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Opalesque Round Table Series '10

AUSTRALIA

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Editors' Note

Dear Reader,

If Australia isn't on your watch list yet, that may soon prove to be an error.

With 9% of every person's salary in Australia getting invested into a registered superannuation (pension) fund, the country has created one of the **fastest growing asset pools worldwide. With A$1.2 trillion (US$1.1 trillion), the Aussie pension fund industry is now the world's fifth largest and continues to grow dramatically.**

Australia has very mature wholesale and retail markets, which both offer unique opportunities for local and global hedge funds. But: you need to be aware of the rules and the set up of those markets. Beyond wholesale and retail, this Roundtable also explains how to access **a third rapidly growing asset pool, the so-called mezzanine market** which is managed by the local dealer groups.

One of the most stunning aspects of the Australian pension fund industry has been the ascent of the Self-Managed Super Funds, where the individual is managing his pension assets himself as a self-directed investor. At the smaller end, a Self-Managed Super Funds may have only $250,000 in assets, through to many millions at the high end. **Within just five years, over one third of all superannuation assets have been moved into the 400,000 self-managed super funds.**

The domestic Australian hedge fund industry has traditionally been a strong performer and was also able to protect the downside in the crisis of 2008, where the average Australian hedge fund lost 17.74% against the ASX which fell over 40%. At the same time, depending which database you look at, the global industry fell somewhere between 17% and 21%. In addition, 25% of the 200 plus managers in the Australian Fund Monitors database produced positive returns, and over 90% of them outperformed the ASX200.

Hear from some of the **leading Australian hedge funds** what **opportunities** they see for their funds and strategies going forward, **how these institutional Superannuation Funds actually select their hedge funds,** and what excites **seeders who work exclusively with Australian funds.**

The 2010 Opalesque Australia Roundtable was sponsored by Australian Fund Monitors Pty Ltd. We also thank Chris Gosselin from Australian Fund Monitors for helping us put the group together, UBS Sydney for providing the beautiful meeting venue, and Custom House Group and Taussig Capital as our 2010 Roundtable Series sponsors.

Roundtable participants:
- **Bruce Tomlinson,** Portfolio Manager, Sunsuper Superannuation Fund
- **Adrian Redlich,** Chief Investment Officer, Merricks Capital
- **Chris Gosselin,** Founder, Australian Fund Monitors
- **Dominic McCormick,** Chief Investment Officer, Select Asset Management
- **John Corr,** Founder, Fortitude Capital
- **Larry Simon,** Co-Founder, Lazorne Group
- **Nelson Lam,** Head of Investments, Ascalon Capital Managers

Enjoy the read!

Matthias Knab
Director Opalesque Ltd.
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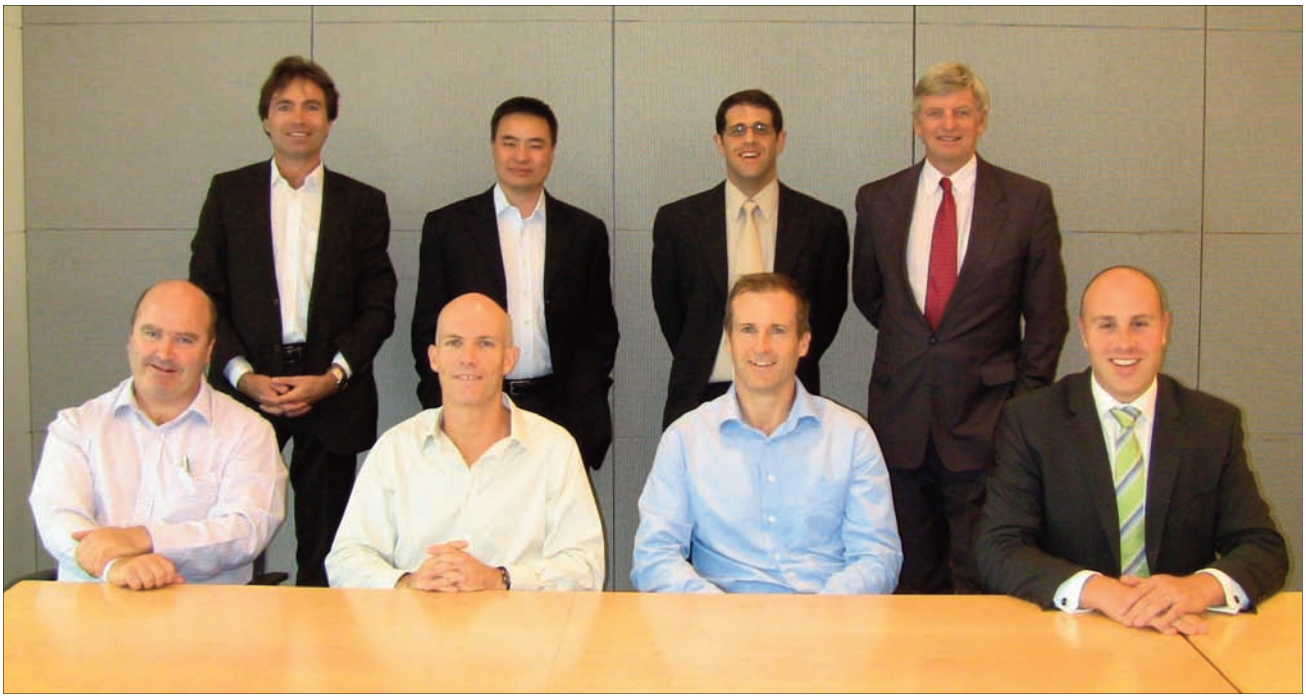
Cover Photo: Sydney Harbor, Australia. Photo by Matthias Knab

Participant Profiles



(LEFT TO RIGHT)
Standing: Matthias Knab, Nelson Lam, Larry Simon, Chris Gosselin
Seated: John Corr, Bruce Tomlinson, Dominic McCormick, Adrian Redlich

Introduction

Chris Gosselin
Australian Fund Monitors

My name is Chris Gosselin from Australian Fund Monitors (AFM). We were established in 2006 and provide an information service on the absolute return and hedge fund industry in Australia. AFM is a combination of database and research house, and provides consultancy covering over 230 funds either managed in, or marketed to Australia. AFM delivers general information and fund data via its website www.fundmonitors.com, and also provides customized research on individual funds and model portfolios.

