



Opalesque Round Table Series '10 NEW YORK

Opalesque 2010 Roundtable Series Sponsor:



Editors' Note

Dear Reader,

Welcome to the Opalesque 2010 New York Roundtable!

Once again we have assembled an unique group of New York based alternative asset management experts, ranging from a \$12 billion hedge funds to an emerging manager. This animated Roundtable discussion highlights one of the most important aspects of active money management: **idea creation, execution and risk management**. On 27 pages, this Roundtable includes exceptional insights and intelligence:

- How do hedge fund and alternative asset managers create their trades and strategies?
- Can academic studies be relevant for active money management?
- How did alternative asset managers manage to identify risk early in 2007 and 2008 and successfully created insurance positions to protect capital?
- How did some hedge funds trade and profit from Quantitative Easing?
- What systemic risks may be looming right now over the horizon?
- Will inflation be a risk? Where and how can inflation be identified early on?

In addition, this Roundtable discusses:

- What opportunities are hedge fund managers enthusiastic about?
- What strategies should risk-averse investors be looking at?
- How important is Technical Analysis today?
- How have CTAs evolved their risk management since the days of the Turtle traders (the 80s)?
- How important is investor education? Why should hedge funds engage in educating investors and prospects, and how?
- What could be unintended consequences within FinReg and the Volker Rule?
- Which funds have doubled their asset base during the last 12 months?

The 2010 Opalesque New York Roundtable was sponsored by Trading Technologies and took place October 7th with the following experts:

- Robert E. Kiernan III, **Chief Executive Officer, Advanced Portfolio Management**
- Sam Barai, **Portfolio Manager and Principal, Barai Capital Management**
- Bob Treue, **President and Chief Executive Officer, Barnegat Fund**
- Bernie Drury, **President and Chief Investment Officer, Drury Capital**
- Thomas Humphrey, **Partner, Head of Marketing & Client Development, GoldenTree Asset Management**
- Russ Rausch, **EVP Global Buyside Sales, Trading Technologies**

We also thank the Opalesque 2010 Roundtable Series Sponsors Custom House Group and Taussig Capital for their support.

Matthias Knab
Director Opalesque Ltd.
Knab@opalesque.com

Participant Profiles



(LEFT TO RIGHT)

Standing: Matthias Knab, Sam Barai, Tom Humphrey, Bob Treue

Seated: Robert Kiernan, Bernie Drury, Russ Rausch

Introduction

Tom Humphrey
GoldenTree

My name is Tom Humphrey. I am a partner at GoldenTree. I joined GoldenTree about six months ago after 24 years at Lehman and Barclays Capital. At GoldenTree I am responsible for business development and client strategy and work closely with the senior management team on how to best position the firm's investment approach and our capabilities in credit.

GoldenTree is a diversified asset manager with about \$12.5 billion total AUM. It is divided by about \$8.5 billion of absolute return strategies and the balance being CLOs and long-only. We run a number of different strategies, but at GoldenTree we largely do one thing very well - we are a corporate credit specialized investment manager and that is how we derive our returns.

Sam Barai
Barai Capital

I am Sam Barai, Principal and Portfolio Manager of Barai Capital. I have a decade of buy side experience. I grew up as a technology geek (studying computer programming) and became an investment banker prior to attending Harvard Business School. Subsequently, I spent five and a half years as a senior technology analyst at Ziff Brother Investments, before becoming a portfolio manager. Since 2005, I have been managing equity long-short hedge funds focused on tech-telecom-media stocks, including a \$250mm fund at Tribeca Global Management (Citigroup) between 2005 and 2007.

All of this experience has given me a perspective on how to evaluate technology product cycles and business models. At Barai Capital, my team and I combine fundamental analysis with active risk management to invest in a select group of stocks. We are patient investors. As fundamentals change and there are inflection points, we are not afraid to go short the companies that we have previously been long. Whenever there is a market sell-off, we will often be in the market buying on that weakness based on our long-term trend view.

Barai Capital was launched in April 2008 with seed capital from Protégé Partners. We did not focus actively on marketing the fund during the first two years because of market conditions and our desire to build a unique track record. We have generated a cumulative net return of over 13% in 2.5 years, versus benchmarks like MSCI World Index down over 13% and NASDAQ Composite Index up 3% during that time period. The firm now manages just under \$100 million with a team of five professionals. We would like to now add to that capital in order to take advantage of the tremendous opportunities we are seeing right now in the technology space.

Bob Treue
Barnegat Fund Management

I am Bob Treue. I run Barnegat Fund Management. We have one fund called The Barnegat Fund. It is a fixed income relative value fund. We began in 2001 and have a compound annual rate of return of 18.6%/yr. We manage about \$450 million.

Russ Rausch
Trading Technologies

I am Russ Rausch from Trading Technologies, where I am in charge of Global Buy Side Sales. Trading Technologies or TT as it is often referred to, is an independent technology firm. We have a global presence through our eleven offices, including four in Asia Pacific. We specialize 100% on on-exchange traded futures and serve a pretty diverse customer base, a wide range of proprietary trading firms, banks, and brokers.

In fact, 19 of the top 20 brokers in the world in terms of futures trading volumes have Trading Technologies and use it internally and/or distribute it to their end users. We have a buy side customer base consisting primarily of CTAs, managed futures, and global macro firms, and some multi-strategy hedge funds.

TT is an execution platform, both screen based and through the FIX protocol. A firm can either trade futures through TT in the fully manual, discretionary type of trading, or you connect into our system that offers a set of features around futures trading, for example semi automated trading with a lot of strong spreading capabilities, or as a fully automated trading system, where the client basically has a black box running straight into our system that connects them into the global futures exchanges globally.

We maintain a global trading network that comes with the service. Our global hubs and data centers are New York, Chicago, London, Frankfurt, Singapore, Tokyo, and Sydney.

Bernie Drury
Drury Capital

I am Bernie Drury. I am the President and CEO of Drury Capital. We are a CTA, Commodity Trading Advisor in Princeton, New Jersey with \$300 million under management. Our strategy is broadly diversified, long-term trend following. The company was established in 1993. The Drury Diversified Trend Following program was launched in 1997, and has had an average net ROR of 15.38% in this 13+ year period.

Before setting up my own CTA, I worked in the grain business. I had been a Russian language major in college, which had led me to spending several months studying in Moscow and St Petersburg, and led me into the grain business as well. In 1972 the Soviets had surprised the global grain markets with massive simultaneous purchases from several major grain dealers, and I had read about these as a student. Right after school, in 1978 I went to work in the grain business with Louis Dreyfus and spent the first 19 years of my career involved with the grain markets. I changed my approach to technical trading in 1997 as my research showed this approach to provide a number of benefits.

