OPALESQUE

Opalesque Round Table Series '10

BOSTON

Opalesque 2010 Roundtable Series Sponsor:

Editors' Note

Dear Reader,

Welcome to our inaugural Opalesque Boston Roundtable. More than New York or any other place in the U.S., Boston is probably the place where the two industries - traditional and alternative asset management - most closely co-exist.

We asked ourselves, and the distinguished participants of this Roundtable: "how do these sectors converge, confront, or cooperate? What is the relationship?", and found surprising answers. Were you aware that the majority of hedge funds within the Bostonian alternatives community did actually NOT come from Fidelity, State Street or any of the myriad of large, established asset management organizations, but from somewhere completely different?

In this Roundtable, learn more about:

- ... the structural issues that may prevent established firms like Fidelity Investments from broadly adopting alternative investment strategies
- ... the role, evolution and impact of electronic trading, which has made the market more democratic and allows a startup to be "on par" with institutions running a $100 million budget
- ... a small firm in Duxbury (MA) that trades around 1% of the total U.S. listed option volume - every day
- ... details on a joint venture between a hedge fund and traditional firm – a model for the future?
- ... how Boston based hedge funds participate in the wave of mutual fund launches that follow a classic hedge fund strategy (and a discussion about alpha/beta of those mutual funds)
- ... how Cambridge Associates, one of the largest and oldest consultants focusing on hedge funds, is expanding their model and work with more hedge funds than before
- ... a discussion about the implications and consequences of pension money flowing into hedge funds
- ... the truth about "activist investing" - what really works and what doesn't
- ... insiders' views about what really happened on May 6th, the day the Dow dropped 1000 points.

The Opalesque Boston Roundtable was sponsored by NYSE Liffe U.S. We also thank the Opalesque 2010 Roundtable Series Sponsors Custom House Group and Taussig Capital for their support, as well as Kaufman Rossin for providing the meeting venue for our team:

- **Tim Krochuk, Managing Director,** GRT Capital Partners
- **Eric Brock, Founder and PM,** Clough Capital
- **John Fox, Director, Client Portfolio Manager,** PanAgora
- **Alec Petro, Managing Partner,** Bay Hill Capital Management
- **Kevin Divney, Chief Investment Officer,** Beaconcrest Capital Management
- **Todd Bourell,** Partner, ValueAct
- **Charles (Charlie) Cassidy,** Director of Operational Due Diligence, Cambridge Associates
- **Thomas Callahan,** CEO, NYSE Liffe U.S.

Enjoy the read!

Matthias Knab
Director Opalesque Ltd.
Knab@opalesque.com

Cover Photo: Boston Common and Public Garden, oldest public park in the U.S. (1634). Picture by Matthias Knab.

Participant Profiles

(LEFT TO RIGHT)
Standing: John Fox, Alec Petro, Kevin Divney, Todd Bourell, Matthias Knab
Seated: Eric Brock, Charles Cassidy, Timothy Krochuk, Thomas Callahan

Opalesque Boston Roundtable Sponsor

NYSE Liffe℠ U.S.

Introduction

Thomas Callahan
NYSE Liffe US

My name is Tom Callahan. I am the Chief Executive Officer of NYSE Liffe US, which is the U.S. futures exchange of NYSE Euronext. We are very focused on innovation and on market structure, and I think if the last seven days have taught us anything, it is that obscure issues of market structure can suddenly rear their ugly head and become very, very relevant. So, we have been working very hard for the last two years at NYSE to - specifically within the U.S. futures space - introduce some innovation and competition, and hopefully bring a more balanced market structure which we hope will help all of you and others in the city of Boston.

Timothy Krochuk
GRT Capital Partners, LLC

My name is Tim Krochuk, and I am a managing director and portfolio manager with GRT Capital Partners, LLC. I'm also the Chief Operating Officer for Denver Investments Alternatives—for whom we sub-advise alternative investment products. Denver Investments is an $8B asset manager based in Denver, Colorado. GRT Capital is a Boston-based investment adviser with 11 alternative investment strategies, and one mutual fund. GRT was formed in 2001 by Greg Fraser, Rudy Kluiber and me, all formerly Boston-based investment managers. GRT is a fully independent, employee-owned enterprise with an experienced team of investment professionals. Our managers have decades of experience, and many boast top Lipper ratings in their investment histories. Our team members have worked at major Boston-based institutional asset managers including Fidelity Investments, State Street Research, Wellington, Boston Partners and BlackRock Asset Management. Strategies at our firm include value long-only and long/short, opportunistic long/short, market neutral Europe, three long/short sector focused strategies, closed-end fund long/short, microcap long/short, ETF global tactical asset allocation, and an equity multi-strategy separate account structure called United Alpha. This structure essentially unites our strategies into what we believe is both an operationally unique and a client-friendly multi-strategy account.

Charles Cassidy
Cambridge Associates

I am Charlie Cassidy of Cambridge Associates, where I am the co-head of our hedge fund research group. Cambridge Associates is a provider of independent investment advice and research to over 800 institutional investors -- especially foundations and endowments -- and private clients worldwide. We were founded in 1973, and our services include investment consulting, outsourced investment office services, independent research, and performance monitoring and tools across traditional and alterivative asset classes. We emphasize due diligence, proprietary research, customized service and complete independence from money management firms. Overall, we have over 150 dedicated research professionals who produce about 100 proprietary reports per year; our databases track thousands of managers and funds across traditional and alternative asset classes, globally. In fact, we have advised clients on alternative assets since the 1970s. Today, we advise clients on $21 billion of hedge fund assets.

Eric Brock
Clough Capital

My name is Eric Brock and I am Portfolio Manager at Clough Capital. We have about $3.3 billion under management. Our flagship offering is a long/short global fund that just had its ten-year anniversary, and there is about $950 million in that fund. In addition, we raised three closed-end funds between 2004 and 2006, so we do have some public funds. The closed-end funds also have global mandates and represent about $2 billion in assets. We also have a couple of Asia-focused funds. One is an Asia-Pacific long/short fund. We have been seeding that for a couple of years; primarily internally, though we are now bringing investors into that fund. We were recently named manager of a five-year old open-end, long only China fund, now called the Clough China Fund. In addition to our Boston headquarters, we have a Hong Kong office that we established last summer. So, we are globally oriented and outside the United States we have a particular interest in Asia. We invest across asset classes, but we are primarily equity-focused.

Alec Petro
Bay Hill Capital Management

My name is Alec Petro. I am the Managing Partner of Bay Hill Capital Management. Bay Hill is a volatility-focused, multi-strategy hedge fund so we only trade in equity volatility products globally. We trade with a quantitative bias where we have automated, high-frequency strategies and some less high-frequency, but model-assisted or technology-assisted strategies. We have nineteen professionals between two offices. One office is in Duxbury, MA and we have one outside San Francisco, CA in Danville. Bay Hill is only three years old, but it evolved out of a proprietary trading business that was solely options-focused. We have about $130 million under management and a quantitative team of four PhDs. We have a technology group that facilitates trading on the different exchanges. Our trading systems are co-located on all of the major options exchanges in the U.S. and execute approximately 10,000 transactions a day between our strategies. We place a real emphasis on remaining neutral to market direction and moves in overall volatility levels. We seek to profit by exploiting inefficiencies in the market's pricing of volatility on a product by product basis.