John Corr
Fortitude Capital

I am John Corr from Fortitude Capital. Fortitude runs a market neutral long-gamma Australian equity fund. We have a track record of 5 years on our domestic funds, and slightly longer for one of our managed accounts. We pride ourselves on low volatility and consistent returns. The fund has a history of producing about 5% alpha with minimal drawdown, and volatility is about 3%. We apply a multi-strategy approach, particularly concentrating on arbitrage and arbitrage-like trades. We are based in Sydney and have a team of six full-time staff.

Nelson Lam
Ascalon Capital Managers

Nelson Lam, Head of Investments for Ascalon Capital Managers. Ascalon started in the year 2000; we are a boutique incubator and we seek to partner with quality boutique fund managers that have the potential to be large, scalable fund managers of the future. Part of my role is to look for new talent either in start-ups or existing managers that want to take the next step in their growth. We only take minority equity stakes in managers, because we believe that in order to remain a boutique, the investment team should own majority equity. Ascalon's value add is our experience in commercializing boutiques, the strength of our own dedicated distribution and marketing teams, our governance and compliance oversight and ability to provide boutiques with an institutional grade infrastructure, that allows the manager to focus on making money for the clients and to give comfort to consultants and rating houses that they are investible-grade boutiques.

Ascalon currently has partnerships with 6 excellent boutiques managing Australian equities, hedge fund strategies, and global strategies. Over the company's history we have invested in about a dozen managers.

Larry Simon
Lazorne Group

My name is Larry Simon. I am a principal and co-founder of the Lazorne Group. We specialise in providing consulting services in regulatory compliance within the financial service industry, helping companies to apply to ASIC for an Australian Financial Services License, and then also assisting licensees in meeting their ongoing compliance requirements. We have an incorporated legal practice in the group, as well as a fund administration business. In addition, we have developed proprietary anti-money laundering and counter terrorism financing software. Further, we offer our clients e-learning technology, whereby we assist licensees to meet their ongoing regulatory training requirements.

Bruce Tomlinson
Sunsuper

My name is Bruce Tomlinson, I am a portfolio manager at Sunsuper, which is an Australian pension fund. I joined Sunsuper about three years ago, after 12 years with AMP Capital. I have been managing and reviewing hedge funds for about five years. Sunsuper has about $15 billion assets and around one million members. While the average account balance is pretty small, our members are generally quite young and have a lot of years of contributions in front of them, therefore our cash flow is pretty healthy.

About 30% of our fund is in alternatives. In our case, alternatives is a broad category that includes real assets like property, infrastructure, and timber, as well as a private capital portfolio and a hedge fund portfolio. I look after the hedge fund portfolio, which has about $900 million in assets, roughly 6% of our fund.

I also have an analyst who supports me. We also use a specialist and a generalist consultant, who do due diligence on the managers before we invest. We have a reasonably concentrated portfolio consisting of about 20 managers, with almost half our capital in global macro strategies.

Overall, our portfolio displays a very low market exposure. We see equity market risk as the biggest risk in our overall fund, and therefore we do not have much money in equity long/short strategies. Aside from macro, we have a fair bit of money in credit and spread-type strategies and also with some large multi strategy funds. We are a direct investor in hedge funds and generally prefer larger, well-established, institutional-grade hedge funds.

In the past we did try funds of funds, in fact over the last four years we did actually have three fund of fund investments, but - they have not worked out as we wished, and so we decided to invest direct for various reasons.

Last year we did our first managed account in a credit strategy; up until that point, all our hedge fund investments were in pooled offshore funds. We are finalizing our second managed account this year. While we are certainly not aiming to get all our assets into managed accounts - that would be extremely unlikely, and in general we are happy to stay invested in comingled vehicles - but where appropriate or suitable, we like to benefit from the improved transparency, liquidity, lower fees and other, better terms you can get through managed accounts.

Adrian Redlich
Merricks Capital

My name is Adrian Redlich, I am the Chief Investment Officer of Merricks Capital, an alternative Funds Manager based in Melbourne, Australia established in 2007. We have 14 people in our team of which 10 are investment professionals. We run Asian focused funds and managed accounts including Asian long/short equities, soft commodities and a multi-strategy fund. We only invest in the large markets in Asia – primarily being Japan, Hong Kong, Australia where you find the best liquidity and availability to borrow stock, which allows us to provide monthly liquidity to our investors. We have an Australian Unit Trust where we offer an Australian dollar class and a traditional Cayman master feeder structure in US dollars. Since the inception of our funds in January 2008 we are up approximately 15%.

Our core philosophy is one that has evolved out of my fifteen years spent at Merrill Lynch and Citadel. Merricks Capital focuses on fundamental investing, predominantly what many people would call stock picking, where we spend a lot of time visiting companies and travelling through the region. However, the stock picking is combined with a portfolio construction philosophy that unlike most managers in the region, we hedge out most of the systematic and market risk. Typically we run a portfolio where we have a maximum of 20% of our risk coming from different systematic factors, including the market going up or down, or different themes flowing through the market. So the general philosophy is really try to maximize work done on individual companies or individual commodities and really run a relative value-type portfolio.

So, we like to say that we take the 80:20 rule. Rather than long only managers who have 80% of their risk and return dependent on markets going up and down, we really try and focus 80% of our risk in the companies and commodities that we spend a lot of time researching. This has resulted in mid teen returns over the past two years versus long only managers who have been dragged down by the Asian markets and are still down over 20%.

Dominic McCormick
Select Asset Management

My name is Dominic McCormick, I work as Chief Investment Officer of Select Asset Management. We are a boutique multi-asset, multi-manger across both the conventional and alternative assets and strategy areas. We have around $550 million under management, mainly in diversified and alternative multi-manager funds for retail investors. Around about a third of that is invested in alternatives with a significant component in hedge funds. Historically, we have also been involved in third-party marketing for a small number of global fund managers in the alternative space. Although that is a component of our business, we have scaled it back in recent years.

Matthias Knab **Going forward, what is the outlook for your strategies?**

John Corr We are market neutral and long-gamma, and one of our mantras is that we actually do not make predictions on the future - we let the market provide opportunities and aim to take advantage of those. That being said, we have weighted our portfolio slightly in late 2009 to early 2010. We have dropped the target theta rate that we run within our portfolio from a historic 6 to 3 in this environment.

Last year, the derivatives portfolio was a drain on our performance, realizable volatility levels remained below implied trading levels, which has been a battle for us over the last 12 months. We remain committed to the long-gamma philosophy and will vary that target from time to time, and will be more strategic about it.