I worked for several years at Commodities Corporation in Princeton. I was at Commodities Corp during the period when they were purchased by Goldman Sachs (1998). A couple of years later I left Goldman and set up the Drury Capital office.

When I said that our strategies are broadly diversified, what I mean is that we trade a full array of commodities plus financial instruments such as interest rates, stock index futures, and currencies. We aim to capture trends that have a duration of several months on average, so that within the CTA universe, we are considered long term traders.

Robert Kiernan
Advanced Portfolio Management

I am Robert Kiernan, the CEO of Advanced Portfolio Management, a specialty asset management company registered as an investment advisor with the SEC. We manage approximately \$2.1 billion of customized active management portfolios for banks, pension funds, insurance companies, and university endowments. We have clients in Asia, Europe, and North America, and about half of our AUM is from U.S. university endowments.

Constructing and managing customized investment exposures is our core business. We believe that hedge funds are not an asset class, but rather a form of active management that can be broken down into two fairly simple activities: security selection and market timing. At APM, we build portfolios that create active management exposures for our clients that are either related to their passive exposures or designed to fit within their existing active exposures. We also manage thematic active exposures for clients in credit, volatility, and commodities.

All of our products are managed to realize our clients' unique investment objectives and risk parameters and our current mandates include active management overlays, alpha transport programs, completion funds, and stand-alone multi-manager active portfolios. The critical defining attribute of our investment process is the integration of experienced qualitative investment judgment with rigorous analytical structure. Together, the professionals at APM have

over 100 years of combined investment and capital markets experience which provides a fairly comprehensive understanding of the potential profit opportunities and the accompanying risks of active investing. To complement this experience and judgment, we utilize a state-of-the-art analytical platform which includes: (i) manager-level risk and return attribution analysis and risk budgeting, (ii) non-linear Monte Carlo simulation processes driven by forward-looking expectations of return and risk, and (iii) portfolio optimization and rebalancing in a shortfall risk framework.

We firmly believe that by integrating experienced qualitative insights with robust analytical methods, we can deliver superior risk-adjusted returns with negligible correlation or beta to the major market factors or benchmarks. This allows us to separate investment decisions regarding the desired exposures to active management from the decisions regarding the desired exposures to various market factors or betas. We invest a significant portion of our capital in hedge funds, but also use direct investments in securities and derivatives to both realize investment objectives and to dynamically manage risk.

Because all of our mandates are customized, none of our products is commingled which allows our clients to ignore the hedge fund of funds benchmarks and avoid chasing the common manager names that necessarily populate portfolios of many of the large commingled fund of hedge funds. Likewise, our clients avoid the inherent structural liquidity subordination that can result from multiple share classes and varying coinvestor liquidity terms in large commingled vehicles.

Previous to founding APM, I worked at Salomon Brothers and then Lehman Brothers, in both New York and in London, where I built and managed several global businesses in fixed income, capital markets, investment banking, and private investments. In addition to my role at APM, I am a Senior Fellow at the Kennedy School of Government at Harvard where I work on the impact of non-pecuniary motivations on socially responsible investing.

Thank you for your introductions. To start, can you share with us some current developments from your respective companies and funds? Is there anything that excites you right now? Or, if not something that scares or worries you at the moment?

Robert Kiernan

In our case, we are enthusiastic about opportunities that we would characterize as ‘post-crisis’ and which manifest themselves in mispriced assets held by forced sellers, in several parts of the distressed credit space, particularly in Europe, and in what we like to call the “event-driven restructuring” opportunity in equities. We are also enthusiastic about a wide range of investment opportunities related to commodities, resulting from the current and expected volatile dynamics of the global economy. In all of these cases, we think that there are significant opportunities to generate superior risk-adjusted returns from active management without requiring any significant rally in the underlying markets.

This is especially important in the current investment environment as we are also concerned about potential systemic risks that may be looming just over the horizon.

The last such risk that concerned us was what we saw as an impending liquidity event that, unlike risks that we monitor and manage on a daily basis, is a form of uncertainty that is less measurable, or what Frank Knight famously labeled “randomness with unknowable probabilities.”

We all have managed risk over a fairly long period of time and therefore have experienced previous liquidity events including the 1987 equity crash, the Mexican peso crisis in 1994, the Asian currency crisis in 1997, the Russian default and LTCM crisis in 1998, and the 2001 9/11 event. In each of these Knightian instances, even well-constructed, highly diversified portfolios displayed significantly increased risk attributes as correlations converged across risk assets. However, since historically each instance was accompanied by a spike in volatility, we typically hold a small long vol position in all of the portfolios we manage as a form of insurance.

In the spring of 2007, when the Bear Stearns hedge fund failed and the senior loan market began to trade at a discount to par, we became increasingly anxious that a liquidity event was forming and significantly increased our gamma exposure in those insurance positions. We also added other positions that would benefit from the likely impact of a liquidity event, such as widening credit spreads and a flight to quality. Frankly, we had no great insight into what was about to transpire precisely, but we looked terribly prescient at the end of August that year after what is now known as the ‘quant crisis’ unfolded. We used the gains in August to extend the term structure of the insurance positions and even created an outright long vol overlay for a client who had a rigid policy portfolio allocation to equities.

These moves – and I would reiterate, motivated more by fear than prescience – protected capital in 2007 and in 2008 and provided significant dry powder, allowing us to move quickly and early into what we perceived to be the single largest opportunity created by the crisis which was dislocated and distressed credit. Those credit positions are up over 75% since the beginning of 2009.

Today, when we consider systemic risks looming over the horizon, we worry most about the future inflation rooted in ongoing policy responses to persistent high levels of unemployment. This has caused us to spend a lot of time thinking about inflation as well as analyzing potential hedges or investments that would be likely to perform well during periods of high inflation. We have found it useful to decompose inflation into its related but component measures – wage inflation, asset inflation, CPI inflation, PCE inflation – and look at the historical correlations of each sub set of inflation against a variety of potential hedging exposures including precious metals, the energy commodity complex, inflation-linked government bonds, and short fixed income.

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Bernie Drury

Our approach is a technical one. Often, when markets break down like we saw in the economic crisis of 2008, this can produce trading opportunities for our strategy. We are technical traders and apply very strict risk controls. One of the other panelists spoke of profiting during the mortgage crisis of 2008. Our strategy likewise generated profits from the same crisis, although in our case, predominantly from the downward price moves in the commodity markets.