John Fox
PanAgora Asset Management

I am John Fox, Director at PanAgora Asset Management, which is another client firm here in town. We run a little less than $18 billion. The vast majority of those assets are long-only equities, but we do have several market-neutral funds that we run using physical equities long/short, but we also have a number of futures-based, multi-strat solutions which are run at a variety of volatility levels for a handful of institutional clients. PanAgora has been around since 1985, originating out of the Boston Company. We became independent in 1989. We have co-ownership between Nippon Life and Great-West Life/ Power Financial in Canada. Our hedge-fund capability primarily evolved from some of our long-only quantitative solutions, and so our largest clients have been long-only, global-equity investors that recognize our capability to implement the short side of the book. Because of this, we have had a great deal of success with some very large corporate pension plans, most of them in Europe but doing fully market-neutral long/short equity strategies.

Todd Bourell
ValueAct Capital

My name is Todd Bourell and I am from ValueAct Capital. We have been in business for ten years and manage $4 billion in one fund that is hedge fund fee structured, but long-only. We describe ourselves as governance-oriented investors, so we end up on boards for about a third of our portfolio companies and try to help unlock value through our actions in the boardroom. We are located in San Francisco and Boston and were founded in 2000 by Jeff Ubben, who is my partner.

Kevin Divney
BeaconCrest Capital Management

I am Kevin Divney, Chief Investment Officer of BeaconCrest Capital Management here in Boston, a firm that I founded a year ago this month. We started trading our first fund in October. The strategy is long/short equity focused on U.S. stocks. It is a blended investment strategy where we use what I would call a traditional but more high-frequency quantitative model to identify candidates, and there is fundamental research around that. The other thing we do is we try to overlay a macro view in the fund, and that really manifests itself through industry bets. I have been in the investment industry here in Boston since 1988 -- this is only my fourth firm; I guess that is kind of unusual. I have been managing money here since 1994, and one of the reasons I founded the firm is because I believe the assetmanagement industry is truly at an inflection point and all the lines between the different fund wrappers are starting to blur, and we saw that as an opportunity.

Matthias Knab

More than New York or any other place in the U.S. – Boston is probably the place where those two industries - traditional and alternative asset management most closely co-exist. How do they do converge, confront, or cooperate? What is the relationship?

Kevin Divney

The relationship has been one where the traditional big firms did not really know what was going on in the more innovative firms that set up their shop and started to gather assets and do something very unique, but ultimately I believe it comes back down to clients. Clients in the last decade have not been served. Whether you are a union worker with your 401(k) or you are CalPERS, over the last ten years, basically whatever asset allocation plan you had has pretty much failed, in my opinion, on a risk-adjusted basis.

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And so I think we are seeing this convergence of the two worlds – traditional and alternative - because we have all this talent here. I am somewhat surprised that not more people are leaving the large firms to go out on their own. The barriers to entry are still low, but surely they continue to go up over time. A big positive driver is the abundant training that is offered here. Great talent comes through the traditional, large firms in Boston here where people get solid traditional training early in their career, and this talent can then be used by the alternative managers as well.

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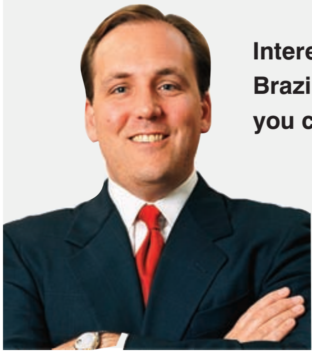
We also see evidence on the side of the larger firms where they try to run hedge fund-like and capital preservation strategies and wrapping them different ways.

I am not sure how the backend of the asset management firm of the future is going to look, but I do believe that what client need on the frontend, the final product, has changed. Who delivers what, how a product is wrapped up, really does not matter in the long run.What matters is what kind of return stream a client gets, how sustainable it is and what is the downside risk.

Eric Brock

For a hedge fund, Boston is a great town to manage money in, and one reason is the smaller environment here. If your process is fundamental and research intensive, access to corporate management teams is very important. We are a global fund and we are active in Latin America and Asia. We go see them, of course, but they also visit us. All of those management teams come to the States and usually start their trip in New York, and of course they also then come to Boston. They have to meet with the giant mutual fund managers that are here. It's not just the large blue chip firms we see, but also small and mid-cap companies.

We are a growing firm but small relative to some of those giants. Still, we don't have much of a problem connecting with corporate managers, because there aren't dozens of firms just like us that we are competing with for attention.



Interestingly, when our own clients come to visit us, inevitably they run into a team from China or Brazil for example, and I think they are always surprised to see that, given our size. So in Boston, you can run a reasonable amount of money and still have enough scale to ensure that you have needed access to managements. Incidentally, we can say the same thing about our relationships with the external research firms and their analyst teams. Boston is unique like that for the small to medium-sized hedge fund managers.

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Charles Cassidy

When I was considering the hedge-fund industry in Boston, the first thing that struck me is that you would expect the industry here to be filled with people coming out of Fidelity, State Street or any of the myriad of large, established asset management organizations. After all Boston has one of one of the most significant concentrations of asset management firms in the world due to its position in the mutual fund industry. But if you look at many of the larger hedge funds that operate here, they are really spinouts from Harvard. Over the years, a lot of the talent has actually come out of Harvard, which is somewhat obvious given the size and nature of the Harvard endowment and its historically large allocation to alternative assets and hedge funds.

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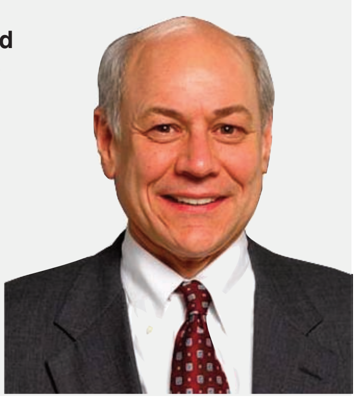
The other thing that struck me is that the industry in Boston is more investor- focused and less marketing-focused.

Charles Cassidy



The other thing that struck me is that the industry in Boston is more investor- focused and less marketing-focused. Many of the firms in Boston promote themselves much less aggressively than similar organizations in other cities.There are a number of organizations that are very happy to fly under the radar, while still managing very significant amounts of assets.. There are some very big firms in this city and it clearly should be considered one of the centers of the hedge fund industry.

Timothy Krochuk

It is also worth noting some of the structural issues that may prevent established firms like Fidelity Investments from broadly adopting alternative investment strategies. First of all, adding hedge funds to an existing long-only business could create cultural issues. Who gets to run the hedge funds? Who keeps running the mutual funds or long-only portfolios? Suddenly a firm would have two classes of citizenry and everyone would want to be in the exciting, sexy and highly profitable hedge fund side. The manager of the largest mutual fund in a firm may suddenly feel underappreciated when compared to the much more profitable hedge-fund manager of a fund 1/10th the size.

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The other issue is related to disclosure. Reporting of short positions has been required in the past, and could conceivably occur again under tighter regulation. Such disclosure could be a public relations nightmare for many large institutional players. Imagine that one of your portfolio managers elects to be short the stock of a very profitable 401(k) client. I'm sure that would make for an interesting meeting the next time your firm is up for review with the investment committee.

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Charles Cassidy

Wellington is one organization in Boston that comes to mind, and I am sure there are others that have actually done a good job in this respect. They created a hedge-fund business within the organization and have successfully seeded it with people from the organization, and figured out the economics of it in a way that encourages people to set up hedge funds yet remain within the Wellington organization.

Timothy Krochuk

You are absolutely correct. In fact, GRT Capital was founded on similar principles. We are a manager-owned collective of previously successful investment managers where everyone is highly, and correctly, incentivized.

Alec Petro

My perspective from the quantitative side is a little bit different. I went to school in Boston, moved around and then came back here with the desire to start a more quantitatively oriented shop. You have a lot of long-only firms and not that many quantitatively focused funds, but there is a lot of talent from Harvard or MIT which makes Boston a great base to start a fund that has a different focus.