In terms of returns, we target 5-10% above cash rates. Last year was a bit disappointing, as we came in just over 3% above cash rate, however that was only the first or second time that we have not reached that target. Let me add here that cash rates in Australia are basically 4% now after touching 2.75% or 3%.

In terms of a general outlook regarding our portfolio, we do see a major event or take over happening in the financial sector. The adjustment within the financial services sector in Australia will be interesting for us, and of course the continual interest from Asia in Australian resources companies will not go away. There will be a number of corporate activity in that area, albeit with some political and regulatory implications – the future will certainly be promising here as well.

Within fixed income, we are reducing our yield exposure or credit exposure; but by default, in that there is less instruments that suit us at the moment and be that from a top-down approach we probably think that is the right time at the moment.

Nelson Lam Ascalon have recently partnered with two boutique fund managers, a global equities market neutral boutique called Helix Partners and the first Australian based clean tech and renewable energy fund manager, Arkx Investment Management.

When doing the Arkx partnership, I looked into this industry on a global level and found there was quite a lot of activity in the U.K. and the U.S., strong domestic interest but limited domestic investment options available to the domestic investors. Arkx invests in globally listed equities in the clean tech and renewable energies space with a two-year track record. There is already a lot of interest from the wholesale clients. The general feedback from Australian investors is very positive and there is a real sense that they want to make an allocation into this sector.

As far as this outlook goes, fund managers have to prove that they have a real understanding on the technology as well as the new laws and policies that are coming out, and generate returns out of that. They need to stand out in this area. There are many people entering this space with a strong environmental drive and passion, but some of them may miss the point that while trustee boards want get involved in the sector, their fiduciary duty is still to primarily make money for their investors. What is your view on this, Bruce?

Bruce Tomlinson I should point out Sunsuper is perhaps a bit different from some of the Australian pension funds in that our trustees have delegated a fair bit of decision making to the investment team. We have a reasonably large internal investment team. Our sector portfolio management strategies are annually approved by the Board, and then it is up to the team to go ahead, implement and allocate capital accordingly. That means we do not have the typical beauty parades, in fact, very few managers present to our trustees.

In our case, we compare clean tech and renewables to any other investment that is available to us. For us, probably most funds in the space are too small, too boutique and not institutional grade, so we will not allocate capital to them. We do compare them to other strategies, and often they are just not up to scratch.

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Last year, we spent a lot of time reviewing IG corporate and ABS credit in our long-only portfolio. In the hedge fund portfolio we were engaged in the more trading-type strategies within long/short credit, basis trading, capital structure and arb-type strategies. We also put more money in to distressed debt type funds, which are more private capital type vehicles with long lockups and deferred incentive fees.

Bruce Tomlinson

So, very likely we will not enter this sector any time soon - there are just too many other wonderful opportunities out there. Last year, we spent a lot of time reviewing IG corporate and ABS credit in our long-only portfolio. In the hedge fund portfolio we were engaged in the more trading-type strategies within long/short credit, basis trading, capital structure and arb-type strategies. We also put more money in to distressed debt type funds, which are more private capital type vehicles with long lockups and deferred incentive fees.

As for the future, I concur with John's approach. In the portfolio that I look after, we try to be market neutral and not to tilt too much one way or another. At the margin, we might slightly lean one way or another, but we are really looking for alpha, absolute returns; therefore, I do not really want to be tilting too much one way or another.

Adrian Redlich

I want to touch on some of our short-term investment perspective, and a couple of medium to long-term investment opportunities:

In the short-term, say the next three to six months, we are actually optimistic on the world, and this optimism comes from our bottom-up focus. In the equity space, companies continue to have robust earnings, margin expansion, and surprise on the upside.

We are focused on the alpha space, so beyond the equity market beta for us the opportunities are in the relative value and the market neutral type of approach.

Right now, we see a lot of opportunity in the material or hard commodity players in Japan. This sector has gotten a lot more attention in places like China and Australia, from both global and domestic investors. We see a geographic arbitrage, regarding Japan, where some of the big trading companies like Mitsui & Co. have joint ventures with BHP, Rio Tinto, Vale, that makes them one of the worlds' highest quality iron ore players. While there is almost euphoria in this part of the world (Australia) about the potential demand for iron ore or coking coal, Japanese companies are priced far more reasonably. We perceive a geographical mismatch between how certain things are priced in different parts of the world. In the end earnings results will level the playing field.

In contrast, we see firms that really are only a middle man - for example a steel producer in Japan - are priced too richly when compared to companies like Mitsui and Itochu. Investors seem to be a little optimistic in the ability of downstream players to pass on raw material prices to customers such as a struggling auto sector. Whilst they will get big volume increases in Japanese steel output as the world recovers, we certainly think they are going to be squeezed from a variable margin perspective. There are a number of industries that share this characteristic: very tight upstream supply of raw materials with a contrasting inability of downstream players to pass on increased costs to struggling customers. As we come out of the V shape recovery this contrast will become more apparent.

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In the medium term one of big themes of differentiation between companies is going to be those that can grow or represent good value in spite of a world that will continue to deleverage. We are seeing a big opportunity in the mid-cap range of companies. In the last six months, there has definitely been a flow towards large-cap liquidity. We do monitor some billion-dollar capitalization mid caps that actually are almost cash boxes in terms of good operations and incredibly good balance sheets. Some of these firms will be big winners in the coming six months or so, because we still see that the world is starved for credit. Even in Australia, which is supposedly the best performing G-20 economy, the banks are only lending for residential mortgages, but that's almost it. In fact, we have had negative credit growth in to businesses.

Apart from that cash-centered approach, we see a second investment theme in the ongoing growth of China. However, we believe that a much safer way to invest into the country is to look at the industrial rationalization and economization rather than just outright growth. There has been a lot of beta plays like infrastructure investments, however we prefer companies such as China South Locomotive, one of the duopoly operators who builds the fast trains that will be at the center of urbanization. We would much rather focus on companies that have higher margin, for example through a duopoly positioning, rather than many of the infrastructure plays who were just along for the ride of big government spending.

Adrian Redlich

For us it is quite interesting comparing the dynamics of a market like Japan, which is highly liquid and reasonably well covered; but focus on metals and mining companies is not really their core focus. Therefore, we see substantial opportunity in the material markets, but outside of the traditional markets like Canada, Australia, and more recently a China focus.

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We therefore believe that those firms with capital and good cash flows, those who have buffers and cushions, will be big winners. That sort of takes me to the second big, longer-term theme - deleveraging. The reality is that growth will be muted if there is not a credit growth. History shows that if there is no provision of capital in lending, businesses are challenged in their growth. Therefore, we focus on identifying who can grow, and who cannot. Last year was about survival, this year about growth.

