&P 500; you have to look at the beta in all sub-sectors. When I think about transplanting all of that beta into alpha-producing trades, a huge area of opportunity that sticks out to me resides in the **healthcare sector.** We think the long case is clear. Healthcare providers grow both their top and bottom lines more than any other sector driven by the secular tailwinds of aging demographics around the world together with massive healthcare reforms. Another point about healthcare is that the sector remains in a mergers and acquisitions cycle, where biotech companies are getting bid up because the drug companies need new products, and because every product is patented. But there is a short opportunity too whether it be related to regulatory scrutiny of drug pricing or the impact of generics. For all of those reasons, I believe dedicated healthcare managers have a huge opportunity to generate outsized returns right now and into the future.

Another investor theme that we have observed in allocator circles is the **chase for yield** in the current markets, because it has led investors to buy any security that has a dividend or a coupon. Some of these products that they are buying are fundamentally flawed. In August you saw Corrections Corporation of America, a well known REIT that had gotten bid up because of its attractive yield, come crashing down after the Department of Justice (DOJ) ruled to eliminate for-pay prisons, so when that happened the stock fell 35% in one day. If you shorted those stocks, and a few hedge fund managers did in anticipation of this ruling, you made a ton of money. I think there is a lot of opportunity in this search for yield where securities were bid up to a point beyond where they should be valued.

Chris Solarz: We are always looking for best-of-breed managers across all of our hedge fund strategies. That is the most important research we can do for our clients. We do consider opportunistic investments when we find severe market dislocations, such as high yield debt at the beginning of this year, but it is very difficult to select and recommend a specific market sub-sector and then to get that decision approved at several different investment committees in a timely manner before the opportunity evaporates. As a consequence, we try to build portfolios from the bottom-up because we can make narrow recommendations on specific best-of-breed funds.

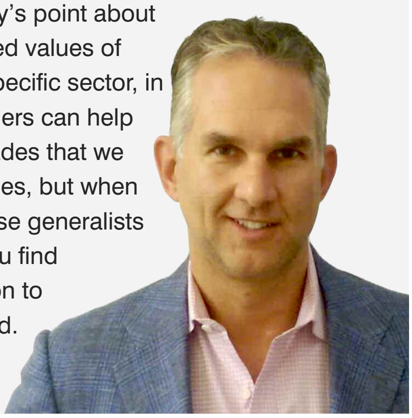
We are looking for 15-20 managers in our portfolio that are diverse and as uncorrelated as possible. That is the "Holy Grail" of portfolios, although it is very difficult to realistically find 15-20 uncorrelated managers that all exhibit positive expected returns over time.

Peter Tarrant: All investors say that they want to have the best-of-breed managers in their portfolios, but most investors who we talk to are also sitting on portfolios that are already fully allocated. If Rob is bullish on healthcare, for example, he already has significant exposure in that space. The reality is that investors tend to have a natural loyalty to the hedge funds with whom they have already invested. They are not apt to trade horses. They might want to add more exposure in a certain sector, but they are not going to double that exposure. I think there is a **misconception among emerging managers** about the likelihood that investors will redeem capital current managers and redeploy that capital to a new fund.



As far as opportunities for investors, the **financial services consolidation trade** has performed extremely well in recent years. Managers with experience in those areas have done phenomenally well. If you were to cluster the performance of all of the hedge funds who have executed those consolidation trades, you would be hard pressed to find a set of managers with a better track record over the last five years.

Steve Simmons: We like to have frequent calls with our managers, which goes back to Larry's point about facilitating communication and developing a true partnership with investors. One of the added values of that communication is that we can float our ideas to underlying firms if we are bullish on a specific sector, in order to see what kind of research and perspective they may have. Occasionally, our managers can help us to verify our own thesis, and in some cases we even utilize those managers to employ trades that we find attractive. I think the "generalist" approach to long- short equity can be dangerous at times, but when you have a good rapport with managers and respect their research process, sometimes those generalists can be used to both inform your decision-making and also to deploy capital to areas that you find attractive. That is a far easier process than asking our family to provide another $5-$10 million to invest in a specific sub-sector, or than pulling money from a fund when you are fully allocated.



Greg de Spoelberch What kind of reporting numbers do you look for from managers, and are there any other metrics that particularly appeal to you as allocators?