I look at Boston as very much a dichotomy between the mutual funds and the hedge funds; but even more so from a quantitative area – the city seems to have a lot of talent, but not that many quantitatively focused funds. It seems that the majority of the talent here focuses with long-only managers. Meanwhile, our space does offer a lot of opportunity, and we can easily find talent willing and able to join us, so we have gone out and started our firm in small steps.

We were also involved in starting an absolute-return mutual fund with a quantitative overlay, so there are some initiatives to extend more advanced, if not cutting-edge investment strategies to the general public.

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John Fox

I agree with what Alec said, particularly about the quantitative dimension. Frankly, we do not view our competition in the local Boston hedge fund or institutional space but rather in Greenwich or New York.

The competition is not just in long/short but on the long-only side too, because most of our solutions are multi-strat in nature and encompass equities, currencies, bonds and yield-curve arbitrage on a truly global and multi-strat basis.

Todd Bourell

From the perspective of a fundamental stock-picker, I like not being in New York. Being out of step with the hedge-fund scene in New York means that you can miss things; but I think most of the things you miss are the things that at the end of the day I would rather miss. Our investors do tell us that we have relatively little overlap with other hedge funds, and I think that geography plays at least a small part in that.

Thomas Callahan

Although I do work for the New York Stock Exchange, I was born and raised and educated in Boston – so I have grown accustomed to biting my tongue when the topic of sports comes up in the office.

If we take a look at the three primary money-center cities in the U.S.: Boston, New York and Chicago, the traditional stereotypes are that New York was very bank-dominated; Chicago was dominated by the professional traders - the groups that came out of the pits when the markets went electronic and set up proprietary trading outfits; and Boston has been dominated by your traditional long-only asset managers. But, in terms of NYSE flows and where our volumes are coming from, those lines are just starting to get blurry now. For example some of the big Chicago firms that started off as just small groups of people with good technology and some decent market savvy have grown to the point where now they more resemble traditional long-only asset managers than they resemble hedge funds. And if you look at how the banks conduct their business in terms of providing liquidity, they really adopt high-frequency trading strategies as a survival mechanism, because just a guy and a phone is not enough to really be competitive in the current markets. Boston has definitely adopted both of those cultures.

I joined the Exchange in 2008 after having worked at a bank for most of my career, and from my position here it feels a bit like peeking under the curtain. Market participants may think they know where volumes are coming from; but when you are at the Exchange and you really see where volumes are coming from, it is fascinating to see how electronic trading has transformed the

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Thomas Callahan

market. It is not just the large players that drive volumes anymore - electronic trading has made the market so much more democratic. This not only includes cities like Boston, but you can go way outside of even our borders into regions like Latin America or Eastern Europe, where huge volumes are created by people that no one around this table has even heard of. This is possible because these people are very smart, they have invested in very good technology and they understand market structure. I believe that ultimately this is a very good and beneficial development that results in flows being more balanced than they would have been five or ten years ago.

Matthias Knab **Would it be possible to tell us a little bit more or some more of those surprises or insights that you have seen when you lift that curtain?**

Thomas Callahan It is every time a surprise when we go into offices that are about as big as this little conference room and host just five or six traders, but these folks turn out to be dominant in many of the large futures contracts that operate around the world, because their technology and strategies are excellent. Co-location certainly has leveled the playing field – you don't have to be a behemoth institution with a huge sales force, you can just compete with your technology and on your wits.

Kevin Divney I concur that electronic trading has made the market more democratic. Coming from two large institutions that were backstopping before - one had a $100 million budget at one point - I have set up an investment infrastructure for my own business in the last 12 months, and let me tell you that I was pleased, and somewhat shocked to see that we are on par because of technology.

The one nice thing about Boston is that you can understand the flows, or occasional herding that happens. You can see those trades going on – and if you have the right technology and the right systems, you can even see things like the flurry of activity after some firms end their daily morning meeting. This democratization of the markets has enabled the smaller firms to compete directly, execute much more efficiently and pursue their alpha strategy.

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Kevin Divney

A lot of traders in the traditional firms focus mainly on impact, versus say VWAP. They were always measured on how much harm they did on the impact, where if you are in a position to be a price-taker, the implementation of your strategy can be much more streamlined.

Technology can really put you on par with the large firm that does not have that ability to move things anymore. You can build that institutional infrastructure pretty quickly without having to take five, ten years to build it.

Alec Petro

We are a smaller firm in Duxbury, MA , and our trading systems are co-located on every exchange in the U.S. and trade around 1% of the listed option volume every day in the total of the U.S. option volume. We did this in Duxbury, MA because the technology allows us to. It is a nice place to live; and now, a lot of the people from my firm live nearby, for quality of life and reduced commuting. We are somewhat removed not only from Boston, but from New York and everywhere else, as Tom said, nobody knows we exist and I have to worry less about anybody poaching any of our talented team.

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It is a little bit of a different feel out there. We don't have to be in Midtown, or in Greenwich to make these businesses work. Some people say they are in Boston because they don't want to be in New York. In my case, we would rather be in Duxbury on the waterfront than Boston.

Alec Petro

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Matthias Knab

Tim, I want to single you out a bit, because you have started a joint venture with a midsize traditional asset management company. Can you tell us more about how this came about and what you are doing? What are the benefits? And, do you see this as a trend?

Timothy Krochuk

Sure, let me step back a bit to give you the broader picture. In the 1980s we had institutional money management - fees were transparent and reasonable, and a lot of the business was based on relationships. Then in the 1990s the hedge funds kicked in and they brought a lot of good things to the table, for example lots of great talent and better ways to control risk. Hedge funds added some additional tools, specifically leverage and shorting, to the portfolio management toolbox. Used properly, these tools were used to better achieve the conservative goals of institutional investors. But it wasn't all great. The 90s also saw the introduction of multiple layers of fees that hedge funds became famous for. Disclosure was replaced with secrecy and a lack of transparency. In 2008 capital was restricted as investors discovered how painful lockups and gates could be. Ultimately theft and fraud left the industry in shambles. The history of hedge funds has certainly had its ups and downs.

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What we decided to do was change up the model a little bit. Together with a larger, institutional partner, we have created a new product called United Alpha. We take all ten of the independent managers at GRT, and allow our clients to invest in any combination of those strategies through one separately managed account. This account will have some exciting features including daily transparency, daily liquidity and netted fees. Netting of fees means that gains are offset against losses, if any, before the application of the performance fee. This means investors will never pay a performance fee when the whole account is not profitable—even if one of the sleeves is positive for the period. This was a problem in 2008, when some managed accounts/platforms or fund-of-funds paid a performance fee to positive managers on an account that had negative performance in the aggregate. I'm glad I didn't have to explain that one to an investment management committee! We eliminate that issue completely with the netting of the fees.

Given the disruption in the overall marketplace, it seemed a smart thing to do to become affiliated with a larger organization, which we did with Denver Investments in 2009. With this combination, the client gets the expertise and track record of an established boutique hedge fund manager, but with the comfort that one can derive from dealing with an investment management firm with over $8 billion in AUM. Our partner Denver Investments has been around since 1958 with a diversified and longstanding client base.

Denver picked up that talent, track record and infrastructure in one step, while GRT received scope, scale and distribution by being associated with a large, well-established firm. While the venture is new, there is nothing really new about this product as the underlying strategies have live track records.

The United Alpha account is getting good traction so far. Consultants and advisers like its flexibility. When they make a decision to move assets between sectors or asset classes, we can start to trade on their recommendations the very same day. They are not "locked-up", and they do not have to wait for the end of a quarter or a month when we are competing with everybody else to trade.