At the moment, our technical analysis is also pointing to some of the factors you are alluding to. For example, some of the commodities, such as the metals - particularly gold, and to a lesser extent silver and base metals, have been in strong up trends. Gold is in a category of its own owing to its symbolic value – its role as a store of value. Gold has multiplied by about five fold in the last decade and that is not only because of its supply/demand considerations. Supply/demand considerations might be the reason why soybeans are at \$10 now and not \$5 as they might have been a decade ago, but there is also the degradation not only of the US dollar, but of currencies in general in the view of a lot of investors worldwide. As a consequence, investors are looking for something that is more solid than any currency.

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considerations might be the reason why soybeans are at \$10 now and not \$5 as they might have been a decade ago, but there is also the degradation not only of the US dollar, but of currencies in general in the view of a lot of investors worldwide. As a consequence, investors are looking for something that is more solid than any currency. Usually, when we talk about currencies people think about relationships such as Dollar-Euro or Dollar-Yen, and certainly those values fluctuate, but not on the order of the quintupling of value in the course of a mere decade.

There are different ways to skin the cat and different analytical approaches. Ours is on the technical side with broad diversification and strong risk control. Fears of the collapse of the bond market in the face of eventual inflation, mentioned as a risk factor, are very real. On the other hand it might be that disinflationary forces will continue to carry the day and that interest rates will remain low and bond markets strong. In either event, our process for managing the portfolio will be based on trend management and rigorous risk control.

Russ Rausch

While 2008 was of course a bad time for most everyone, but at the same time we saw a couple of trends on the technology side that excite us and that have been good for us. For example, the major bank failures - we had alarmed a lot of trading partners about their counterparty risk. We as an independent technology platform that you can get from any banker/broker have benefited from that as more and more end users, hedge funds, asset managers decide to take control over the execution and direct market access themselves and not through a bank's voice brokerage.

Bob Treue

Robert Kiernan mentioned our TIPS v Treasury trade that had been written up in the Financial Times. The FT article focused on a research paper written by four academics which they titled "The Largest Arbitrage Ever". The FT journalist who wrote that piece knew about us and that we had actually captured that same arbitrage. That trade occurred in 2008 and it is a pretty good example of the type of trade that Barnegat focuses on.

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Bob Treue



Robert Kieran

Was it really 20 points, as reported in the National Bureau of Economic Research (NBER) cited in the FT article?

Bob Treue

Yes, at one point, those TIPS were mispriced by 23 points in relation to Treasuries.

It was actually 23 points or 23%, meaning if a nominal Treasury cost 100, TIPS cost 77 and that was the size of the arbitrage. The paper was very well done and contained real world relevance. It wasn't a type of ivory tower work. The paper was 50 pages long and you can pull it up on the NBER website at www.nber.org.

I started Barnegat long before that, in the middle of the chaos when Long Term Capital Management went under. What many people don't realize is that LTCM was correct on every single fixed income trade, but they were not around at the fruition of their trades to collect that profit. As their fund went under, they destroyed a lot of trades and left fantastic opportunities for others. The same chaos occurred when Lehman went bankrupt. Lehman held a lot of TIPS as collateral which they threw onto the market, and at the same time everyone else was running into Treasuries thinking Treasuries were the safest place to be.

Therefore, at that moment, at the end of the 2008 - and that is what the academics wrote about - you could buy TIPS (they give you a real yield and pay you whatever inflation is going to be) and

hedge out the inflation rate with an inflation swap, effectively turning TIPS back into Treasuries yielding 5%. Simultaneously, you could short similar maturity Treasuries yielding 2.50%.

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This means that we were able to buy TIPS, lock in inflation and take in 5%. At the same time, we could short the nominal – same maturity, same issuer, same everything at 2.5%. This is a very basic arbitrage with no tricks and no curve balls. We have a bond from the U.S. Government till 2014 that pays 5%; a bond from the U.S Government till 2014 that pays 2.5%, we take in the 5% and pay out the 2.5%, and that's it. That was the trade written up in the academic paper, and then FT ran a subsequent series of articles about it.

This trade is a good example of what Barnegat does – we are looking at mispricings between securities around the world.

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This trade is a good example of what Barnegat does – we are looking at mispricings between securities around the world. We cover Canada, U.S., all Euro countries, Scandinavia, UK, Switzerland, and then Japan, Korea, New Zealand and Australia. This gives us a very broad and diverse universe where we look for anomalies, and we hold our trades for years.

When I get asked about investing in TIPS versus Treasuries, people say “TIPS are always cheap to Treasuries. Why are you going to hold them? What will be the catalyst or trigger to correct the mispricing?” In an important point, we are not looking for a catalyst, we are indifferent to a catalyst: taking in 5% paying out 2.5%; that is sufficient. For the duration of the trade, we are just happy to take in the 5% and pay out the 2.5%. This is the type of trading Barnegat engages in the fixed income relative value space.

Robert Kiernan

Do you still have the TIPS/nominal trade on?

Bob Treue We have some of it, not nearly as much as we did. The end of 2008 was probably one of the best set of opportunities ever, a great time for us. Whenever a large part of the fixed income competition gets wiped out, as happened with Long Term Capital and Lehman, you are left in a very good spot. Whether you are making widgets, or you are a hedge fund or do whatever - significantly reduced competition is a good spot for any business.

In 2008, 2009 and still now, there is very little fixed income relative value competition. Back to your question, we still hold some of the trade, but not nearly as much as we did, just because the securities are not as mispriced as before.

Robert Kiernan How much leverage did you use in the trade, at its peak?

Bob Treue We held about three times the value of our fund in that trade.

Matthias Knab Where else do you see opportunities right now, outside of that TIPS trade?

Bob Treue We trade around the world, the US represents only about 25% of our portfolio. Another great spot for us was the U.K. quantitative easing of March 2009. There, the Bank of England came out and said “we are going to buy back 25% of all outstanding gilts between 5 years and 25 years. We are just going to buy these maturities, and we are going to do this in an enormous size.”

At the same time, the U.K. Treasury said “we are going to issue just as much, because we have deficit problems. We have to issue everything from zero to 50 years; we have to issue gilts, we have to issue linkers, everything.” So you end up with an enormous buyer and giant seller which are not allowed to trade with each other. As a consequence, the Bank of England forces the yields from 5-year to 25-year quite low, while the U.K. Treasury, issuing everything they can, forced those other yields quite high. This is the Promised Land for a relative value fund.

Now, in 2010, the Bank of England has stopped the quantitative easing and things snapped back. Normally, bonds can stay mispriced for years. We sit in between the mispricing and collect the difference in yields. We were fortunate in the sense that the U.K. first created the problem, we got into the trade, and when they halted Quantitative Easing a year later, we are able to collect a profit. Usually we are not able to monetize our trades that quickly. It can take us several years to monetize these trades.