Chris Solarz: We interview and monitor hundreds upon hundreds of managers, and I do not need to see weekly numbers from all of our prospective managers. The provision of monthly reporting is sufficient. However, I do appreciate it when I am allowed access to weekly and even daily reporting statistics upon request. Strangely, many funds that want to partner with us are often unwilling to give us access to those numbers, and I am not sure why that is. If they did, it would be a nice step toward building a relationship because it shows mutual trust.

I appreciate Larry's comment on the importance of a partnership mentality between investors and managers. As I study the global macro hedge fund space, I am consistently surprised by the **dearth of communication that is provided on an ad hoc basis**, especially during times of extreme market stress. During the devaluations of the Swiss Franc and the Chinese Yuan last year, I rarely received an email from managers attempting to explain what was happening. *These funds wanted us to invest with them, but they made no attempt to explain how they were actively handling severe market dislocations.* We want to hear from them when they are losing money, not just when they are making money. Conceptually, the principle is so simple and obvious, but funds often fail to communicate effectively, and it is disappointing.

Steve Simmons: I will give you a concrete example of proactive communication from a manager which I really appreciated. We were following a fund that we had not yet allocated to, and which was enduring a "challenging" month. I love the fact that the head of investor relations reached out to us in the middle of the month and directly told us that the fund was taking a major loss. The fund ended down about 7.6% for the month, which was historically awful for them.

She explained that three of the companies in which they had short positions had been acquired that month, (which is always a risk) and they got hammered there. They reinforced their investment thesis and their views going forward. Within 45 days, they had covered the loss and ended up doing very well for the remainder of the year. That firm had been on our very short list of candidates, so the fact that they reached out and provided that level of communication right out of the gate was paramount, and we ended up investing with them, and *their open communication about a bad situation benefitted them.*

We need frequent communications with our managers regardless of market direction; understanding the mindset of the manager, prevents you from being caught completely off guard in times of duress, and as an investor that psychological safety net that you established through communication and trust with a manager is imperative to a healthy, two – way relationship. We do not take an ownership stake in the funds themselves, so we try to strike the right balance with our managers, and to act as a relatively fair partner.

Peter Tarrant: The single market adaptation that I would like to see from the hedge fund industry is **enhanced standardization of reporting.**

For example, many funds employ illiquid or less liquid strategies, so they avoid reporting their monthly numbers and are consequently only reporting quarterly. It is difficult for investors to track those 400 to 500 funds that are providing performance numbers less frequently. My personal belief is that *those funds are making a huge marketing mistake*, since an investor cannot look through their portfolios end to end if the reporting is not standardized and they cannot find a place where those illiquid strategies would complement the portfolio. Ultimately, investors will focus on the quarterly or annual number, but I also think the more illiquid strategies should deliver monthly numbers as well, if only to be evaluated on an apples-to-apples basis with their peers.

Rob Kaplan: I believe unequivocally in the value of communication, especially when it comes to a manager's ability to write. I firmly believe that **writing makes you a better investor.** If you can sit down with a pen and paper or keyboard and communicate what you are thinking, it does make you a better investor. This is not a daunting task to perform once a month. Tell your investors what worked, what did not work, what you think, and why you have come to your conclusions. If you have decided to change course in your strategy, simply tell me why.

As an investor I can always tell whether a manager actually communicates their perspective or when the investor relations representative steps in to send me an update. My advice is that *all managers should personally learn to write and to send investor updates on the fund's performance and on their market outlook.* I become a better investor when I read something revelatory, and I believe communicating candidly and consistently will make a manager a better investor as well.

Chris Solarz: I read over 100 global macro hedge fund newsletters every single month and roughly two-thirds of them are regurgitations of what happened in the markets the previous month. *This is consistently disappointing because it is my single touch point of communication with most managers.* Their newsletters are extremely boring because although they may discuss a particular trade from that month, such as shorting the Yen, there is no intelligence I can extract from that communication; it is a very common trade.

My advice is to take one paragraph to summarize markets and the rest of the letter to explain your views and current portfolio positioning – this is what clients want to know. They do not want to hear about your August performance on October 7th!

Rob Kaplan: My mentality is that I should have a general idea of what your performance is going to be before you actually disclose it. If you are long a stock or a sector or a currency and know that that position has rallied, I expect you to make money.

The most frustrating thing in the monthly reporting is to see a manager with a great thesis and the market goes his way and yet he doesn't make money. We had a commodities manager who was exceptionally prophetic, called for the oil markets to collapse based on the oversupply coming from US shale and the OPEC combined with slowing global demand. Yet when the collapse happened and oil dropped by 50%, the manager made only a fraction of that performance.