Timothy Krochuk

What we decided to do was change up the model a little bit. Together with a larger, institutional partner, we have created a new product called United Alpha. We take all ten of the independent managers at GRT, and allow our clients to invest in any combination of those strategies through one separately managed account. This account will have some exciting features including daily transparency, daily liquidity and netted fees. Netting of fees means that gains are offset against losses, if any, before the application of the performance fee. This means investors will never pay a performance fee when the whole account is not profitable—even if one of the sleeves is positive for the period. This was a problem in 2008, when some managed accounts/platforms or fund-of-funds paid a performance fee to positive managers on an account that had negative performance in the aggregate. I'm glad I didn't have to explain that one to an investment management committee! We eliminate that issue completely with the netting of the fees.

We never raised gates at GRT in the 2008 liquidity crisis. Then, as now, we provided liquidity to the market when it needed just that. At the peak we were set to reach $1 billion and now we are closer to $300 million. Notwithstanding that, we still wanted to pursue our own growth goals and launch United Alpha. Given the disruption in the overall marketplace, it seemed a smart thing to do to become affiliated with a larger organization, which we did with Denver Investments in 2009. With this combination, the client gets the expertise and track record of an established boutique hedge fund manager, but with the comfort that one can derive from dealing with an investment management firm with over $8 billion in AUM. Our partner Denver Investments has been around since 1958 with a diversified and longstanding client base. The United Alpha product is offered under their umbrella with GRT's experienced hedge fund managers running the strategies. GRT is the sole alternative investments sub-advisor to Denver Investments.

When I look at where the hedge fund industry is heading, maintaining one's independence and investment focus, but offering the comfort derived from a large investment advisor, makes a great deal of sense. For us, the joint venture was right because Denver wanted to get in this space. They had no alternative products, while we have a nine-year alternatives track record, multiple audits, a proven back-office and both long and short capabilities. Denver picked up that talent, track record and infrastructure in one step, while GRT received scope, scale and distribution by being associated with a large, well-established firm. While the venture is new, there is nothing really new about this product as the underlying strategies have live track records.

The United Alpha account is getting good traction so far. Consultants and advisers like its flexibility. When they make a decision to move assets between sectors or asset classes, we can start to trade on their recommendations the very same day. They are not "locked-up", and they do not have to wait for the end of a quarter or a month when we are competing with everybody else to trade. We believe this product is very client-centric. It draws from all of the lessons learned in 2008, essentially putting the clients and their advisers back in control of their assets.

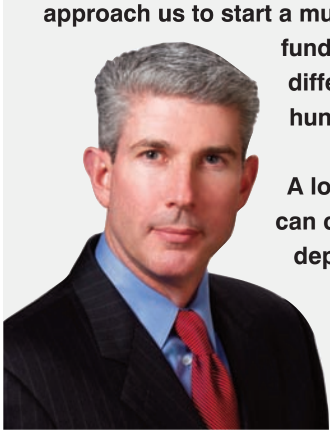
One other benefit from our new approach is a streamlined due diligence process—and in the post-Madoff world we all know how important due diligence will be! By having all of our ten independent managers trade through one trading desk, under one investment adviser, with one single investment management agreement—we can increase the comfort level for our clients while saving advisors and consultants time and money.

Kevin Divney

The pension funds will be a major source of assets for hedge funds. However, it may take the majority of them two-to five-years because they are refining their due diligence process. Many of them do not want to use fund of funds, which would be the quick way, but rather use single managers. But they do not necessarily want to invest with someone who was a trader for two or three years, but rather a portfolio manager who has managed large pools of assets with client constraints.

I see there is a new trend happening right now as well. We just started out and we have already had two people approach us to start a mutual fund. In the last 15 months about 35 mutual funds have launched with a classic hedge-fund strategy. So, what does this mean for fees? If the return and Sharpe ratios are not any different in three years, someone is going to write a paper that says "Well, you got this for a hundred and you were paying two-and-twenty; but the Sharpe ratio is the same".

A lot of the products come out of this town because you have MFS, State Street and others that can crank things out in no time. These firms have massive marketing departments and legal departments, they can do everything in three months, it's incredible. The core investment strategies will just take on these different wrappers, but the regular core investment strategies really have not worked. We had bond funds that were down 35-40%, right?



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Matthias Knab **Do you think there is Alpha in those mutual funds, or is this already a Beta?**

Kevin Divney The risk of Beta has overwhelmed the Alpha. Let me explain what I mean. If you tell me that my 250 equity analysts were fantastic to create Alpha, that still did not keep you from going down 40% in 2008. So, on a relative basis there is Alpha, and I think that if you base an asset-allocation decision based on the 1980s and 1999s paradigm, then you are saying "well, equity markets generally go up; they do not have these big draw-downs, so if I can get a little bit above that and earn my fees, that Alpha is worth it".

For the Alpha that is there, even for the good funds, I don't think some funds are worth the risk. So yes, there is Alpha, but the Beta can overwhelm that and in a short time period all the Alpha can get washed away. You can be top-quartile and get all these awards; but you are down 17% and the market is down 25%; that does not feel too good in real life.

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Capital preservation, maybe giving up the eighth and ninth innings on a trade, are okay if you can protect the downside. I think it all comes back to why people traditionally put money to work in the capital markets: to beat inflation. You may have some skill or something else, but does it work year-in and year-out? I think that looking at longer cycles is another Boston mentality.

I remember there were times when people who wanted to get a job in the investment world had to wait for somebody to retire. Then around the year 2000 all this changed and for many of the old hands it was quite incredible seeing all these people getting jobs as analysts and portfolio managers. I think that is another kind of cultural thing about Boston: people do not jump around as much as they do in other parts of the country. People do not measure their success in a calendar year but rather with "I have been with this firm for a decade" or "I have been through this down market, and this momentum market, and this valuation trade".

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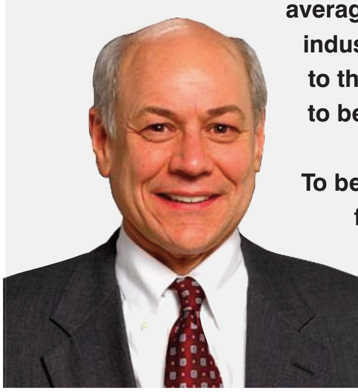
Matthias Knab **Charles, what are the trends that you are observing from a consultant's perspective?**

Charles Cassidy Our clients have been significant allocators to hedge funds for a long time. For example our clients average allocation to hedge funds is around 20%. Now compare that to the pension-fund industry, where hedge fund allocations are in single-digit percentages. I think that people need to think about how much of that pension money will be flowing into hedge funds. Is that going to be good for the industry, or is it going to be bad for the industry in some respects?



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To be honest with you, I am concerned about this big wave of pension money that is going to flow into the hedge-fund industry - and whether it ultimately will be good for the industry.

Charles Cassidy

While we all want to see more capital in the industry, I also believe that in 2006 and 2007 it was a problem that too much capital was flowing into the hedge fund industry too quickly. There was just too much money flowing into the industry as a whole; too many people got into it. It was relatively easy to become part of the industry and raise significant amounts of capital - certainly much easier than it is has been for the last two years. Of course, some of that occurred because credit was too easy, and this wound up being bad for the industry. Therefore, to be honest with you, I am concerned about this big wave of pension money that is going to flow into the hedge-fund industry - and whether it ultimately will be good for the industry.

Another trend we see is the desire to allocate more money globally. We prepared a report on the African hedge-fund market earlier this year for our clients thinking about developments in and the evolution of the African hedge-fund market. We also did a similar report on Latin America in 2009. We held one of our client conferences in Latin America last year. We continue to look for opportunities for alpha, for unique strategies not only in the U.S. but outside of the U.S., and we do see that the hedge fund and asset management industries are continuing to grow outside of the U.S.