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The China cement industry has been somewhat of a laggard from a stock market perspective while a lot of other industries benefited from the market uplift. Cement in China is an aging industry with 1.8 billion tons of productive capacity, of which about 600 or 700 million tons is based on extremely outdated technology - and needs to be changed as its energy inefficiency is unsustainable. There are just a few companies that dominate the new implementation of cement technology in China, and we believe they offer leverage to China's continued growth but also should grow from economization of raw material consumption even if China does not grow.

Dominic McCormick

We do take views on the broader asset classes, and how we want to be positioned. We started 2010 being a bit more cautious on equities, taking a view that some of the imbalances, particularly in the Western world are still there and still have to be resolved. Deleveraging at the consumer level is obviously one of the issues. We are looking for strategies and investments that can benefit from a range-trading situation in the equity markets. We are also worried about the longer-term implications of what central banks and governments have done, particularly about the implication of inflation over the longer term. Given this we have diversified using various inflation hedges, whether that is the inflation linked bonds, commodities and gold-related investments, and these have been a theme of the portfolios for some time.

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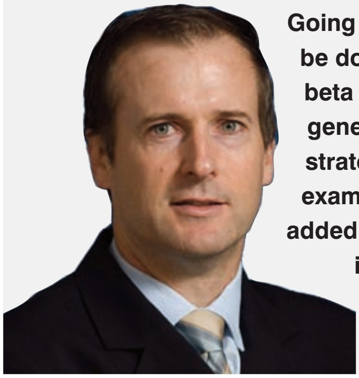

Going forward, we have essentially moved away from using a fund of funds as the core and will be doing a lot more selection ourselves. We do have a small component of cheap hedge fund beta to the extent that we think the broader hedge fund universe will perform. However, as general rule we are not looking to buy the hedge fund universe, but want to identify those strategies and managers that can add certain return and risk benefits to our portfolios. For example, managed futures worked well for us in 2008 and in 2009 we broadened that out and added some macro managers. We are now looking to add event-driven, multi-strategy-type of investments and think they can potentially add value to our portfolios.

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Going forward, at least as far as retail investors are concerned, it will be very challenging for the typical large, global, very diversified fund of hedge funds offerings given the issues of 2008. There will be niche fund of hedge funds, there will be more concentrated funds, those using managed accounts, but particularly at the retail level, the experience both from a return and the especially the liquidity perspective has left a bit of a bitter taste there.

Adrian mentioned the changed attitude to liquidity, and I agree that this is not going to change back soon, particularly in the retail space, where we focus a lot. It is a permanent change in the mindset of a wide range of industry participants.

We believe that going forward, the broader-based alternative products that invest across a greater spectrum of liquidity, those who actually got through this period without liquidity issues, could become a more important part of retail investor's portfolios across the board.

Matthias Knab **Going forward, what is the outlook for your strategies?**

Chris Gosselin At the moment capital raising is the greatest difficulty for the industry, both for established players and emerging managers. Of course the challenge to raise capital has always been there, but it was certainly much easier four or five years ago to raise capital or seeding from one of the big global banks. That is incredibly difficulty now. So the greatest challenge for the industry here, especially in the small to medium sized manager category, which is where the majority of Australian managers are, is capital raising. The Top 10 hedge fund managers in Australia probably have 80% of the assets under management.

Of course this scenario is not unique to Australia.

I was interested in Nelson's comments, as he is obviously solving that problem for the managers he has on the Ascalon platform. However I imagine he probably turns down 20 managers for every one he looks at. And even once a manager is seeded and starts trading, the challenge continues until he has built up the critical mass to be of interest to an institutional investor. The paradox here is that many of the best managers are boutique managers with the best performance.

Nelson Lam As a consequence of the global financial crisis, I am seeing more managers or new boutiques starting up in Australia who were probably managing money in the U.K. or U.S. before. There is a healthy growth of new managers who run money in the Asian region as well.

There is room for more players in Asian Equities in this growing trend for managers to set up boutique investment businesses. Apart from clean tech and renewable energy, which I had mentioned before, there is a lot more appetite and managers opening in the CTA or managed future space. Of course, as CTAs invest in liquid instruments, it has helped them meet investors' expectations regarding liquidity requirements.

For example H3 Global, which is one of Ascalon's Boutique Managers, has gone from about $80 million to $240 million in the last 6 months. If you studied that fund's success, you would find that a key differentiator - apart of the fact they are in the commodity asset class – is that they were rated by a few high profile asset consultants, which is important for distribution in Australia, and also because they can provide daily liquidity. These were key differentiators for a lot of investors.

One other observation, when I speak to local hedge fund managers, is that a lot of them have learned a lesson about diversifying their client base, their source of assets and their revenue. Before the financial crises, a lot of them were quite successful in attracting offshore fund of funds money.

Despite this success, they ignored local investors and spent little or no time on local marketing or distribution As the redemptions came in from the foreign fund of funds, those same hedge funds businesses are now under pressure to come up to speed very quickly on how to navigate the local market.

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A lot of boutiques, particularly the younger ones, feel that if they can rank number one in the surveys consistently that is enough. Just because you have good performance, it does not mean you are necessarily going to raise the money in Australia.

Platforms, for example, administered around 80% of the retail flows in Australia with thousands of funds on those platforms. That is challenging for sub-scale boutiques that may be under $100 million in size. On the one hand, you may have good performance, but on the other hand you have still need to play this patient game of getting through the right gatekeepers and more importantly learn how to navigate the layers of gatekeepers to the end investor.

Nelson Lam

As an incubator I think the lesson for many boutiques is: in order to build a successful and sustainable investment management business, a quality performance or track record is necessary, but by no means sufficient.

So to your second question of how do managers make it?

I feel a combination of good alignment of interest between the investment professionals and clients, a quality strategic partner that can provide the capital and distribution support, and a business philosophy of operating a sustainable business will provide investors and gatekeepers with the confidence to invest and allocate to the boutiques regardless the asset class or strategy.

Unfortunately, a lot of boutiques, particularly the younger ones, feel that if they can rank number one in the surveys consistently that is enough. Just because you have good performance, it does not mean you are necessarily going to raise the money in Australia.

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Larry Simon

A large portion of our clients are fund managers or start-up fund managers. The start-ups are traditionally a proprietary trader at a bank or are seeking to start something themselves after being let go as a result of the recent global financial crisis.