Sam Barai Barai Capital is an equity long/short fund investing in technology/media/telecom (TMT) sectors. We look for alpha on stocks. Our strategy is to analyze inflection points and product cycles in technology companies. We typically maintain low net exposure, driven by long and short positions. We are not overly concerned with macro events. If there is a major event, we look to benefit on the short side. If not, we seek to benefit on the long side. Overall, with a bottom-up research driven long and short book, we look to generate absolute return.

What happened in the tech-telecom space during the 2008 market turmoil was very interesting. During the summer of 2008, technology firms that required regular capital investment for growth suddenly could not access commercial paper. Businesses could not expand. For example, AT&T buys mobile phones on credit. They need to access capital markets for their business. When they could not secure credit to purchase new units, there was a massive inventory build-up of mobile phones across the supply chain.

Multiple technology companies faced similar problems. In July of 2008, our extensive field primary research uncovered a looming supply-chain issue. As a result of this, we were active in shorting various semiconductor/component and wireless handset companies that were facing declining fundamentals. While we generated alpha with this thesis, it was tough to capitalize on it longer term.



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2009 was a different story as we came out of that downturn. With credit coming back into the market, we found emerging opportunities particularly in China during the first quarter of that year. While the US focused on financial stimulus, China was the first country to introduce a technology-focused stimulus plan, focusing on infrastructure build-out. The Chinese government gave subsidies to Chinese individuals so that they could buy all sorts of electronics, such as notebooks, LCD TVs and PCs. For us, this was a signal that consumer spending on technology was on its way back. We generated strong returns from investing in those companies that benefited from a boost in sales, which played out for most of 2009.

In 2010, we are focused on the risk of a “double dip”. We are bullish on the technologies and companies that have been and will continue to benefit from the proliferation of wireless devices, such as smart-phones, iPads, eReaders. Also, long term, we believe that corporate enterprise IT spending is going to increase. For example, the burgeoning storage needs of the Fortune 1000 companies are growing at a tremendous rate.

Tom Humphrey

When I think about what gets us excited or makes us concerned, we at GoldenTree sort of give equal weighting to both sides. We are bottom-up, fundamental credit investors and trade credit from non-investment grade or distressed credit. We have an absolute return target and have designed for each of our strategies a target IRR.

We are a value credit investor. Our process is to construct a portfolio and then build in risk management functions given the absolute return objective. Those risk management tools are set up to protect capital during periods of increased volatility.

When you go through a credit cycle like the one that we had - that really began in 2007 - there were a lot of abnormalities over the last four years. I think credit has actually persevered at one level, but at the same time, if you look at some of the repair of the last 18 months, credit has repaired considerably and defined new requirements for constructing a portfolio.

Other aspects of risk management in a credit portfolio relates to where you are on the capital structure, deal size and all considerations that lead to a liquidity framework.

In our view, we think about hedging, we think about macro themes. In that regard, we believe we are pretty unique in bringing down the portfolio or macro themes in the most efficient way. We express those views across the portfolio, not just in individual names, but in specific strategies.

We all remember the market trading based on market fear as opposed to fundamentals, therefore today, we focus to manage tail risk in a very dynamic way.

We actually tested our approach quite well during some of the recent events, like just recently when the world seemed to conclude that the Euro zone and the European debt crisis was going to be a systemic issue, which pushed the S&P down 8% - a fairly large move.

If we reflect about credit over the last four years, 2007 was not normal; 2008 was definitely not

normal; 2009 was as unusual as 2008, given the beta recovery in credit. If we look at 2010, we could argue that it has been a more normalized year, but there are many things about the fixed income markets that are not even close to normal. There are persistent low level of rates, call it 5 years at 115 and the 10 year at 240. In the years to come, we will be thinking about the world in a very different way.

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Tom Humphrey



But without looking that far forward, what concerns us is that this persistent low level of rates and the QE2 component that is now apparent in the market, which has certainly helped the equity markets recently.

In corporate credit we had seen a large refinancing wave. You had record primary origination in high yield and leveraged loans of about \$350 billion to \$400 billion on an annualized basis, together with improved corporate fundamentals and cash rich balance sheets. At the same time there are low levels of LBO activity where people take advantage of the debt markets to lever up corporate exposures. This means that we are really in a bit of a sweet spot. As a result, year-to-date the credit markets are up 12% or better.

Lower leverage has been a healthy thing, and summing up near-term we feel quite constructive. There are certain aspects of this recovery that are a concern. Therefore, longer-term we have some concerns, given how fragile the recovery is.

I cannot remember a time when we have been so tied to the outcomes of a mid-term election. I guess they are always interesting, but this one feels a bit more interesting than others. I think once we get through that period, we might have a little bit more visibility around fiscal policies and some of the other drivers that are affecting the corporate environment. Obviously, given policy it

has been labeled as a non-business friendly environment, but I believe we will get to know a lot more at the end of the year and into 2011.

We came into 2010 thinking it would be a good year for credit, but not a great year. I think if you look at the number of companies that have been able to finance themselves and at the absolute volume and the healthy outcomes, I would say we would move it from a good year to a better than good year. Going forward, we look at 2011 in a more measured way, relative to what we have experienced here in 2010.

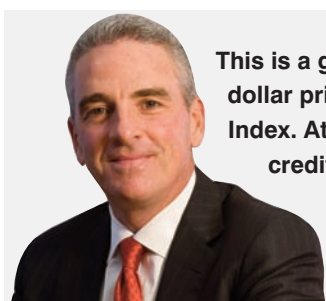
Robert Kiernan

Tom, an observation and a question: As I mentioned earlier, one of the things that we were able to do with the proceeds of our long volatility positions at the end of 2008 was to exploit what we then saw as the most egregious and anomalous consequence of the crisis which was the dislocation in credit. We felt strongly at the time that a critical determinate of risk and return would be the timing of entry and exit, so we broke the broad credit space into 12 different sub-strategies ranging from whole loans to RMBS to converts to senior bank debt to high yield to direct lending, and so on. Our initial view was that our investment thesis would play out over three years of carefully timed entries and exits through the various sub-strategies and that the expected return would be about 20% annualized, with significant returns resulting from both long and short positions.

The credit beta rally in the first six to nine months of 2009, which actually yielded the portfolio we built upwards of 40%, was stunning to us, especially considering the magnitude of the short positions that were included in our portfolio. But when we sit here today, 18 months into the trade, and consider the magnitude of the pending maturities of high-yield corporate loans and bonds over the next four years, and continued opportunities to find mispriced structured products, it would appear that there will be a persistent and large investment opportunity in credit for some time to come. Do you agree with that perspective?

Tom Humphrey

This is a great question. In this beta recovery, the market was priced at the end of 2008: the average dollar price in high-yield credit was \$0.64 and you had a 55% absolute return in just being long the Index. At that time, the market was priced for 20% default scenario across all of non-investment grade credit. These are pretty astounding numbers. Obviously, the realized default scenarios have come way down. We are trending towards three as opposed to 20%.