I spent some time recently in Asia and feel that the Asian hedge-fund market is well-structured and poised to grow. There are several growing pockets of hedge funds in Singapore, Hong Kong, China and other cities.

Matthias Knab **Can you go a bit more into the details of the risk that you see if the pension money is coming in? Are we going to see the same errors of the 2000s?**

Charles Cassidy A lot has been written about the challenges that pension funds have with their unfunded liabilities. Many of the states are underwater relative to their pension liabilities. They need to be doing something different now. They seem to be viewing hedge funds as a source of superior returns, which may or may not be the correct perspective. Regardless, they're beginning to look at hedge funds that way.

If you look at the amount of pension assets, small changes in the overall pension allocation to hedge funds will have substantial consequences. They don't need to go from 5% to 20% in order for substantial assets to flow into the hedge-fund industry. My concern is that as more pension money flows in subpar talent will get into the industry. There could be a range of ramifications.

Matthias Knab **To what extent has the consultant's job to select managers changed? There is so much more data available now on hedge funds, no?**

Charles Cassidy Yes, there is considerably more data that is available from firms today than that there was, say, two or three years ago. The information available continues to evolve in response to investor needs. In addition, one of the things that we clearly find is that clients are much more interested in understanding the details involved in the due-diligence process. They want to understand what we are doing and how we do our jobs. There is certainly a heightened level of interest in understanding what goes on in a hedge fund. In fact, hedge funds are generally perceived to be less transparent than they actually are.

I actually find most hedge funds to be very transparent. We have always strived to have relationships with managers where we can fully understand what they are doing, and if we cannot understand what a hedge fund is doing, then we will not recommend them. Therefore, transparency has always been and will always be critical to us. We understand managers need to protect their competitive edge, but, at the same time, investors need to understand what they are investing in.

Matthias Knab **You are, of course, one of the largest consultants. When you look at hedge funds, what are your criteria? When does a hedge fund really become eligible?**

Charles Cassidy One of our goals is to narrow the industry down to a manageable universe of hedge funds that we can spend the required amount of time with to fully understand how they achieve their results and how they fit into a diversified portfolio of hedge fund investments. It is a constant process for us, trying to winnow that universe down. We have as an organization developed some fundamental biases over time. For example, we have not historically been big proponents of highly leveraged strategies, global macro or quantitative strategies.

Cambridge Associates has traditionally been a fundamentally focused investment consultant. We like to understand investment strategies from the fundamental stock-picking basis. We have built our business, our reputation, and our knowledge base off of fundamental investment analysis. It has worked particularly well for our clients over the years, and it has definitely been a bias that we have had.

At the same point in time, as our client base continues to expand and grow more diverse, we are encouraged to explore a broader set of strategies. Clients understand the benefits of various strategies as they relate to diversification and hedging, so they continue to look for different sources of Alpha and different ways to manage the risks in their portfolios. As a result of this, we continue to broaden our perspectives, this is certainly something that we continue to work at every day.

As a side note, over the last couple of years we have become a user of MeasureRisk and are using that also as a risk-management tool to gain additional perspective on managers. More and more managers are now willing to participate and to provide data to MeasureRisk. We at Cambridge are building out our capabilities to use these quantitative tools to evaluate managers and understand performance attribution.

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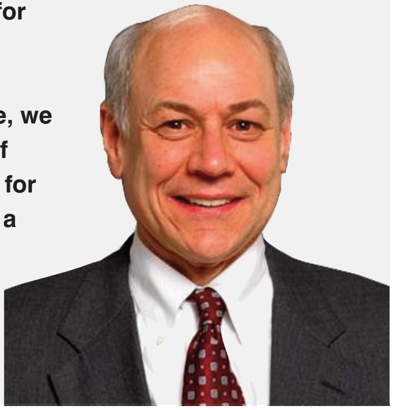

Matthias Knab **Who else is doing something new or launches a new product?**

Alec Petro We are preparing an Alternative Beta product that we will launch in different variations. There are already a couple of mutual funds launched out of Boston that are effectively hedge fund replication funds. They break down five to eight factors that drive hedge fund returns at a much lower fee structure. These products have a very transparent and liquid structure and daily liquidity.

At the moment, we are running the strategies internally and researching what would be the best way to launch them, possibly in a mutual fund format. We have had success with the absolute-return mutual fund I mentioned before. A successful launch for an alternative Beta mutual fund is $500 million, so it takes a while to get to critical mass.

Our absolute-return mutual fund demonstrated that if you can produce a good product, investors will come and buy it, they will buy it for the Alpha and won't have to pay for Beta.

All of our team members and we as a firm have a strong options background. We have also experience an increased demand for options overlay strategies to reduce volatility of returns for long bias-managers. A lot of long-biased hedge-fund managers who had a difficult time in 2008 saw their investors run for the hills, because they did not want to pay for Beta. They are paying those fees for Alpha, and a lot of the managers are trying to look at ways to mitigate their volatility.

We are thinking about offering overlay strategies for other managers where we say to the manager "tell us what you want your volatility to be, and we will create an overlay strategy to fit your target. Or alternatively, tell us what your investors' target is for the volatility..." Interestingly, a lot of the long managers or long-biased managers have no idea what volatility means - that is the scary thing. They say, “We don’t know what our fund volatility actually is... What is my volatility?” And when we tell them “well, your volatility is 1.5 times the S&P”, and they are like “oh, really, we need to reduce that”.

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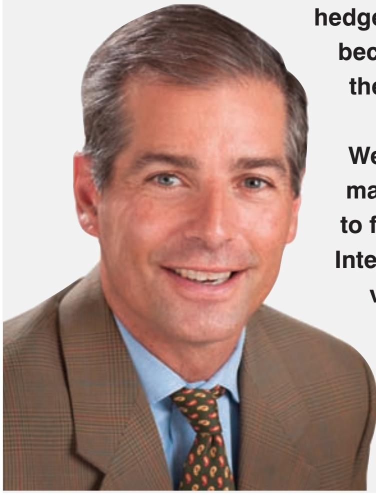

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Kevin Divney

We have one product which is currently in the research phase. We used part of this within our long/short strategy, and it is rooted in the evolution of the market - something I observed over the last year – however on longer time periods. Basically it is trying to exploit fundamental factor rotation but not in a high-frequency trading strategy.

There are Wall Street firms that put out baskets of characteristics of types of stocks; but you do not always know what is in them, and think their models are not as calibrated for sustainability. But we can empirically 100% guarantee there is rotation between things that are dominating in the markets and sustainable periods, meaning it is weeks, it is not hours and seconds. We apply a different perspective here. In the past, those rotations used to happen in cycles of months or even years.

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You could always see this rotation; it is just that the velocity has accelerated in the last 10 years.

Kevin Divney

So on Thursday May 6th when we had the 1000 point drop, momentum sold off and valuation worked. And we can see a model portfolio where we were actually generating Alpha on an absolute basis on that day. Now, that affects our long/short fund; but it is not an explicit strategy.

I think some investors would almost use that as a risk tool in some way. For example, if your growth managers start becoming too momentum-ish, but you still like your growth managers and you do not necessarily want to rein them in, then I can slide this value thing in to hedge them back a little bit. The whole process is based on security fundamentals.

Like any money manager, I observe and study the markets very closely. You could always see this rotation; it is just that the velocity has accelerated in the last 10 years. It started after dot-com and it just goes on: you go from a value market to a no-quality market, to a high-quality market, to a momentum market. It is all happening in weeks, while before people could say "I am the deep value manager in the '90s and I can have a terrific year" or "I am the high-momentum manager and that is my normal portfolio; I can just sit there, and eventually the market will kind of come to me".