Greg de Spoelberch

Tell me about what factors play into your decision to finally redeem from a fund. What is that process like for yourselves and your investment teams, and at what point do you actually exit as opposed to giving the manager more time?

Larry Morgenthal: One of the major problems which will trigger red flags and potential termination is the practice of strategy or style drift, as Steve discussed earlier. If there is a disconnect between the manager's stated mandate; what they told us they are doing on a day to day basis and what they are actually trading, that can definitely lead to terminations. The **style drift** itself is a huge red flag from a due diligence standpoint, and it is also personally frustrating as an allocator, because the manager was dishonest about the product that they sold to you.

Poor communication is another red flag, and a topic that we have discussed here today. We were forced to have a conversation with a manager because we have not been happy with their communication around performance and transparency. We had to remind them that there are 10,000 managers in the world, and no fund's performance numbers are so strong that I am forced to keep them in my portfolio. If we cannot have a true partnership and sufficient communication, we will move on.

Over time we have also terminated managers because of what we perceive to be a culture shift in the firm. Sometimes a small manager can perform and communicate well, and can act as an ideal partner for us. However, once they become more successful and the management team is financially stable, they do not return calls anymore. That is representative of sloppiness in the **business culture,** and can lead to a redemption.

There are other examples where redemptions are just a natural part of the business. In certain circumstances we will pull out of a sector because we develop the top-down outlook that there are simply not sufficient opportunities. If we come to such a conclusion, we will elect to redeem from a manager or managers in that sector, which can be a difficult process because we have built a solid relationship with them. They might be the world's best manager in their market or strategy, but if it is an area where we do not see sufficient opportunity, we will elect to move on.

I can give you an example. In 2015 and early 2016 we did not think that distressed debt was an area that would yield abundant opportunities so we redeemed from several pure distressed debt asset managers who were sitting on a significant amount of cash. Those managers have the talent; we simply had a negative outlook on the asset class during those time periods, and so we chose to put our money to work in different strategies which had a higher upside. However, we will revisit those same distressed debt managers when we feel that the timing is right, because they are some of the best in that market.

That is why it is *critical for us as investors to also communicate our reasoning behind redemptions to our managers*, because although it might be somewhat painful for both sides during the termination process, in the long run you have a better relationship with the manager if you have been very transparent as to how you came to your decision. That manager will give you the ability to invest in the fund at a future time. Managers will often disagree with your decision to pull your capital, which they naturally will do, but at least you maintain a level of trust with management teams and can reinvest at a future date.

Chris Solarz: Regarding redemptions, one of the considerations for us to analyze is how the portfolio losses were accumulated. Are they **mark-to-market losses or are they realized losses?** That factor is important to consider, because to give you an example, if you go back to 2008 you had an abundance of emerging market corporate credit managers whose portfolios were decimated. Some of their bonds were traded down to $0.20 on the dollar, which a year later paid out at par. If they maintained that portfolio and there was only a paper loss, and you understand the trade and agree that it is still a great investment, then you want to keep that manager in your portfolio. However, it is a completely different proposition if the losses were realized and the fund is down -40% in cash starting again.

Another consideration that I always keep in the back of my mind is that *over a ten year period, funds will almost inevitably have a peak-to-trough drawdown of monthly returns equal to twice that of their annualized volatility.* So if you have a 10% annualized volatility fund, it is going to experience a 20% drawdown within that ten year time frame. That is my expectation going in as an investor. Therefore, I am not going to automatically penalize those funds when they go through the 20% drawdown, but we just hope that occurrence does not happen as soon as we invest! Our research and industry knowledge to be able to predict some of those inevitabilities help us to put things in perspective when considering redemptions.

Rob Kaplan: **Credibility fatigue** is the single biggest driver that causes me to redeem from a manager. What I mean by that is that the manager simply does not make money for me anymore. If a manager produces poor returns for a number of years, I lose faith in them and will move on. There are also certain **lifestyle considerations** that can hurt a manager's credibility. If an individual is very successful and buys a sports team, for example, it is a red flag for me because I question the attention of the manager. I do not want any external distractions which may indicate a lack of focus on the ultimate goal, which is driving good performance.