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Tom Humphrey

Robert Kiernan

Isn't that an historically unprecedented number for realized defaults?

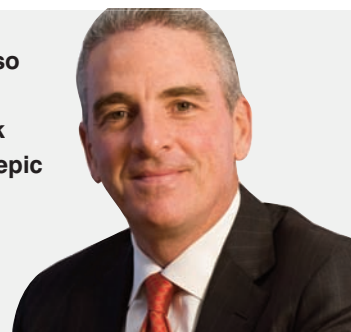
Tom Humphrey

We did go back and look to 1970 where you saw significant spikes in default scenarios. Also then, the realized defaults came at a fairly sharp drop-off, as the market actually priced in more default downside than was realized, and this one is no different in that regard. I think what was different in 2008 than what had been in different peaks in default scenarios, was the epic size of the crisis of confidence and the ability to get financing.

As a matter of fact, we have raised this year our first dedicated distressed debt fund at a time where you have had a tremendous rally in corporate fundamentals together with the ability to finance these companies. We raised that fund so that we would have the right capital on hand to take advantage of what we see as uneven recovery over the next 1 to 3 years.

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Tom Humphrey



Everything that has happened in the last 18 months, except for the interruption in May, would give you cause to suggest that this is a very orderly recovery and that all good and healthy spreads continue to tighten. Yet the Fed feels that they have to go out and buy more bonds to keep or get the rates lower.

So, things remain uncertain. We look at the residential sector being unresolved, and there is a tremendous consumer overhang not on just fiscal balance sheet issues.

Many of the companies that have taken advantage of the refinancing wave are large market cap names – the wave started with them. However, when you look at what needs to be refinanced between 2011 and 2016, it is pretty daunting, because many of the smaller market cap names have not been able to come to market.

All that said, since the world stabilized in June and we had probably the best summer we have had in 5 years in terms of credit performance, a number of companies have been going into their future maturities and pulling forward and renegotiating and extending their maturities. This is healthy for the overall credit markets, and we still see an uneven recovery with certain interruptions and distressed opportunities, we do not anticipate it is going to be a straight line.

Sam Barai

We are in the midst of a cautious recovery. Unemployment remains high. Housing prices have not returned to pre-2007 levels. The resolution of these issues is critical for recovery to take hold until 2011. A combination of improvement in both employment and housing prices will be critical for sustainable consumer confidence and a spending recovery.

To date, we are still seeing a business-induced recovery, where many enterprises have continued to invest in operations, technology and infrastructure. But this alone will not encourage the economy to fully recover soon.

Tom Humphrey

I think what Sam is describing is that we know we have a business led recovery and we have a significant consumer lag which is tied to the residential sector and the jobless environment, which is why the administration is under such great pressure.

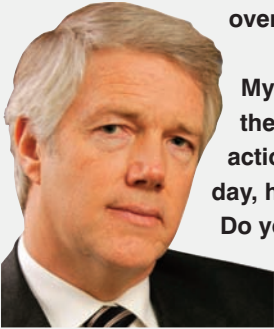
Robert Kiernan

I would amplify Tom's earlier point about the unusual significance of the mid-term elections. There is a reason why there is currently more cash on the aggregate US corporate balance sheet than has ever been historically reported and it is not simply a lack of investment opportunities. There is too much uncertainty emanating from Washington, whether it concerns monetary policy, fiscal policy, budgetary policy, the unknown cost of the healthcare legislation, the future of cap and trade, or the 2,000 page financial regulation bill with literally hundreds of blanks to be filled in by contemplated regulatory agencies that do not currently exist.

Corporations make investments when they believe their shareholders will be compensated for the risks inherent in those investments. At the moment, corporations are hoarding cash because the current potential return on those investments does not compensate them for assuming the current magnitude of risk in the government's tax, regulatory, labor, monetary, and budgetary regimes.

Bernie Drury

I am impressed by how well-informed you guys all are in the fundamentals of your markets. I had been a fundamentally-oriented trader and analyst for almost two decades before getting into technical trading, which I have been doing now for 14 years. In the past I could talk about grain markets all day long as I was interested overwhelmingly in the grain markets, as you guys are deep into the fundamentals of your markets.



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My question is this: when it comes down to actually taking your macro point of view and executing the trade, I am curious as to how much you guys may employ technical analysis in the trading actions you may take? I mean, it is one thing to have a point of view, and another to say, today is the day, here is my entry price, this is going to be my position size, and this is going to be my exit strategy. Do you guys use technical analysis in your investment operations?

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Sam Barai

A year and a half ago, we did not use much technical analysis at all, though we have always managed our risk actively based on changing fundamentals and stock price movements. Nowadays, stock technicals are more of a factor, even if not the driving force. It has definitely become more important in helping us make decisions on entry points, exit points and sizing. So yes, we use it more marginally as a portfolio construction and risk management tool.

Tom Humphrey

Technical analysis would be one of the inputs, but not the ultimate driver of decision making. In this respect, technical analysis relates to our risk management function, which is managed by Brian Pennington, and to our quantitative analytic team. We also use it as one of the inputs for hedging the overall portfolio for both defensive hedges as well as tail risk.

Robert Kiernan

My colleagues and I are Chicago- and MIT-trained, so we tend to genuflect at the altar of modern portfolio theory and the efficient market hypothesis which leaves little room for technical analysis as a complete and exclusive investment strategy. However, we are also empiricists so when we can observe and measure a phenomenon such as momentum in a time series, we certainly consider it a useful factor. But we also get nervous whenever we witness too much money flowing into momentum trades as the ultimate reversals can be extremely violent and often are related to broader liquidity events. Likewise, we observe and understand mean reversion, especially in our hedging activities, but we would probably not make an entry or an exit decision based on exclusively on mean reversion. In both cases, the potential impact of changing market liquidity should always be a consideration in the sizing and risk management of positions.

Bernie Drury

It is a really different pursuit. When I was a fundamental trader, we would talk about value. So, for example, if the corn market was at \$2.25 and you thought it could go up, you might formulate something like this: the price could go down \$0.15 and it could go up \$0.60. That's an attractive risk 15 : reward 60, so you would put on a position, but if it goes half that distance, what do you do next? The risk-reward has shifted greatly. There is probably new information that is supporting your original hypothesis, but the risk-reward has shifted to maybe a risk 45: reward 30 proposition.