So to me, the mystique of what Alec and the high frequency traders do is exploiting this factor rotation on a real short-time basis. I can recognize their impact through our tools and strategy.

Alec Petro

As you mentioned, we modeled factors into our model. Incorporating a factor model is actually part of our "secret sauce". We try to understand factors and also dial into their dynamics. When we see that a core factor gets more volatile, we dial it down. Obviously, we want to target the volatility; but we also think that it is relevant in the factor rotation part of the allocation process.

So it is kind of interesting, because both of us think about the same thing but from a slightly different angle and approach.

Kevin Divney

Yes, we look at not only the volatility of the factor, because you can see a momentum factor is very volatile, especially if you are using the 14-day RSI, so that is very volatile.

But then you can if you have a long time-series perspective, meaning "long" these days could be one year for your risk metrics, five years for your Alpha metrics; but if something is over-earning. So momentum clearly was over-earning until last week. When you have the S&P RSI over 70 for 3 weeks and it is the selloff on Thursday, it did not shock me because the market had gotten up there and you see just momentum was working; so when valuation rotates back, that is another way we are trying to dial it.

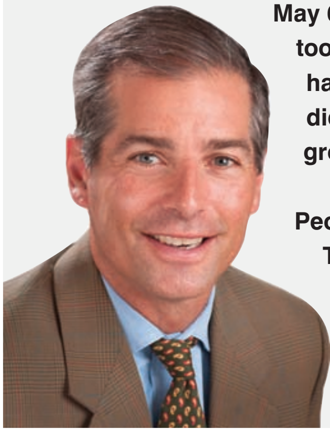
But the thesis behind it - having working with both fundamental and quantitative specialists during the last 15 years - is that the ultimate price drivers of equities have not changed that much over time. Things just move much faster today. Ten years ago, every group in an industry did not report on the same day or maybe a day apart - now, they do. And, if they report a day apart the analyst gives them a hard time on the phone: "What are you doing? I am trying to get ready for my call here".

So I think the equity-pricing relationships have not moved away from Graham and Dodd; but the velocity of them has changed because we are incorporating information so much more quickly. I remember standing by a fax to get a 10Q at 7:30 at night. Now it is on your Blackberry and you are riding your bike to work, so you do not really need to be all these places to exploit this information. I want to add that my comments are rather U.S.-centric, because here we have much more a level playing field, especially in my universe, which is the Russell 1000 and the S&P 500.

Alec Petro

May 6th, the day the dow dropped 1000 points, was a great example of too much information and too much velocity overwhelming liquidity, and a lot of people are still searching for what happened on that Thursday. Everybody wants to blame the quants; but what guys like us really did, was just turn our machines off. I do believe that this sudden withdrawal of liquidity by a group of systematic traders did affect the market.

People were used to a certain level of liquidity and we made a decision at a point on that Thursday that we cannot trade reasonably in this market and went into a “wait” mode, that created a vacuum and a certain momentum along with that. Hopefully the Exchanges will unify their circuit breakers, because the circuit breakers, when they kicked in, did a good job; it is just that not everybody was on the same page with them.



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Alec Petro

Thomas Callahan True, some of the other exchanges or liquidity pools were not on the same page as the New York Stock Exchange.

Our view is that the NYSE model worked very, very well and actually prevented what could have been an even bigger mess. If those rules had been more broadly adopted across the industry, you would not have seen this sort of needless volatility and the trade breaks that we saw. I am not sure what the outcome of some of the D.C. meetings will be - Duncan Niederauer, our CEO, was at the SEC on May 10th, and I think Larry Leibowitz, our COO, testified on May 11th. But I would be very surprised if what comes out of this is not something where the NYSE LRP type of concept is more broadly adopted across the industry.

Alec said something extremely important: the market has started to rely on high-frequency traders - automated traders, algo traders, whatever the acronym that you want to use - the market relies on that community to have liquid-stable markets. And by and large they do an amazing job of it. I would hate to see what comes out of that May 6th experience as a further attempt to try to demonize that community.

If you look at any academic, objective analysis of the value that high-frequency trading brings to all markets - lower transaction costs, more transparent markets, more liquid markets etc. -- and when they all pull out at the same time, which is I think probably the most simple explanation ultimately of what happened last week, we hit certain triggers in volatility. There was probably a set of high-frequency traders that by and large have similar triggers in their models as to when they pull out. Their models probably gave them an exit signal around the same time, and when lots of other orders came in, it resulted in excess volatility.

Again, it goes back to some of the things that I was saying earlier on about the importance of market structure. No one really likes to think these things through until something goes wrong. Our view at the NYSE is that - having lived through the profound changes in equity market structure that have occurred over the past seven years, with a lot of changes brought in by the SEC - the equity markets really have level playing field. There is no monopoly nor duopoly in the market, the equity market structure has been well balanced. Maybe some will argue after the May 6th experience that the markets have become a little bit too balanced and needs to be somewhat more concentrated, but in general there is no debate that by and large the changes in the equity market in the last number of years have been very good for the end-user investors.

At the same time in the futures market we have gone the exact opposite way. We have actually gone from a relatively balanced market structure with multiple U.S. futures exchanges all competing day-in/day-out to the consolidation that has given us a de facto monopoly in the U.S futures market.

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We have been working on our NYSE Liffe U.S. exchange for about two years now. Our big launch is going to happen this summer where we will be competing with the CME in both U.S. Treasury Futures and Eurodollar Futures, which are their two biggest products. The centerpiece of that strategy is focused around a new clearinghouse that we are building with DTCC that you may have heard of; it is called New York Portfolio Clearing. The big bet there is that in the current environment, capital is very scarce and very expensive, and we as the clearinghouse will be cross-margining cash bonds and futures together. Those are natural complements, but at the moment every investor is being double-margined. To the degree we can put futures and cash together at the clearing level, we will be able to release a significant amount of trapped capital back to the market and we hope that will be the reason for liquidity to move to our platform.

Thomas Callahan

Probably somewhere in between those two extremes lays a happy medium, so therefore our mission at NYSE Liffe is to try to introduce some competition into the U.S futures market. There is a reason why it hasn't happened before. Multiple players, as most of you probably know, have tried to compete with the CME, and so far the CME is 4 and 0 in dispatching those aspiring competitors. The reason is because it is very difficult, and the barriers to entry in the U.S. futures market are extremely high. People tell us all the time that they want competition -- no one likes having one vendor for any product, be it a telephone service, or energy, or derivatives -- but at the same time they are not going to do economically senseless things in order to get that competition.

Obviously the NYSE has a very substantial footprint in the U.S market - not only equity clients, but also as owners of the Liffe Exchange in Europe, which is the third largest derivatives exchange in the world. About a third of that volume actually comes out of the U.S. markets, we are therefore very familiar with the core players in the U.S. market that operate very actively day-in/day-out in the futures world.

We have been working on our NYSE Liffe U.S. exchange for about two years now. Our big launch is going to happen this summer where we will be competing with the CME in both U.S. Treasury Futures and Eurodollar Futures, which are their two biggest products. The centerpiece of that strategy is focused around a new clearinghouse that we are building with DTCC that you may have heard of; it is called New York Portfolio Clearing. The big bet there is that in the current environment, capital is very scarce and very expensive, and we as the clearinghouse will be cross-margining cash bonds and futures together. Those are natural complements, but at the moment every investor is being double-margined. To the degree we can put futures and cash together at the clearing level, we will be able to release a significant amount of trapped capital back to the market and we hope that will be the reason for liquidity to move to our platform. We will be updating and informing the market more in detail about our offering, and we expect that in the third quarter of 2010 we will be competing in the US interest rate futures market.