The managers largely differ in respect of their infrastructure. Obviously having the infrastructure at a big institution provided for you is a huge advantage, compared to starting your own business where the fund manager has to contend with all the administrative issues of running a business, whether it be preparing regular financial accounts, staff payroll matters, compliance etc.

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The managers that tend to be more successful are the ones that can focus on the trading and have sufficient resources and/or the ability to outsource these distractions, say for example by an incubator. We see a number of incubators, I think it is a growing trend in the industry for that very reason.

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Bruce Tomlinson

From our perspective, we evaluate Aussie hedge funds against global funds. For example, when Nelson was talking about CTA here in Australia, we would look at say a Sydney CTA versus a London CTA, and if the former does not stand up in terms of process, people, infrastructure and everything else, we just do not invest.

I think a lot of the Aussie funds don't necessarily recognize the amount of choices a direct investor has, particularly large super funds like ourselves. We are not going to take unnecessary risk, such as business risk or operational risk, that may come with a smaller, local fund. A lot of local funds have lower level of resources, but want to charge the same fees as the better resourced offshore funds, which does not make any sense to us.

For example, I have seen quite a few local funds trying to charge 1.5 and 20, or 2 and 20 for really just a few people, versus the deeply resourced offshore funds in Manhattan or Mayfair...so from our perspective, there is a bit of a disconnect there, and some people may want to reconsider their business plans in that respect.

So, as a net result, we currently have only one Australian fund out of the 20 that we are invested in. We are getting a bit closer to allocating to a second, but I would not see many more Australian managers in our fund, because as I said, they are competing in the global space. Hedge funds are global, we do not have an allocation bucket to Aussie hedge funds and global hedge funds - it is just hedge funds to us.

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Bruce Tomlinson

What Nelson said about consultant coverage is true, that certainly is an impediment.

The reason they are hesitant is that the funds are too small, they do not have much capacity, the consultants might be more interested in long-only than alternatives/hedge funds, so for them it is probably not worth doing a lot of work on it, because the fund says they only want to manage $100m or $150m. That means for the consultant, that they will not be able to put many of their clients in. Therefore, they are just not that interested.

We talked a bit about liquidity, but let me add that an investor like us does not need short-term liquidity, because we have a very good cash flow. However, that does not mean we like to be in a situation like what happened with the global financial crisis, where funds were frozen, liquidating trusts carved out, and investors locked up. For us, that was unforgivable when managers with quarterly or semi-annual liquidity suddenly said "well, no, we are going to put you in a liquidating trust", and two years later, we are still waiting for our money. There are quite a few that are still doing that - not just single strategy hedge funds, but also fund of funds where after two years I am still trying to get money out.

That's my take on liquidity. We don't really need daily or monthly liquidity, but rather we expect people to honor both their legal and moral obligations to investors and not breach them. I am very critical of some of the offering documents we see, that are so finely crafted by Wall Street lawyers, and it is unbelievable to see such little alignment of interest between the LP and GP.

Adrian Redlich

We started Merricks Capital in the beginning of 2007, and launched our first fund in January 2008, which means we launched right into eye of the storm and have gone through that environment. It is correct that the hurdles are much higher in terms of operations, structure, processes, and the history and background of the people involved.

In addition, the domestic industry in Australia has not been big supporters of alternatives for a number of reasons, whether it is as Bruce said the asset consultants that do not have the skills, low demand or interest, or they cannot get remunerated. We think it is an irony that now having going through a liquidity crisis and volatile markets, a lot more players in the domestic market have become more benchmark-aware or even benchmark-huggers in terms of how they invest.

In Australia and the Asian time zone, the investor objective is still very different from my experience of a decade in the US where you have an environment, even forgetting about the last two years, where you had to eke out a return from flat markets for 10 years. In sideways markets you have much more interest in alternatives if you are an endowment that needs to generate 8% to maintain your tax free threshold spend plus inflation.

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You are much more open to looking at alternatives that will generate 10%, 11%, 12%, versus an Australian investor who is really used to being hitched to the Asian bandwagon and enjoying 12% - 20% growth. So part of the slow uptake in alternatives it is quite frankly driven by less need to eke out a return in sideways markets.

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In the last year, there is another effect on top of that. Our institutional clients are all offshore, and the tyranny of distance has gone up for a lot of those institutions. They have shrunk organizations and their travel budgets have been reduced. In a world where everyone has to do multiple onsite due diligence and follow various processes to make an investment, it's a lot slower and challenging for everyone.

Dominic McCormick

We definitely see that recently more managers setting up, particularly out of the investment banks, although I am not sure that not being able to find a job is a good reason to start a hedge fund. We see a lot of activity in the multi-strategy area, and we also see a lot more global hedge funds making some sort of commitment to the Australian market in terms of coming down here, trying to get their hands into the market and diversify their client base.

I suppose we are a bit different from Sunsuper, we are not using global consultants and asking them to cover the whole global universe for us. In practice, about half of our hedge funds exposure is local funds, and we are happy with those generally, and the other half are based globally. When it comes to the global funds, they tend to be ones that we have either known for a long time or they have a commitment to Australia by having an office here or they come traveling down here quite a bit, because our size limits our offshore travel budget.

Another key issue is certainly fees. We have always been prepared to pay full hedge fund fees where we really believe significant value is being added. But, this perception that you set up a hedge fund and 1.5 and 20 or 2 and 20 is the normal rate and every hedge fund should be able to get away with it is just ridiculous.

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Dominic McCormick

I believe that as we come out of the crisis, there is a recognition that fees have to come down, at least for some strategies. The idea of paying full performance fees from zero in a market where you can get 6% on a one-year term deposit here in Australia, with most hedge funds without even having a cash hurdle, is something that the whole industry has to address, particularly in strategies that are long-biased and have a significant beta component.

John Corr We touched on the impact of distance and the difficulties in capital raising, and let me add an observation that kind of proves in what a bizarre world we are living. We established Fortitude six years ago, our track record has been fine, we won some awards and all that, so we had seen a lot of fund of funds coming to Australia looking to give us capital, and I thought that was all very successful. The funny thing is that now all these fund of funds are still coming down to Australia; they would come in for a meeting and inquire about our developments for about half an hour, and then they ask us for introductions to super funds. So, that's pretty bizarre.

I was interested in hearing Bruce's comment that distance plays no part in their decision, because we hear the same comment regularly from offshore investors that having someone around the corner that I can check on a fund regularly is a positive. So, the question is pretty straightforward, do you think local investors get any benefit at all, by being able to knock on the door at any time, quite literally? That is a serious question, whether there is a benefit in that at all.