A prudent trader who is operating on the value premise might reasonably exit or lighten up based

on these shifted odds. By contrast, a technical player who is following the price action may do something different. My thought is that even a fundamental trader who has the right idea at the beginning of a move, when he perceives a value play, has difficulty taking good advantage of markets with strong trends

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Bernie Drury



In other words, the same market information can lead to different trading actions, because of different decision making frameworks. As I said, personally I began as a fundamental, or value-oriented trader in a narrow set of markets – the grain markets – and have morphed to become a technically oriented trader managing a broadly diversified portfolio.

Matthias Knab

Bernie, I think people would like learn about how has risk management changed, particularly, in a strategy like yours - long-term trend following - because mostly people would say many markets were very choppy recently. If you will, today's markets are different from what the Turtles traded in the early eighties...

Bernie Drury

That's right, over the course of the years our systems have continuously evolved, and we trade many more markets than we did in the early years, but the newer systems trace their lineage back to the original ideas. Our basic premise is that if you diversify very broadly, if you cast a sufficiently wide net, you will find some markets that will be poised to undergo major price adjustments. Very strict risk control measures play a critical role in limiting the losses of unprofitable trades.

Regarding risk management, different investors have different considerations and expectations. Some investors are institutional and may be interested in a tamping down of the overall exposure and volatility, as compared to years past. They may be satisfied with less return on the upside in exchange for reduced overall volatility and downside risk. We are considering launching an institutional product for this type of investor, but otherwise, we are comfortable with our current average targeted level of volatility of about 17%, and believe this matches our clients' expectations. We work to produce the best possible risk adjusted rates of return, at that level of volatility.

Our process starts with any member of our research group generating an idea, which is then simulated on our research platform. The platform itself is the beneficiary of more than 15 years of upgrading and improvement. The research is exhaustive, but highly automated. While we obviously do not expect the future to be exactly like the past, the premise is that markets have a

tendency to be well priced most of the time and yet capable at times of undergoing major price changes. The strategy employs proprietary sizing and portfolio management techniques, and much of our work recently has been in the area of further diversification.

Matthias Knab

For whom of you is execution technology an issue? For a lot of funds having an edge in execution technology has become very vital.

Bob Treue

For us, execution technology has clearly reduced our bid/offer. For example, we can trade bonds electronically now. You used to have to do that over the phone, calling a broker who would quote you a price. Now, we can just send out a message saying “we want to sell 5 million of these bonds”, and it goes to whomever we have lines with. They all compete and obviously we get to pick the best price. As more and more things move to exchanges, the bid/offer comes down which obviously improves returns.

Russ Rausch

The revolution of electronic trading on most markets has made a big difference on execution and spreads. The spreads tightened considerably, which makes a big difference. Liquidity is a major issue too – electronically traded markets tend to become more liquid, they are more transparent, price discovery is easier as everybody can see the bid/offer. With the increased liquidity and transparency, the slippage gets reduced. Firms can now take things in their own hands and also significantly reduce costs around the brokerage commissions

All those factors contributed to why we have had a boom in electronic trading and helped people with their returns. In our market, the futures market, volumes doubled every four years until recently.

Matthias Knab

Are the regulatory developments in the U.S. a concern for you as hedge fund managers?

Bob Treue

I realize no one is going to have pity on the topic of a hedge fund manager’s compensation, but just one item that frustrates me about that is that the government has clearly encouraged banks to pay their employees in stock and less in cash. When things go well they benefit, when things go poorly they suffer the consequences. However, the government has banned offshore deferrals for hedge funds, which effectively is the same thing that they were pressing for with corporations. Previously, I had been able to pay my employees in shares of the fund and we did that for 8 years, deferred almost everything, and it worked great for us. But it just seems contradictory logic that they want to properly incentivize the banks, which is a great idea; but they have decided to do the opposite for hedge funds.



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Robert Kiernan

I think the economic logic on banning offshore deferrals for hedge funds was not thought through by the drafters of the legislation in the way you just articulated it. It was, rather, a more populist

political logic that animated them to define the capital gains tax rate on deferrals as simply a lower marginal income tax rate for hedge fund managers. It is the same issue the private equity managers have been so vocal about with regard to carried interest. There was no consideration of the fact, in either case, that deferrals and carried interest are at risk and thereby investments; only the fact that the return on those investments, if it was realized, should be taxed as ordinary income or not allowed.

Bob Treue

We were not that clever to structure our fund with carried interest, because we do not have an onshore fund, we are just offshore. That means I am paying full income tax on all our deferral. For our tax returns, the Government is costing themselves money with this deferral ban. As long as the rate of return on our fund exceeds TBills, the present value of our future tax liabilities will be greater than that of our current tax liabilities. The Government really seems to have hurt themselves with that strange contradiction between corporate incentives and hedge fund incentives.

Tom Humphrey

When we think about FinReg, we see a global framework that seems to be very coordinated. Details drift a bit depending on which jurisdiction you are talking about. Obviously, the U.S. and Europe take the lead on many levels.

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When we look at the immediate impact from financial regulation, a lot of the constraints were directed at the banks for all the obvious reasons. As a result, the business model at the banks is changing. For us, the increased regulation or constraints applied to banks and everything from private equity to proprietary trading – entities who put a large portion of their capital at risk for profit as opposed to being a transaction, a facilitator of risk - has created more opportunities for investors.

As an example, when we look how credit was priced, banks always played a major role starting with the origination process all the way through to what they might want to own and take exposure. This part of the business will be meaningfully constrained going forward. Basel III applies the overall capital requirements to all banks. Interestingly, even though banks were given time to migrate to this new world, they are already acting like they cannot do this business much longer.

We are seeing this already in the pricing. Maybe pricing is not the best indicator, but in the future if you are in a difficult market and there are fewer large pools of capital to be applied to a risk asset in credit, we view this financial regulation framework as quite positive for investors due to more attractive pricing.

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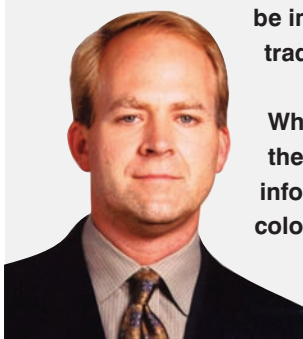
Sam Barai

For smaller funds, regulatory burden could be a bigger issue, because we do not generate enough management fees to cover the rising costs due to increased regulation. I expect that it will become a more difficult time for small funds to survive in the short-term, leading to a slowdown in new hedge funds startups longer term.

Russ Rausch

Tom, to your earlier point of positive effects of the financial regulation, there are also two downsides.

When I saw the Volker rule coming out, I had assumed most hedge funds would probably secretly like it, because it means less competition for them in terms of some of the trading strategies. On the other side, I believe there will also be impacts on liquidity, especially in the over-the-counter stuff where you can easily get difficult trades on and off when a broker is in a position to execute this trade.