Alec Petro

When you say "cash", do you mean that I can hold stock and futures in the same account across margin?

Thomas Callahan

It is initially focused on U.S. Treasuries, agencies, and the agency mortgage-backs; so not initially focused on the equity market.

Matthias Knab

We also have Todd from ValueAct here, whose fund has probably a much different investment strategy and holding period as the other players here at the Roundtable. How has value and activist investing changed over the last few years?

Todd Bourell

First of all, we might not characterize ourselves as "activists". We end up in Board roles in typically about a third of our investments at any given point in time, but over the course of ten years in business have only conducted one proxy solicitation process. If you take this as the mark of someone being activists or not, this is not something we typically do.

Matthias Knab

But there is a approach called the friendly activists, right?

Todd Bourell

I guess some might describe it that way. In our portfolio structure we tend to have about 20 investments, and probably 85% of the invested capital is in say 15 investments. For those core 15 investments I would say we have a three- to five-year average holding periods. There are some investments that are almost verging on life-of-fund investments now - going into their seventh or eighth year.

Part of the effect of 2007 and 2008 to our industry was a shakeout in the type of activism that was regarded somehow as "fun and easy". Here people launched absurd proxy challenges along with absurd claims against managements and Boards. The assumption was that there was such an active environment for controlled purchases by private equity, so that as soon as you could push a first domino in a situation you could end up selling a business. There were a lot of people who did not know how to work the management teams or cooperate with Boards – some managers may have tried to be "activists" because they were in fact able to go out and raise money from people who all of a sudden wanted to allocate to activist strategies. That situation was entirely absent through most of 2008, all of 2009. It might be changing now to a degree. I would say there was a big shakeout among people who claimed to be activists.

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At the end of the day, we are fundamental-focused stock-picker who try to help generate excess returns by cooperating with management, often as parts of Boards, making changes in business composition and capital structure that derive return that is independent of the market over time.

Matthias Knab **How does it work exactly when you approach a company suggesting you want to invest heavily and work with them?**

Todd Bourell Let me start out telling you that the general presumption that a typical Board will include company shareholders is simply not true. On top of that, while there is this great sort of theoretical respect for this unseen shareholder, when you are actually in the room as a shareholder – in our case we would represent 15% of the shares of a firm – in some firms we come across this odd perception that somehow ValueAct's interests are not aligned with the interests of this amorphous theoretical shareholder that they represent. And this even though these Directors typically have none of their own capital in the business. Frankly, it is a very bizarre dynamic.

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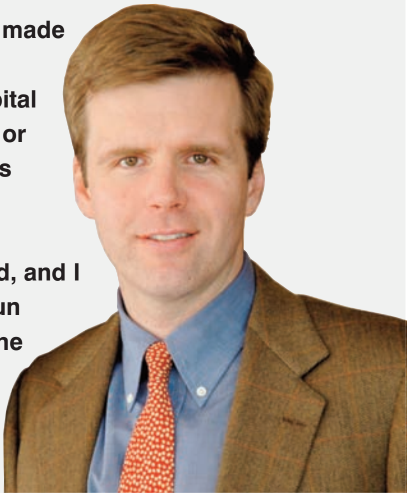
A CEO can - until the company is run into a ditch - tell a typical Board that the moon is made of blue cheese, and it is not the inclination of the typical Board of Directors to throw themselves in front of a CEO strategy. I think what we can bring to bear is that our capital compels us to do the proper work, to understand what is really going on in a business or an industry, and that knowledge combined with the capital brings a certain heft to one's arguments in a Boardroom.

That being said, to your original point, the knock-knock, "I would like to join your Board, and I think you can help" line is not how you typically start a first date. Unlike people who run proxy solicitation processes to achieve a settlement that ends up with them being on the Board, ours is typically an outcome that flows out of a courtship process.

Todd Bourell



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Matthias Knab **And what is the greatest skill that is required to do this type of work? Psychological?**

Todd Bourell First, you better be right on the investment, because all of a sudden you are married to the business indefinitely as an insider with a 15% position, heavily locked up in the way you can transact in the stock. If you look at the portfolio, the firms we invest in tend to be highly stable businesses that have been around for decades and operate in oligopolistic industries. These are businesses that are not likely to blow up.

Businesses like that are usually highly valued, so you have to find them at a point when they are not. This can be the case say when either the industry or the business has run into a ditch, or the firm has been mismanaged for a period of time. Therefore being a decent stock-pickers is the precursor for our type of work, because it does not matter how many Boards you get on: if the investment is not going to work, things may not get better just because you are in the board room with one finger on the steering wheel.

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Once you are in the Boardroom, your value add is based on a certain degree of diplomacy combined with knowledge about the business, the industry and capital markets you bring to bear. I would say you have to bring true knowledge and insights into the industry and business as well as the way that public markets operate, combined with an ability to work with a group of people that helps you gets something done at the end of the day.

Matthias Knab **What is your investment outlook at the moment?**

Eric Brock We see a lot of opportunity in the US and Asian markets. You really need to take a global view today. There is certainly a lot of value in large sectors of the US stock market. Corporate America is surprising healthy today. In Asia, and on a smaller scale Brazil, you see secular growth in consumer spending being driven by growing middle classes and increased credit penetration. I will come back to that.

We started the firm and our global fund in March 2000. The S&P 500 was at 1380, and when I left today (May 11th) to come to this meeting, more than ten years later it was 1166. That means, if you threw some dividends on there over the last ten years, your returns are, at best, flat if you have been invested in the S&P or even the MSCI World index. It suggests that a lot of the excesses that we saw in the late ‘90s have been definitively wrung out of equities. This is not true of the economy, because we are on a path of deleveraging, particularly in the household sector which will be multiyear in duration, at least three to five years. But that is not necessarily bearish for equities, even if we are in a slow-growth World as a result.

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If you look at cash balances as a result; money-market funds, bank deposits, U.S. T-Bills, it is a number that was close to $14 trillion, maybe peaked at $14 trillion but it is still north of $12 trillion. That pool of capital, investable capital, is still growing because the household sector is structurally turning into a saver and the corporate sector is a very strong saver now and that should persist in terms of free cash flow in corporate America.

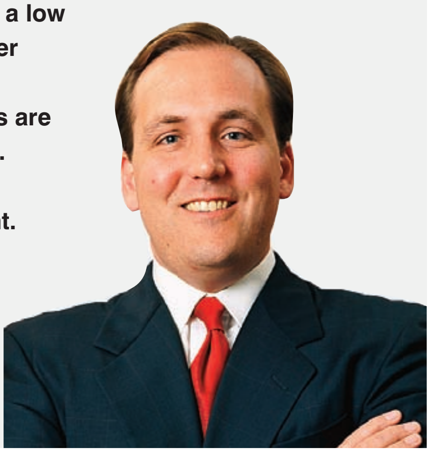
All this capital is stranded capital as we describe it: it is sitting at the money rate, earning virtually nothing, 0%. In fact, if you go to the bank and look carefully at your statement, it is very likely that you are actually paying the bank to hold your money when you consider fees.

We will be contracting private sector credit. We cannot reflate anymore and this means the banking system has to contract as well.

This all means that we will be creating less credit market instruments for investors to purchase while at the same time we have massive pools of capital earning next to nothing in yield. This is a recipe for a low yield curve, especially at the short end and this situation will persist for a much longer period than most people can imagine. It’s bullish for stocks. This is also positive for corporate bonds and credit generally, but those markets, including distressed credits are illiquid and have tightened considerably over the last year and are mostly played out.