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What has been said in respect to the gatekeepers and the benchmarking that it leads to is absolutely correct. Most of my peers with a similar history and about the same age – give a little bit longer or shorter - everyone is switching their marketing to try and raise money locally. After some 20 odd years in the industry, I have never had to deal with gatekeepers, this is a new skill I have to learn again.

I fear that how things are often dealt with at the consultant level seems to encourage benchmarking, because everyone is just scared to do anything different, and if your competitor is not doing anything different, why take the risk? Whether there is any answer to that or how this issue will further evolve, whether it evolves through flat markets or down-markets, I don't know.

John Corr

From our side, as the fund manager, we do prefer local investors because I believe they got a better understanding when something works and when something does not. There will be names, shares or situations that are Australian specific, and them being familiar with the environment is quite an advantage.

What has been said in respect to the gatekeepers and the benchmarking that it leads to is absolutely correct. Most of my peers with a similar history and about the same age – give a little bit longer or shorter - everyone is switching their marketing to try and raise money locally. After some 20 odd years in the industry, I have never had to deal with gatekeepers, this is a new skill I have to learn again.

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Bruce Tomlinson

John, as I said, we have got one local investment and are getting close to a second, we hold local funds to the same standard as offshore funds. We do more monitoring of our local exposures while for the offshore ones, we rely more heavily on our specialist advisor.

We do travel, but like Dominic our travel budget is limited. We do rely on our advisor who can be all over these funds regularly – at least monthly.

When it comes to the local funds in Australia, in fact we end up doing most of that due diligence work ourselves and do not rely that much on the local advisors, as I am a little bit critical of local advisors that generally are not looking at hedge funds full-time. They mostly do multiple different things in their business, and I believe you have got to be a focused, dedicated specialist to be working with hedge funds.

Let me add that this is how we run our hedge fund investments at Sunsuper, other super funds may have a completely different approach, either by doing things more direct (their own due diligence) or being heavily consultant led.

Chris Gosselin

Up until the global financial crisis, local institutions had almost all of their absolute return allocation through offshore funds. That is starting to change as many of those investors had bad experiences with gating and liquidity issues from offshore managers.

The fact is that generally Australian managers, with the exception of fund of funds, had an excellent track record when it came to meeting the redemption flood of 2008 and early 2009. However, local investors who followed the advice of the consultants and gate keepers to invest offshore were dramatically disadvantaged by both liquidity issues and either the effects of the Australian dollar, which fell from US$0.90 to around $0.60, or the cost of having to re-hedge their currency exposure before it rebounded back to US$0.90 again.

The industry here is heavily influenced by the consultants and gatekeepers both local and global, who carry huge influence, and no doubt prefer it that way. This does not only affect local managers, but also offshore funds wanting to raise capital in Australia.

It is not that there are no funds onshore, but Bruce made the point that it is sometimes very difficult to get some consultants to look at local managers. Investors often tell us how they had to really push the consultant to research a local fund.

One of the major consultants told us they are not prepared to do research on managers which don't have a billion dollars capacity, because if they put them on a recommended list, the fund will reach that capacity too quickly. This creates a potential conflict of interest, and is not necessarily in the best interest of the investor.

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Chris Gosselin

The reality is that investors often prefer to rely on consultants. There is a trust factor as well as a knowledge issue, where it is safer to take the advice of consultants in the event of a poor outcome.

Nelson Lam The managers have to remember that consultants run the business too, which determines what is worth their while. They also have to sell a product.

John Corr Isn't it the problem that they are selling a service to a client – that is getting rated by a consultant as a hedge fund – and then the fund manager sells a service to an end investor etc., and isn't the end investor actually paying three or four levels of fees on the way, without getting three or four levels of good service?

Bruce Tomlinson I agree, there are issues with the model. I draw this distinction between generalist consultants and specialist consultants, and I have made the case internally to move our fund away from the old model of having one generalist principal consultant over the whole fund. I am talking from an institutional perspective here - I think that is an old model which is not appropriate for funds like ourselves that have internal capability and a well resourced team.

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What is more appropriate is having specialist consultants who focus on particular asset classes and niches. From my perspective as a multi-manager or a portfolio manager, I want specialist advice. I want somebody who say is in Midtown Manhattan and who is all over these funds all the time, not a generalist relationship person in Sydney who knows less about hedge funds than I do, who does not travel as much as me, and does active research only part-time.

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Adrian Redlich

From a general point of view, if we contrast Australia to overseas, we are an immature industry. There are very few funds here with 10 years of track record. There are very few organizations with the robustness and stability to prove they can do something through time, when the markets fail. And I believe there is a kind of immaturity on the investors' side as well. When you look at a hedge fund investor say in Chicago or New York, where I spent a lot of my time, they did not expect the hedge fund manager or an alternative manager would be taking no risk. They expected that they took risk that was differentiated to a lot of the other risks in their portfolio.

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Adrian Redlich

To get a return, you have to take risk. I think that has done some damage here in this country that there was a misunderstanding and mis-marketing that hedge funds were a cash proxy.

But I strongly believe that there will be a need for us. We are going to go through a deleveraging phase here. We have an economy that has a multiple of over 100% debt to GDP at the consumer level, so we have to de-lever like most of the world. Without credit growth it is very challenging for long-only investments to perform in an aggressive manner, so I believe our time as absolute return managers will come. Now it is all about investing in your processes and surviving - like in most markets, you need to be liquid longer than the market can stay irrational... That is always the challenge, particularly as a manager.

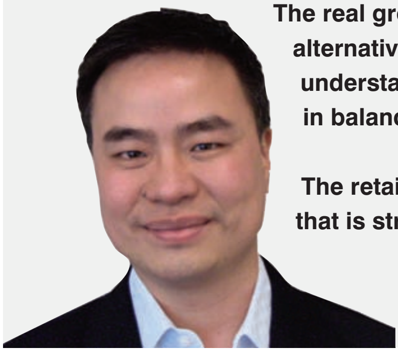
Matthias Knab

From where is the growth going to come for the Australian alternatives industry?

Nelson Lam

I believe the real growth will come from improving the understanding of the risk and return attributes of alternative and absolute return strategies to superannuation portfolios in Australia. A better understanding and acceptance will ideally result in large allocations to alternative asset classes in balance funds and industry funds.

The retail market will certainly play a role as well. Australia has a very different retail market that is structurally different to most offshore markets like the U.S. or the U.K. Financial planners and gatekeepers drive investment decisions and allocations which can sometimes even disadvantage absolute return managers, or managers that want to have the ability to go to cash.