Russ Rausch

What I also was surprised to hear is that a lot of times hedge funds will get good market color from the other participants. I usually hear the opposite that the hedge funds are concerned about the information of their trades leaking to the other side, but there is also an effect where they get good color from the market, because they are involved in the markets.

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Tom Humphrey

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In 3 years we will look back on a lot of things, and there will have been some tweaks and changes, but we won't go back to where we were.

The last time Volker was involved with separating capital markets in sales and trading from commercial banks, letting down Glass-Steagall was probably the first unintended consequence. Glass-Steagall was designed to protect us from exactly the scenarios we went through of 2007, 2008, 2009.

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Matthias Knab

What insights can you share from your own client base, that is from the hedge fund investors? What are their preferences or concerns? Do you see inflows into your funds at the moment?

Robert Kiernan

We do not manage any commingled funds, so we cannot measure client preferences or concerns in terms of inflows or outflows. What we can say about capital flows is that we have received incremental capital from our existing clients and received additional mandates since the crisis.

We find hedge fund investors to be a heterogeneous group that is difficult to characterize in general terms. That said, I believe that institutional investors are generally still more risk averse today, two years after the Lehman bankruptcy, than they were in the run up to the liquidity crisis. Rightfully, I think, most institutional investors consider attribute leverage to be the principal catalyst of the crisis to leverage and therefore continue to worry about leverage across multiple dimensions—leverage in the financial system that has been temporarily socialized and is therefore still unwinding; leverage in their own larger enterprises, whether they be public pension plans or corporate pension plans, or even endowments; and leverage in sovereign balance sheets ranging from Greece, to the US, to Japan.

The utility function for risk is less than it was in the previous five or even ten years and consequently risk adverse institutions need additional compensation to assume risk.

One post-crisis investor preference we are skeptical about is the demand for easier liquidity terms which some managers have in turn offered to rebuild their asset base. In some cases, this is the triumph of marketing over risk management as the new liquidity being offered is inconsistent with the investment strategy being executed, which invariably creates an unstable fund. In other cases, we are concerned that some investors are relying on the false promise of better liquidity to create the illusion of less risky portfolios. Both cases concern us because liquidity management, while extremely important, is no substitute for vigilant and robust risk management. We think both investors and managers may be missing the larger point here.

Bernie Drury

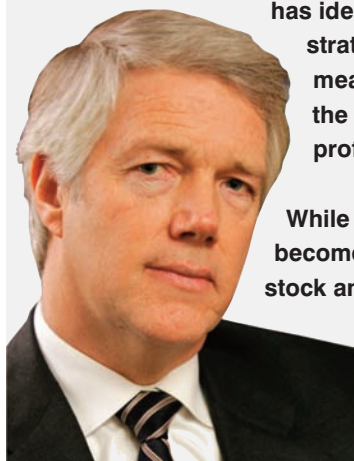
We have been fortunate; our assets have approximately doubled in the last year or so. The favorable performance of CTA strategies in 2008 has probably helped in the raising of some of this investment capital. However I think that the fact that our strategy was profitable in 2009 when many managers had losses probably helped us even more so.

What helps in the long run is that our strategy tends to have very little correlation not only to the stock and bond market investments, but to other hedge fund strategies as well.

I believe an underlying premise of many hedge fund strategies is mean reversion, in which the manager believes he has identified an inefficiency, and anticipates a return to normal pricing, as in many long-short strategies. We do just the opposite. We look for directional moves to persist. In any event, this means we can play a favorable role in an investor's portfolio and have a smoothing effect on the overall portfolio returns, reducing volatility. During crisis periods, CTAs often produce profits. Our strategy made 75.65% during the crisis year of 2008 and in 2009 we made 9.10%.

While I am pleased with the increase of assets, to a certain extent it is clear that the world has become very risk averse. Nonetheless, the CTA message is one of low levels of correlation to stock

and bond markets, and even to most other hedge fund strategies, so that it is volatility-reducing to include CTAs in a portfolio. A risk-averse investor should be interested in including CTA exposure in a portfolio.



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Bernie Drury

Bob Treue

We may be a bit different as a firm, as we really do not have a marketing department for our fund and therefore we do not have many inflows or outflows. 81% of our investors have been with us since 2001, and we have held pretty much between \$400-500 million for almost a decade now.

Sam Barai

We are an emerging manager. Having launched Barai Capital right before the 2008 crisis, we were hurt most by investor wariness following events like Madoff, making it more difficult to raise new capital for lesser-known funds like Barai Capital. Investors have been more focused on investing with the largest hedge funds with well known prime brokers, auditors, and administrators. We have always worked with a well-established network of service providers, which should give potential investors more confidence in Barai Capital even if our assets are not in the billions of dollars.

Now, we are focused on growing our brand. Since 2008, there has been increasing consolidation and fund closures in the fund of funds community, reducing available capital for hedge funds like ours seeking new capital. Therefore, we have also been focusing more actively on investors who remain opportunistic and have cash available for new investments. One area of immediate interest is pension funds, which have typically been investing in large, established investment firms, but are showing growing interest in emerging managers like Barai Capital. We have been focused on minority-owned investment manager programs organized by select pension plans.

Tom Humphrey

Just as an observation, I believe the AUM increases in the last couple years were mostly NAV-led as opposed to new capital flowing into hedge funds. I think it is noteworthy that if you look at corporate or public pensions, the one thing that has not changed throughout this entire period is their liabilities. That's still a huge issue in this persistent low rate environment globally, where spreads continue to tighten. From a fixed income standpoint, it is very difficult to meet these liability streams. And it is the same in the insurance space. The underlying need to take risk and make money remains the same.

The appetite for leverage is still poor. While we were able to get quality returns the last 18 months without deploying a significant amount of leverage, we do see now certain scenarios where good assets together with a conservative amount of leverage might be an option for longer-term investors.

I agree with Robert that investors do remain cautious with regard to risk. The world is not a perfect place. Even though we have made significant progress to a more normalized market environment, what has changed for investors is that their appetite for risk has been more measured, and their due diligence process has gone up considerably. As a matter of fact, this has been a good thing for us as a registered investment manager, together with our strong infrastructure team.

Themes like transparency, reporting, compliance, customized, separately managed accounts versus comingled strategies etc., all these issues will prove to be permanent requirements. This is probably a good thing for the markets and risk taking, because the bar has been raised. I believe pre-2008, risk elements were not that well defined and the bar was too low in terms of investment strategies that were able to get up and running.

Russ Rausch

Talking to a lot of managers we do business with, it seems that investors are now more concerned about avoiding loss than about maximizing returns. This also led to certain asset concentration in the larger funds, the multi billion dollar household names. The rationale is, of course, if you are an analyst or decision maker on the investor side, if something goes wrong you may not be criticized for going into those household names, even though a lot of the smaller firms have done a lot better over the last three or four years. Many small or midsized funds have had great returns, but may still have difficulties raising money because of that dynamic.