Equities become the default asset class of choice here in a yield starved environment. This is bullish for the shares of any quality company with a high free cash flow yield and it’s also bullish for areas of the world where you can find growth and positive ROI, like we see in China’s domestic economy.

Eric Brock



We are seeing a shortage of yield emerge, and it’s a serious problem for an aging country and for fiduciaries who have to earn returns. During the crisis of 2008 we saw massive portfolio deleveraging, much of it forced. The household sector, retail investors raised cash; many hedge funds were put out of business, they are certainly are using less leveraged strategies today, and of course we have the shadow banking system and that is in runoff now.

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All of this capital is stranded capital as we describe it: it is sitting at the money rate, earning virtually nothing, 0%. In fact, if you go to the bank and look carefully at your statement, it is very likely that you are actually paying the bank to hold your money when you consider fees. The prudent saver earns negative returns. For providing that service, the bank is actually getting paid in this low-rate environment.

So financial portfolios have been delevered and corporate America has as well, but the household sector still wants to, needs to, pay down their mortgages and other consumer loans. Demographics demand this. This will take a while and is likely the dominant factor driving the financial markets for awhile. If you look at the big picture, the private-sector debt to GDP ratio in the U.S. is well north of 300, close to 360%. By now, the fact that we will be reducing leverage in order to repair balance sheets in the US is a consensus view. It is right.

However, you can only de-lever by either paying down debt or growing incomes. As I mentioned, corporate America is being run for cash, so that is not an area of balance sheet growth. We really can't grow incomes or GDP without credit expansion, and after the last housing cycle, we have no material unencumbered asset class like housing to leverage. Further, mortgages amortize to the tune of 14% a year; just the average life of a mortgage is just seven years because people move and, of course you are paying it down. So mortgages shrink, not grow from here. We will be contracting private sector credit. We cannot reflate anymore and this means the banking system has to contract as well.

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Equities become the default asset class of choice here in a yield starved environment. This is bullish for the shares of any quality company with a high free cash flow yield and it's also bullish for areas of the world where you can find growth and positive ROI, like we see in China's domestic economy.

In an economy which struggles to grow, areas with excess capacity, think services sectors such as lawyers and education, and of course real estate, will have trouble maintaining pricing and margins. Fortunately, the market in the US is so big, we don't have to be involved in those sectors plagued by overinvestment and weak demand. There are other areas where we have seen consolidation and dominant companies emerge, so that even in a slow growth domestic economy, pricing and margin integrity can be maintained.

Sectors I am talking about include the auto-supply chain and other industrial areas like aerospace, for example. Technology is, perhaps, the best example. You have elements of pricing power; but you do not even really need incremental pricing in these industries because free cash flow is so high. So a company like Microsoft generates a 10% free cash-flow yield today, and at 10% if you do the math it doubles in a little over 7 years. So within the next few years Microsoft, Cisco, Dell or even more mundane industries such as bottling with a Crown Holdings or Owens-Illinois will give you this very high free cash flow as a substitute for near-zero returns at the money rate. This will be arbitraged down before too long. The cash is eventually going to build and is going to be recognized by equity investors. We'll get our hands on it.

So in the US we can find a lot of free cash flow value, whereas in Asia, we can access very strong growth. Fortunately, we also have surprisingly low valuations in Asia. China is our focus market there and given the correction we have seen over the last nine months, this is particularly timely. We generally structure our portfolio along themes. For most of the last ten to fifteen years, China's growth model and policy was centered on promoting a powerful export sector along with creating national champions in its domestic economy. Both were quick, efficient strategies to generate capital and scale and to promote labor market growth. China has been a policy-driven market, and it will remain policy driven. Today that model is changing and policy is unambiguously focused on economic rebalancing where household consumption and the urbanization and development of the large Central and Western provinces take priority.

We see a very long cycle of increasing consumer spending in China which will be helped by a rapidly growing middle class and disposable incomes. Consumer credit is also beginning to take hold creating demand for consumer durables. Some terrific, entrepreneurial, privately owned, though listed growth companies are emerging in these sectors and the cycle is very long. Those that say China is overbuilt, tapped out, are taking a much too narrow view of this $4 trillion economy. The excesses in China are obvious, but less problematic than some believe. China's interior is going to be developed and they have the blueprint from the now wealthier coastal regions to use for the investment model. You need to head past Shanghai to see the emerging investment stories. Investors will miss this if they avoid or passively index China. These new themes have materially higher upside than the prior cycle winners.

So we think it is a great time to invest in global equities, particularly if you consider where we have come from.

Kevin Divney

My view on equities is that the complacency that a lot of investors got into now will have to change for a number of reasons. From a macro perspective, we thought the business cycle was gone, and now it is back. Even though it was the great recession it was also pent-up recessions. We did not really have economic slowdowns, it was very mild shallow ones compared to U.S. history. Therefore, I believe equity prices are going to follow that and we are probably going to have more shallow recessions and those more frequently than we did in the recent past.

The reason for this is that 60%, 70% of world GDP growth today is explained by emerging markets - developing economies. Their self-correcting mechanisms to adjust monetary and fiscal policies as well as their information systems within the economy are not as good as ours. That is another reason why we are going to see more volatility. How will Brazil adjust to something, how does China do it or India? These countries and their policies are accounting for a bigger share of the U.S. economic growth including the last crisis, because we are a lot more connected. The capital markets are really reflecting that.

While I think probably short term I am more positive on equities because it is a recovery trade - the economy is in recovery, and the market is not terribly expensive. I also think that it was impressive seeing how U.S. managements were adept and so rapid at adjusting to changing conditions in firing people and drawing down capital stock and keeping Selling, General & Administrative Expense (SG&A) in line with revenues. All firms now have this agility, because of the power of real-time information systems. You do not have to be the Six Sigma GE, you can be a little billion-dollar company and still have your earnings report on the seventh business day after the quarter.

I am not sure what we are getting will be a fire-and-forget equity market, but still investors need the ability to stay with a long trade like we just had, and of course to adapt as other changes come in. I don't know what the second half is going to look like. Some Economists are saying it is going to be awful again. Structurally things are still in disorder – different definitions and redefinitions of unemployment are understating the true drag on the economy. There is the first, official one that showed something like 9%, then there was this other with 17% and a third measure is at 22% because they counted people that should be working and are not - college grads and people like that.

So, we are in the camp where your investment horizon has to flexible, I do not think you can really look out more than six months right now, with the structural challenges: the deficit, unemployment, global synchronization of debt, and correlation in equity and capital markets. When things go wrong, as we saw again last week with that 1000 point drop – the impact can be violent and sudden. These kind of surprises - while probably all not that magnitude again - are to stay.

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In the U.S I believe we will see more volatility. You can observe how at times these volatility storms manifest themselves in the U.S. equity markets - they just come out of nowhere.

I also like to warn people who think they can just put money into a vehicle and walk away for two years. A lot of investors, both institutional and retail, have been trained that way for the last 10 or 20 years and may continue to habitually invest like that, while in reality this has become a very dangerous strategy.

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In the U.S I believe we will see more volatility. You can observe how at times these volatility storms manifest themselves in the U.S. equity markets - they just come out of nowhere. As in August 2007, when levered quant strategies melted down. Pricing relationships that predicted equity prices over 30 years stopped working for a few days. That meant something bad was going to happen – and it did.

As I see the market trending one way or another, I set myself up to exploit that. I prefer to invest in U.S. companies because of the transparency they provide and their agility.

I also like to warn people who think they can just put money into a vehicle and walk away for two years. A lot of investors, both institutional and retail, have been trained that way for the last 10 or 20 years and may continue to habitually invest like that, while in reality this has become a very dangerous strategy.