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Nelson Lam

John's point about benchmark awareness is actually a symptom, and the cause is how investors' portfolios are structured, specifically with the idea of a financial planner designing the asset allocation including how much to put into cash. This means every manager that is pegged into the portfolio has a limited ability to go into cash. In offshore markets, we see that investor pay managers to make that decision. Given the recent events, I think the retail market will probably move towards this or start rewarding good managers for this decision.

Larry Simon

Just touching on that subject, the ASX proposes to launch a platform whereby retail investors will be able to invest in managed investment schemes through that platform. Do you see that changing the landscape?

Nelson Lam

If you look at Australia in general, whether it's fund management, retail, transport, childcare etc., most sectors are dominated by a few players because of the size of the market. That means there is a certain inertia when it comes to change in Australia, in any industry. I believe this applies to retail funds management as well. The ASX may have started a movement to change things, and as an incubator we encourage innovation, but it may require more than just a platform to change things, because retail monies are slow to move and heavily influenced by financial planners.

Dominic McCormick

One of the reasons the ASX is now looking at doing a platform is the broader regulatory move to strip out commissions, probably to eventually ban them and along with this also ban rebates for fund managers. I believe this is a promising sign that provides opportunities for good investment manages out there, whether they are conventional managers or hedge funds. Going forward, financial planners will be under much greater pressure to actually produce better portfolios for their clients rather than skewing portfolios towards the fund managers that pay them the biggest commission or biggest rebate.

I think this clean-up will happen as a result of the various reviews that are going on at the moment and the public's attitude post the global financial crisis. It will take a number of years, and in the end this will provide better opportunities for good managers. The problem is that the retail industry tends to focus too much on return without understanding risk and return. This does make things a bit harder for hedge funds, and education will be more crucial than before, but these developments and steps are positive.

Chris Gosselin

Most of us around the table know the structure of the industry in Australia but it might just be worthwhile outlining it for the overseas audience:

9% of every person's salary in Australia has to be invested into a registered superannuation (pension) fund. This is effectively a tax levied on the employer, but there are also tax incentives for the individual to make additional contributions themselves. There are strong moves to increase the compulsory contribution to 12% or even 15% to help fund the retirement requirements of an ageing population. So the overall pool of retirement funds, already one of the largest in the world, is growing dramatically.

The major superannuation funds can very broadly be divided between "Industry" (or "not for profit" funds), and those operated by the financial services and wealth management industry, the largest of which are now banks such as Commonwealth, NAB and Westpac. However there is an important third sector, called Self-Managed Super Funds, or SMSF's. These self-managed super funds can be termed self-directed investors.

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There are now over 400,000 self-managed super funds in Australia, and over one-third of all assets in the superannuation pool in Australia are now in self managed funds. There has been a dramatic increase in the number and value of SMSF's in the past 5 years, and it has been driven partly by tax incentives and partly by concern over the returns, and fees, from the wholesale funds. This is a huge issue for the industry and for profit funds, and to an extent, financial advisors, as the individuals running a SMSF are either wealthier or more financially experienced than the average.

At the smaller end, a SMSF may have only $250,000 in assets, through to many millions at the high end. Meanwhile, over 80% of financial planners in Australia are aligned to dealer groups, owned by product producers or banks. These self-managed superannuation funds may question if they can get independent financial advice from someone who is effectively owned by a product producer.

So, the opportunity for local hedge funds (and possible the offshore industry as well) is to market to this 35% (and growing) segment of superannuation assets.

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So, the opportunity for local hedge funds (and possible the offshore industry as well) is to market to this 35% (and growing) segment of superannuation assets. The challenge is to find them!

The other great opportunity for managers are the local Family Offices, which perhaps not as large as some of their offshore counterparts, are generally more approachable, and interested in quality local managers.

John Corr

Those self-managed super funds are obviously a sign that some investors are very frustrated with the level of fees and the process of benchmark-hugging we have just spoken about. I can confirm that with every bit of publicity we get domestically, people that manage self-managed super funds do contact us asking how to invest.

Apart from that, I also expect growth coming again from offshore, including foreign fund of funds. Drivers will be rising interest rates around the world which will cause investors to look differently at absolute returns. I also believe that when the Chinese asset bubble bursts, particularly Asian fund of funds will be looking for a more diverse investment base.

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If we look back at the domestic markets, I believe that with the aging population most investors would be looking for less volatile returns. They want to smooth their return profile, and probably 2007 to 2008 taught them that they cannot rely on equity markets in Australia.

John Corr

If we look back at the domestic markets, I believe that with the aging population most investors would be looking for less volatile returns. They want to smooth their return profile, and probably 2007 to 2008 taught them that they cannot rely on equity markets in Australia. Also, if you look at it statistically, Australian pension funds do rely on the equity markets. I think the aging population does not want to rely on rising asset prices for their retirement, so they will look for low volatility returns. Our equity market will go through a period of flat returns, similar to what we see with changing demographics in offshore markets.

Dominic McCormick

I agree with John on the markets. If markets are more subdued, that does create opportunities for other types of strategies that hedge funds can deliver.

Getting the support of self-managed super funds will not be easy though. A lot of self-managed superfund investors want control, they are focused on fees, want transparency, and typically they may be looking for strategies that they themselves cannot do. They can do Aussie shares themselves, so they may be more looking for some global or multi-strategy type opportunities.

From a regulatory point of view, Australia has benefited from the principal of regulating every firm equally, no matter if they run a hedge fund or conventional investments. There is a risk that with the current reviews this principle may change and that regulators in some respect overreact to some of the issues that the global financial crisis has exposed. Hopefully, the self-managed superfunds are not excluded from certain strategies such as most hedge funds because they are seen as the avenue for the more experienced investor. I would hope that hedge funds are not targeted, but it would not surprise me if there are more restrictions on how retail investors can access more exotic or leveraged investments for example.

John Corr

An overreaction in regulations would be a real concern. In an election year, it would be easy for politicians to try and theoretically protect mom and dad by kicking hedge funds. It would be a major concern if politicians or regulators would be giving retail investors no choice.

Matthias Knab **What can you do against that?**

Chris Gosselin I think the key is education. We provide information where possible to the media, but really the level of education and knowledge of the people outside the absolute return space is quite limited.