Style drift is a relevant red flag in some cases, but for us it is not necessarily a cause for the termination of a manager. One of the greatest trades in our industry was John Paulson's 2007 bet against the US housing market. John Paulson was a merger arbitrage manager, but he saw an opportunity and decided to use credit default swaps to effectively bet against the U.S. subprime mortgage lending market. Although that trade was outside the scope of Mr. Paulson's strategy, the investors did phenomenally well. So style drift can work, but the manager has to effectively communicate their idea so that no one is surprised.

We want our managers to be realistic about the number of opportunities in their market, because there might be a better trade somewhere else that they can find. We want to give them some flexibility, because we are hiring extremely smart people, and we want them to look around for different places to find alpha. We take a similar approach to Steve when he is talking with his generalist managers about looking for opportunities, We also enjoy a healthy dialogue with managers about finding the best markets.

There are a few other red flags for us, and one of the biggest is **employee turnover.** When you see a lot of the staff exiting the firm, it can be indicative that there is an internal problem. We have to ask, why are your employees leaving? There can be a myriad of reasons for that, but I like to know why.

We also hate it when managers **change their terms,** whether they make the redemption notice period longer, implement a longer lock up, or increase their fees. Term adjustments like those usually occur because managers are starting to believe their own rhetoric a little bit too much and become a little bit too cocky. When managers take actions such as those, it is usually a time to take some money away. I have been in this business for a long time, and term adjustments are usually a sign that trouble is coming.

One final point is that there have been studies done on the industry saying that funds which are launching a great deal of new products and new share classes can often get into trouble and produce bad performance. Thematically, the results of those studies make sense to me, because those actions equate to asset gathering, which does not contribute to performance. **Too many new products and share classes** are a red flag, so I want to see what is behind the decision to expand those offerings.

So in conclusion, there are a lot of factors that can trigger red flags for us and lead us toward the redemption decision, but the biggest driver tends to be credibility fatigue where a manager fails to perform for an extended period of time.

Chris Solarz

I see the perfect hedge fund as a manager who offers one fund, one strategy, one share class, has all of his own money in that fund, and puts all of his best ideas into that structure. As an investor, because we are the Limited Partner, that structure is ideal because it keeps things simple and interests aligned.

Steve Simmons: Regarding redemptions, because we only invest in emerging managers, we need to ensure that a manager's return potential as an underlying investment vehicle is still feasible in relation to the fund's size. For example, if we are invested in a microcap strategy which is running $20 million, and they grow to $100 million, it becomes more and more difficult to effectively deploy capital and finding optimal entry/exit points. The manager may in effect have become too successful with their strategy, and raised so much capital that they can no longer deliver the initially expected returns; if their size becomes too bloated for what we believe to be the capacity of that strategy, we will terminate them.

It's always humorous when we speak with microcap / small cap funds and ask what they see as an appropriate fund size, and often they arrive at the "magic" $1 billion number. That feeds into Peter's points about managers needing to have a realistic perception of themselves within the greater context of the industry.

The redemption process is hard to put in black and white terms, because it is unique for every one of your investments; there are numerous factors beyond inadequate performance or failure to properly execute the agreed upon strategy that go into the decision to terminate a manager.

A somewhat lackadaisical monthly / quarterly letter to the investor may give the sense that the manager's mindset and motivation are slipping somewhat. Managers need to be passionate about what they are doing; every day is an opportunity to create alpha.

When I observe carelessness in any capacity, I immediately want to ensure the manager is still fully committed to succeed. I can identify with Rob's point, because when managers reach a level of comfortability and self-entitlement, and when they start taking actions like adjusting fees and structures, they can become complacent. That is the point at which you realize it might be time for you to **exit your investment** in that fund.

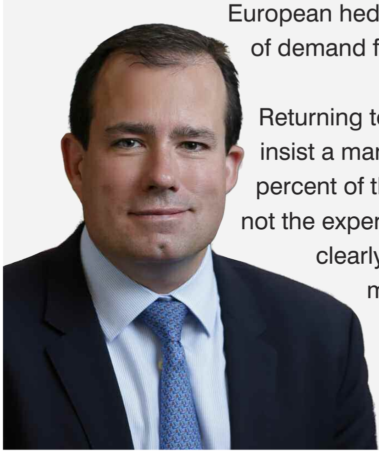
Greg de Spoelberch Peter, I would like to hear some of your observations on the capital raising process and the environment for your manager clients at BTIG. Are investors looking at specific strategies or asset classes, and how do you work with your clients to deliver their message to investors in a coherent manner?