Matthias Knab

HFR reported that in Q2 of 2010, 93% of all hedge fund inflows went into funds that are \$5 billion or larger. According to some, this trend also questions the classic fund of hedge fund model. If everybody just picks the Top 20 funds, what is the added value for a plain vanilla fund to fund? A lot of this new money is coming from public pensions or first time investors that decide to go indirect into hedge funds instead of using a fund of funds.

I have also heard concerns that the overall returns of the hedge fund industry may be negatively affected by this asset concentration at the top tier or blue-chip hedge funds, as they may tend to become mere asset gatherers. It will be interesting to see how this will pan out.

Tom Humphrey

I agree with the brand name and the safe bet issue, we certainly see some of that. On the other hand, this is an obvious outcome given the changed investor and due diligence requirements that we discussed. When we look at the landscape today, the leading businesses are the ones that have continued to deliver value and outperformed. And while performance isn't the only measure, people investing in hedge funds today demand a fully capable asset management company that looks after all of their requirements.

Matthias Knab

Most people all agree going forward the big bulk of money that is going to be invested in hedge funds and alternatives will be coming from corporate and particularly public pensions.

In fact, the pensions are now urging their consultants, also known as their gatekeepers, even the ones who until now were not that hedge fund friendly, to look into some of the higher octane investment strategies. However, the amount of education that needs to be done, not only on the consultant but more on the pension fund, trustee and board level, is immense. There are situations when a trustee or board member tries to explain how a suggested investment strategy works, and he cannot... How do you see this challenge to educate investors, how do you go about it?

Robert Kiernan

I believe the asset management industry at large - as opposed to just the hedge fund industry - does not do as much as it ought to or has done in the past on the topic of education. In fact, I think it is puzzling because, in our experience, informed and well-educated clients are always longer-term clients.

As a firm, we try to write and publish papers in the journals and participate in seminars and conferences with an educational dimension. We are a member/sponsor of the Institute for

Quantitative Research in Finance (the Q Group), part of the CFA Institute Research Foundation Review Board, and regular speakers at CFA Institute conferences. My partners, some of whom are former academics, are frequently invited to lecture at a number of universities and I am a Senior Fellow at the Kennedy School of Government at Harvard leading a research project on socially responsible investing.

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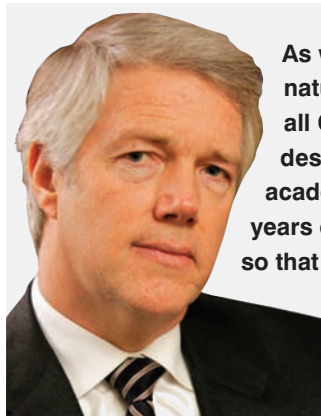
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Bernie Drury

One aspect that we consistently communicate is that the CTA space has already been highly regulated for decades. We trade on regulated exchanges for the most part; we trade liquid markets and prices are highly transparent. This is paramount in the current “flight to transparency” which is going on in the hedge fund area. This high degree of regulation complements the fact that CTAs can offer great diversification benefits, which have been documented and researched in many studies.



As we are systematic traders, our intellectual property lies in the algorithms we employ, so naturally there are protective policies in place around those. However, personally, I think labeling all CTAs as black boxes is neither accurate nor instructive. Perhaps people use the term to describe data mining approaches. In fact, people approach technical trading from many different academic and professional backgrounds. The logic in our systems derives primarily from my years of experience in the grain markets. We describe to investors the general logic of the strategy so that it becomes less opaque and more understood by them. We emphasize that the strategy, even if it is systematized, comes, after all, from a very human thought process.

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Finally, we offer very liquid investment terms. We don't have any lock-ups or gate fees, and there is monthly liquidity with a few days' notice. The markets we trade are liquid and transparent, so logically we pass along this characteristic to our investors. Daily prices are published in the newspapers for most markets we trade; you can't say that about all hedge fund strategies!

Sam Barai

As sector specialists generating alpha in the long run, we see education as critical to our success. Technology sector funds are seeing some of the strongest opportunities for alpha generation. The companies in our immediate universe have some of the best cash balances, fueling M&A activity in this space over the last few months. Those funds without a supportive client base are going to be unable to target such emerging opportunities and not generate attractive returns.

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Unfortunately, quite a few investors invest in equity markets to be able generate significant alpha, but they don't have a long term view when it comes to sector funds. They redeem from these funds during cyclical downturns and try to rush back in when the market is in a strong rally. They miss out on the best opportunities arising from inflection points.

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We spend a lot of time getting to know our investors, communicating with them via meetings and quarterly letters why partnering with experienced sector specialists requires a longer term view and more patience. We highlight the types of trades that force us to be patient and opportunistic during sector weakness, which in the end yield attractive risk-adjusted returns.

Bob Treue

I think for each hedge fund it is essential that an investor understands the strategy. But following an easy and simple strategy does not guarantee each time that it is understood. I have explained at this Roundtable our TIPS versus Treasury strategy we had in 2008: we received 5% on TIPS, paid out 2.5% on Treasuries. Talking about the level of investor education, the reaction we often got was "why doesn't everyone do this? How is this even possible?" and a lot of time even "well, what you are telling me is not possible."

You see, even if people may be familiar with the basics of fixed income investing, fixed income relative value is a bit harder to market. Unfortunately, the most appealing times for Fixed Income Relative Value are when the world is imploding like in 2008 or during LTCM. Those are the times when we are out there trying to tell people to invest now, and no one wants to listen.

As a matter of fact, the educational part in such situations is relatively plain: the opportunities we

are referring to exist because most of our competition went bankrupt, and the guys with the staying power can reap the rewards.

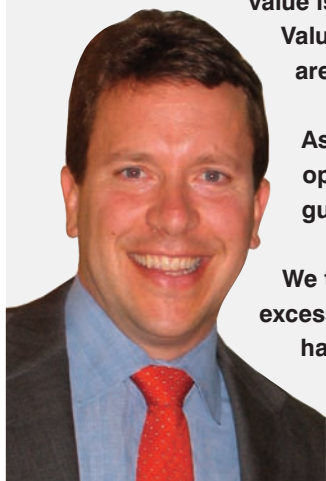
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So, in our case, the education starts with the basic proposition where we explain that taking in 5% and paying out 2.5% is a winner. The next level is then addressing what are the other risks that come from such a trade? Even though we can find trades we know will make money in the end, the tough part in relative value fixed income is to be there in the end. Long-Term Capital Management was right on every single one of those trades, but they just were not there in the end. That is what we have to convey to investors.

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