The knowledge of many mainstream journalists can be very limited – few have a real understanding about financial markets, how brokers work, banks or investment banks, or the hedge fund industry. There have been some wild accusations and a lack of real knowledge amongst a wide cross section of Australia – from politicians down to worried executives - with the result that hedge funds are frequently misunderstood. For instance, the largest manager here, Platinum Asset Management, with over A$16 billion in FUM, does not refer to themselves as a hedge fund. While the mainstream media is part of the problem – which basically is the case in most other countries where you have hedge funds – they are also part of the solution.

Matthias Knab **What can you do against that?**

Adrian Redlich Generally, the level of regulations here in Australia is a point of differentiation. All funds in this country are regulated to a varying degree, which makes Australia stand out if you compare it to other jurisdictions in the alternative space globally, or particularly for offshore investors who are looking to invest into the Asian time zone.

While compliance is of course a tedious work for a fund manager, this highly regulated environment does provide offshore investors the comfort of working with a manager based in a G-20 country, as opposed some manager who may be based in a far-flung part of the world without regulation. While we also are in the far-flung part of the world, we are highly regulated at the same time, and I believe it allows our investors to sleep a little bit better at night.

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Interestingly, we have actually seen a number of inbound inquires from offshore investors for Australian dollar funds; particularly investors from Japan, Europe, and the U.S. where they are questioning the outlook for their local economies.

Cynical people could say this is a form of a carry trade, but I think investors want this not necessarily from a short-term perspective in terms of a dressed up form on interest rate arbitrage, but more as a reflection upon a country that has very low debt at the government level, and where structurally they perceive Australia to be versus say the U.S.

We see this as an opportunity. I cannot say yet if this is short-term or whether it will be a trend, but it has been quite a surprise to hear U.S. investors asking for Australian dollar denominated opportunities, I don't think they have done that before.

Dominic McCormick

I have a quick example of that. We met with a global manager this morning. This firm does not yet have any Australian clients, but they have Japanese clients. Those Japanese clients want to invest in an Aussie currency vehicle. So the global manager is looking to set up an Australian dollar class even before they have any Aussie clients.

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Dominic McCormick

Chris Gosselin

This makes sense for them, not only from the perspective of the currency and interest rate differentials. We have monitored Australian fund performance for three-and-a-half years now, and our data in some cases goes back 10 years. Performance of the local hedge fund industry has been very good. The average Australian hedge fund lost 17.74% in 2008 against the ASX which fell over 40%. If you take the industry globally, it performed about the same, down somewhere between 17% and 21%.

In 2008, 25% of the 200 plus managers in the AFM database produced positive returns, and over 90% of them outperformed the ASX200. It was only the fund of fund sector that was affected by redemption and liquidity issues. Although being in this part of the world may create travel and time issues ("the tyranny of distance"), the industry is well-structured, well-regulated and has a wide range of experienced and quality managers.

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Larry Simon

There is a piece of legislation in front of Parliament that is likely to shake up the industry. The government has stated that it will be abolishing the FIF (Foreign Investment Fund) rules for international investors.

At the moment, if an Australian invests in a foreign fund, that person pays tax on unrealized gains, even though that person has not realized the return yet i.e. that person pays tax on their mark-to-market return of their investment in the offshore fund.

The government has stated that they would like Australians not to be disadvantaged by investing in offshore vehicles. Hence, it proposes to repeal the FIF rules. Going forward, this will mean that Aussie Managers won't be forced into operating a domestic fund. Australian managers can just operate an international fund, because Australian investors will have the opportunity to invest in offshore vehicles without being disadvantaged by the tax rules. This also means less costs and less regulatory burden, which is a big benefit for the Australian hedge fund industry.

Fund managers can also get rid of the requirement to have what's known as a "bed and breakfast", where they traditionally would close the fund at the end of the financial year to realize any losses or gains made and the following day re-open or re-establish the position to ensure continuity.

In addition, the Australian government is trying to make Australia a more tax-friendly and attractive environment for foreign investors. The foreign withholding tax was 30%, it was reduced to 22.5% and currently stands at 15%. Next July, it will go down to 7.5%. It is recognized that 7.5% is certainly greater than 0%, which can be obtained in other regions of the world. However, the attraction is that Australia offers a well-regulated, prudential market with a healthy banking system, which allows foreign investors having comfort that their money is secure.

Regarding the shift towards individually managed accounts, certainly they offer benefits (such as better bargaining power and tailored investments), but people have to be aware that they come with additional risk and compliance issues, for example managing trade allocations between accounts and how that is done equitably between multiple accounts.

A lot of people haven't considered the potential risks with individually managed accounts. Investments in a fund have a limited liability i.e. the risk is limited by the amount of the investment into the fund. However, the investments made for an individually managed account are in the name of the investor (their personal account). They are just "managed" or "operated" by someone else i.e. the dealing is performed by a third party. Accordingly, if that person acts irrationally or the markets turn sharply very quickly and the account goes into negative equity, the investor is personally responsible for the account and the liability associated with it. Managed accounts do come with risks and clearly need to be managed very carefully.

Nelson Lam

Let me add another aspect regarding the make up and evolution of the local financial industry in Australia. Apart from wholesale, retail and the self-managed superfunds, Ascalon have had some success in a fourth market, which we call the mezzanine market. These are made up of large dealers groups that are gaining scale and as a result form their own model portfolios or multi-manager portfolios. This is a potential growing market for hedge funds to target. Instead of targeting multiple decision makers, you may have one expert within the dealer group designing the portfolio, and they may have less reliance on external consultant advice.

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That means you are still tapping into the fast-growing retail market without having to spend a lot of time and money doing marketing, road shows or professional development days. I would guess that the funds these groups would be looking for are more the kind of mainstream hedge funds rather than what you would find at the sharp end of the hedge fund strategies. That means probably long/short, global macro, commodities etc. as I would guess the dealer groups probably understand those strategies quite well.

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Bruce Tomlinson

From our perspective as a superfund, in spite of the fact that we haven't made many allocations in Australia, I am still positive locally. If I look at private capital, venture capital or property and infrastructure, there are many multiples of capital invested in those asset classes, and there is no reason why hedge funds cannot increase their allocation over time.

The difference is that those other sectors have been established for longer, they have better consultant or gatekeeper coverage, people and trustees are comfortable with them. So hopefully over time, hedge funds can also get up to 5%, 6% or 7% allocations.

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However, if you look at the primary hedge fund strategy here – Australian equity long/short - I think the challenge is that institutional pension funds already put so much capital in long-only Australian equities. They take on a lot of systematic market risk, and to a certain extent they do not want to add more Aussie equity beta. That is an opportunity to offer the more unusual or very low-net exposure strategies to them.

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