Peter Tarrant: There is a large world of allocators looking at alternative investments, and we regularly talk with about 1,300 different investors. One third of those are family offices, one third are funds of funds, and the last third is comprised of foundations, endowments, outsourced CIO firms, RIAs, and multifamily offices.

I will reiterate my point from earlier about the **popularity of quantitative funds** right now. There is increasing demand for quantitative strategies, and you can feel that momentum through investor responses and inquiries. However, it is important to also note that a *startup quantitative fund experiences a more challenging environment than a startup with a more traditional strategy,* such as an equity long-short shop. A startup quantitative fund is competing with firms like Renaissance Capital and Two Sigma, which are extremely large, well established organizations that are locked and loaded for bear markets. Those firms have been in business for a very long time, and they have extremely sophisticated, well-proven algorithms and data resources in place. Competing with those large quantitative shops and receiving an end investor's allocation is an uphill battle. The infrastructure to support quantitative systems and algorithms is also extremely expensive and cumbersome, so a startup quantitative shop needs to be able to afford all of those investments.

We see consistent **rotations in the geographic areas** of investor interest. This year, **Latin America** is a perfect example. Investors have hated the region for the last few years while the markets experienced significant losses. However, this year the topic of Latin American opportunity comes up in about two out of every five meetings, because those indices have recovered so dramatically. As markets rebound, you see a lot of reactionary forces as investor interest is peaked by that recovery, and allocators want more exposure. Brazil's stock market, the BOVESPA, is up roughly 60% from the recent bottom, and many analysts who specialize in Latin America project that the market value could surpass the current value by many multiples. The Argentina stock market (MERVAL) is also up roughly 40% to 50%, so there are definitely multiple regions that are looking more attractive now.

European exposure is another theme that frequently comes up in meetings with US investors. US allocator outflows from European hedge funds have surpassed inflows since Brexit occurred, but there is still a tremendous amount of demand for European exposure from US organizations.

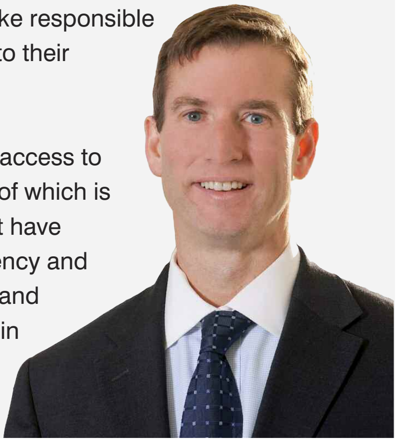


Returning to your question about how we help our managers to raise capital, the first resource that we insist a manager have before we help them market their fund is a **professional pitch book.** Ninety-eight percent of the hedge fund market has paid a professional to produce a top notch pitch book. Marketing is not the expertise of the vast majority of managers, so I tell them to sit down with a professional who can clearly define and communicate their process, edge, and risk management capabilities. The right marketing professional understands the hedge fund business and can articulate the fund's value proposition to their prospects. Funds should sit down with these specialists as early as possible in their formation to produce a world-class pitch book.

We also help managers understand *what is marketable and what is not.* Dual Portfolio Manager structures, for example, are generally unmarketable because the performance statistics from funds that have employed a dual PM structure are absolutely dreadful. There are very few examples of highly successful funds that utilize a dual PM structure, and investors are well aware of this fact. Asking employees to serve dual roles in a company, such as wearing both the CIO and CFO hats, for example, can also be a red flag. Investors want to see a coherent division of labor where the key personnel are not stretched too thin.

In a nutshell, my approach with managers is to keep things simple. I tell them what they need to provide to investors, such as the pitch book and monthly performance updates, and I also manage their general expectations for future growth based on their asset size. For example, where do they realistically want their AUM to be one year from now? Some managers, as we have discussed today, are unrealistic and do not recognize how challenging the capital raising process can be. We also ask them if they have a COO or CFO on staff, and if they do not, can they outsource it? Do they need a "third-party" marketer? If they struggle in their communication with investors, they may need a marketer. If the fund is in a full press marketing cycle, they undoubtedly need a dedicated marketer since they cannot focus on dozens of investor meetings while also concentrating on their portfolio.

Corey McLaughlin: Rob made a point about the value of hiring a CEO, which is a great step to alleviate the pressure on any portfolio manager, and provides the manager with the necessary support to allow them to focus on performance. Along that same theme of an adequate support structure, funds need to ensure that they have **quality service providers** in place to provide an adequate culture of support. They also need to have answers for investors as to why they selected those providers in the first place. If a manager selects a service provider because they are the most inexpensive, and communicates that message to an investor, how will an investor react? Managers need to make responsible decisions for the long-term benefit of their business, and to be able to justify those decisions to their investors.



Service providers also house a great deal of sensitive information. Third party providers have access to performance numbers, but they also have access to trading information and investor lists, all of which is sensitive information. A law firm, third party administrator, and even an audit and tax firm must have adequate systems in place to protect that information. **Cyber-attacks** are increasing in frequency and sophistication, so managers need to understand a service provider's systems and know why and how they are protected, because a cyber-attack can leave both managers and their investors in vulnerable positions.

Greg de Spoelberch

One of the biggest challenges for fund managers in this current industry environment is attracting the attention of an investor, convincing them to believe in you, and actually getting that initial investment. What does it take to convince you as investors to finally reach the point where you will make that first investment with a new manager?

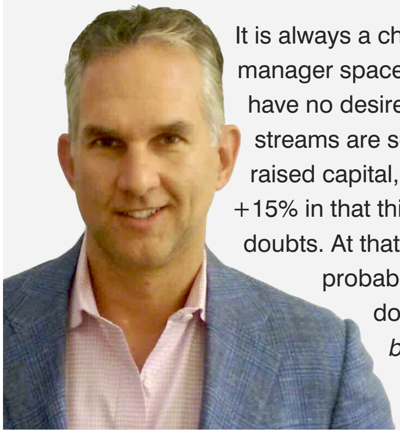
Chris Solarz: I once watched an interview with David Harding, the founder of Adam, Harding & Lueck (AHL), which is a systematic commodity trading advisor he started in 1987. He is a very well respected fund manager and industry member, and I think his perspective can shed some light onto the subject of investor inflows, and also reveals a certain pitfall in hedge fund investing that many allocators are unable to avoid. In the interview, he is asked about the state of the markets and about his predictions. He says that he does not know what is going to happen in the markets tomorrow, because nobody does; *the only thing that he knows for sure is that six months after he reports good performance, he will see fund inflows.* Mr. Harding is right, because investors need to see a track record with solid returns before they invest. However, since they can only invest after that strong performance has occurred, they often miss out on the best early stage returns of the most talented managers. That natural Catch-22 dilemma accurately reflects the current state of hedge fund investing in the industry today, and the results are frustrating for both managers and investors.

Investors really do maintain a herd mentality, whereby they need a confirmation of a proof of concept before they take a chance on a manager. However, investors inevitably miss out on those outstanding early return streams, while the managers are deprived of that early stage capital, which they desperately need. Both parties are missing out on the best of what the other can provide.

Rob Kaplan: I agree with Chris that the current allocation culture makes obtaining inflows very difficult, especially for emerging managers. I used a regression analysis a few years ago, and my research showed that *managers needed 12 months of good performance to even register on the radars of the investors in order to be considered for an allocation.*

As we sit here today, with pervasive negative sentiment around hedge funds due to their poor performance, that proof of concept time period has been extended even further. Currently, an emerging manager needs two years of good performance before he starts to see inflows coming in. Among many allocators, the lead time prior to executing any allocation to a hedge fund investment has been prolonged even further.

Steve Simmons: The initial investment into an emerging manager in order to access those superior return streams does take a leap of faith. We conduct extensive research and perform due diligence on a manager, and then finally write a check. But from that point on, any of the manager's past performance is fundamentally irrelevant. Hopefully the past performance is indicative of what the manager will do, but often that is not the case. It is uncanny how many times you will make that first allocation to a manager, and in that first month the fund underperforms. I know we have all experienced that as allocators.



It is always a challenge being comfortable with an allocation to a new fund, particularly in the emerging manager space where the expectation is that most funds will probably fail. The majority of investors really have no desire and very little motivation to get behind an up and coming manager, even when their return streams are solid. We know a manager who posted double digit returns for three years and never really raised capital, because allocators did not believe they could maintain their returns. Their returns went from +15% in that third year to +7% in the fourth year, which unfortunately seemed to confirm the investor doubts. At that point the fund has unfortunately lost another year in its life cycle, and the investors are probably still not likely to invest with them. I am not really sure what that particular fund could have done differently, so it is *a really sad state of affairs that allocators do not take the leap of faith to believe in a manager early in their life cycle, where the returns are often the strongest.*

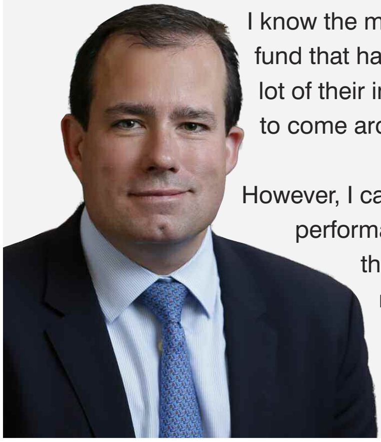
Rob Kaplan: There is a thought pattern or cycle that happens with a lot of allocators and their methodology goes as follows: They initially want to observe and monitor a fund for a period of time, and if the manager performs poorly, then the **herd mentality** takes over and a manager is basically precluded from receiving an investment. However, if the manager happens to have great performance, the investor's thinking then is to wait to invest until the manager has a drawdown, in order to catch that dip in performance and to access an optimal entry point where they believe the manager is due to bounce back and produce good returns. But once the manager reports that dip in returns, the investor steps back to question why the dip occurred, and often pulls back completely. So I can comprehend why managers are frustrated.

Industry members ask me about the first thing that I look at in the pitch book of a new manager that I am reviewing for the first time. I immediately flip to the biographies of the manager and their team. I want to see where a portfolio manager comes from, and the merits of their background. More importantly, I want to learn what they accomplished over the course of their career. I then look at the investment proposition, because that informs me about a manager's mindset, outlook, and if they have any of that uniqueness which I talked about earlier, which is a quality that we value. When I am evaluating someone for the first time, I try and **skip the performance numbers and review those last,** because the moment you focus on performance it skews your vision of everything else in the pitch book, and predetermines your perception of the manager. I look at performance last, because it keeps me unbiased so that I can evaluate someone with an open mind. I wish more allocators would take that approach, because I think it would make them better investors.

Chris Solarz

Investors have to be particularly careful when looking at performance because year-end numbers on their own do not factor in volatility. Your perspective can be skewed if you look exclusively at annual returns because you do not know if the fund's annual performance is 20% with a volatility of 20%, or are the returns annualizing at 20% with a volatility of 5%. Clients and consultants alike sleep better at night with a smoother return stream!

Peter Tarrant: If you are a very small fund, in order to receive an initial allocation you need to produce impressive performance numbers, and you need to avoid significant drawdowns. Alternatively, if you are one of the extremely large firms and are in your third year of single digit performance, you will eventually be placed in an **allocator's beta-producing bucket,** and you will have to enhance your risk profile or investors will eventually move on. I see these two "barbell" trends regarding investor inflows at the opposite ends of the size spectrum in the hedge fund industry.



I know the management team at a $1.4 billion AUM Technology, Media, and Telecommunications (TMT) fund that has produced two straight years of low single digit returns. The fund is now in its third year, and a lot of their investors are starting to get restless. Allocators do not have a lot of time to wait for performance to come around, because they need that sector or strategy covered in their portfolio.

However, I can also see that it is possible for emerging managers to attract allocators in the first year if their performance is very robust. I work with these smaller funds on a day to day basis, and I definitely see those early stage investor inflows. If you continue performing, investors will take notice and the money will find you. We work with a number of managers who have returned 20% annually for two straight years and who are now moving towards becoming an institutional fund; those managers can definitely raise money, even in this market.

Greg de Spoelberch

A lot of the innovation in the industry comes from emerging managers. An operational due diligence specialist at an end investor recently told me that the new operational and regulatory pressures are in fact hurting the industry's growth and stifling innovation. Are these pressures hindering the industry's ability to evolve and be innovative, and in the end are these evolutions hurting end investors?

Steve Simmons: The greatest pressure which is stifling those managers and that correlated innovation is the cost of setting up a fund and enduring the operational overhead. It is important to note that the costs vary among firms who run different strategies. Peter spoke about some of the quantitative strategies which are getting significant attention right now, and there are some spectacularly brilliant market specialists who are launching. However, the cost structure to set up and support their programs which give them the ability to analyze such a voluminous amount of data is extremely prohibitive; cost structure can be very strategy dependent.

There can also be **pitfalls** for specialists who are spinning out from larger shops or investment banks and launching their own funds. The environment at large organizations is incredibly beneficial when you have experienced teams supporting every facet of your operations, where all elements of the infrastructure are already in place. That includes operational support, compliance oversight, research, and trading operations. I am always skeptical of how those new managers will perform without access to all of those resources, because it is far more difficult to succeed in a startup environment. Running your own shop is an entirely different animal, and psychologically, those type of managers can easily get discouraged when they do not experience positive returns immediately.

I think that some of the innovation that these new managers could provide to the industry is actually lost before they even launch, because they were never able to recreate the vital functions which were in place at the larger institutions where they worked.

Chris Solarz: We will not typically look at a manager who fits into Steve's sweet spot. We define emerging managers completely differently: as an institutional-quality manager with a three year track record and at least a few hundred million dollars under management. In our clients' portfolios we have a few dozen managers who have under a billion dollars in AUM, which is still quite a small sized fund when you asset weight the hedge fund industry. We have also followed through on a handful of day one investments, but those early stage and day one allocations are not our focus.

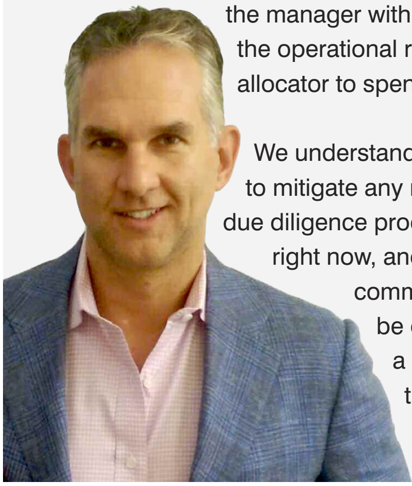
I think there is a significant survivorship bias about emerging managers that is prevalent among the majority allocator circles. Startups do not have robust risk management in place and they do not have a proven track record. These are the firms that can go out of business within a month, which is an investor's worst nightmare. The blue chip names in the industry that have multiple billions of dollars under management can also rapidly go out of business, but that potentiality is far less likely. So it is a tough environment for younger and smaller firms. I think that family offices like Sideris are more capable of providing capital to those managers because they have more flexibility with their investment mandates.

Larry Morgenthal: I find it interesting when I speak to a manager who has a four or five year track record, but is still running a small firm and has been unable to grow their fund. I will ask them if they are a better manager today than they were five years ago. Ninety nine times out of one hundred their answer is yes, they have learned to manage risk more effectively, and they have also learned to manage their staff more efficiently.

What we are doing in such cases is balancing their improvement against a different opportunity set or a size advantage. Let me explain what I mean. A fund with a small AUM and a five year track record generally has to bring something very special to the table, whether it be a unique opportunity or innovative investment thesis, because we do not need a plain vanilla equity long-short strategy carrying a 60% net exposure, who invests in large-cap stocks. If I am going to invest with a true emerging manager, I need something exceptional.

There has to be a very strong reason for allocating to a small firm such as that, particularly when the management team is not as deep as we would like to see, because there is a lot of business risk. Many of these firms do go out of business, so there is a legitimate reason for the industry's survivorship bias. Investing with a very small shop comes down to a tradeoff; am I willing to take the business risk if I believe that they are truly unique, and that they are able to deliver exceptional returns. Another factor I look at for early investment is the capacity of the strategy. We are more likely to be early if we think a strategy will become less attractive with a larger asset base.

Steve Simmons: I believe *funds in the emerging manager space today are in a much better position compared to where they were five years ago,* largely because of the support mechanisms that we discussed earlier. Outsourced vehicles, such as CIOs and risk management capabilities, can fill the necessary functions that investors are requiring without handicapping the manager with excessive operational costs. Those outsourced solutions have also reduced a great deal of the operational risk among small managers by standardizing those functions, so they help me as an allocator to spend more time focusing on performance, which is the bottom line.



We understand a lot of the inherent hazards in the space, but we also take every step that we can in order to mitigate any risks before we make an allocation. If you understand a fund's business and you have your due diligence processes in place, I think emerging managers are an **extremely attractive space** to be in right now, and can yield great returns. Investing with emerging funds boils down to establishing a common understanding between the manager and the investor from day one. Both parties must be on the same page and communicate regularly. I will restate that I am always willing to back a manager who has some skin in the game, is willing to communicate with me, and knows that they need to perform.