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FRANKFURT

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Editor's Note

German investors gear up for alternative investments

Unnoticed by many international investors, the German hedge fund industry enjoyed some very successful years with managers growing assets up to 800% in only 2.5 years.

German institutional investors are sometimes seen as being "behind the curve" when compared to their Anglo-Saxon peers, but interestingly enough, this has to a certain extent also saved them from harm during the 2008 crisis. Now, the Germans are looking more than ever to hedge funds and alternative strategies for diversification and attractive risk-adjusted performance. Some pensions already run up to 20% of their assets in alternatives.

While the UCITs framework helped extending hedge fund type or alternative strategies to a much broader investment base, non-German and Anglo-American managers with offshore structures also enjoy a revived demand from German institutions.

The inaugural Opalesque Frankfurt Roundtable was sponsored by Eurex and Custom House Group and took place at Deutsche Börse on June 7th 2011 with:

1. **Claudia Roering,** Head of Fund & Manager Selection, Deutsche Asset Management Investmentgesellschaft
2. **Dr. Dieter Kaiser,** Director Investment Management, Feri Institutional Advisors
3. **Hans Metzler,** CEO PortfolioManagement, Conservative Concept
4. **Henning von Issendorf,** Managing Partner, Co-CEO, CFO & Risk Management, Tungsten Capital Management
5. **Dr. Randolf Roth,** Head of Market Structure, Eurex
6. **Roman Rosslenbroich,** CEO & Co-Founder, Aquila Capital and/or Roland Schulz, Director, Aquila Capital Institutional
7. **Dr. Werner Goricki,** Managing Director, Prime Capital Asset Management

Game changers: Solvency II and Foreign Exchange

In this Roundtable you will learn that Solvency II, also called "Basel for insurers", will become a game changer for alternative investments in Europe and is in fact already a key driver behind the institutional move into managed accounts.

Foreign Exchange: Participants at the Roundtable further explain why for at least the next five years foreign exchange will be one of the most important decisions on a global asset allocation level. Investors should have a clear view and strategic allocation.

In addition, this Roundtable discusses:

- **The truth about managed accounts: What really happens when asset owners take over control?**
- **What is behind the significant growth of investing in real assets?**
- **Opportunities in renewable energy: still abundant or late to the party?**
- **UCITS Tracking Error: In which cases deviation from offshore funds is actually wanted**
- **How to set up UCITS funds with the same or even lower cost base than offshore funds**
- **Why, and which due diligence is still required for UCITS funds**
- **New tactical asset allocation models include alternative asset classes and strategies.**
- **An investor's view on high frequency trading funds**
- **Options pricing and volatility: Is there a time bomb waiting which will dwarf the "Flash Crash"?**
- **How to solve regulatory issues and specific requirements of large German institutions**

Enjoy "listening in" to this new Opalesque Roundtable!

Matthias Knab
Director Opalesque Ltd.
Knab@opalesque.com

Cover Photo: Frankfurt skyline with the river Main

Participant Profiles

(LEFT TO RIGHT)

Hans Metzler, Henning von Issendorf, Dr. Randolf Roth, Claudia Roering, Roland Schulz, Dr. Dieter Kaiser, Dr. Werner Goricki,

Introduction

Dr. Dieter Kaiser
Feri Institutional Advisors

My name is Dieter Kaiser. I am working as a funds of hedge funds manager for Feri Institutional Advisors in Bad Homburg. We are an multi-asset management company and investment consultant and manage roughly Euro 14 billion, all in segregated accounts for institutional investors.

Dr. Randolf Roth
Eurex

My name is Randolf Roth. I am employed at Eurex Exchange, where I am responsible for the market structure area. I joined Eurex in 1999, first in London, and before coming to Frankfurt I was working in Chicago for four years. Eurex Exchange is a leading global derivatives exchange, trading some of the world's most liquid EUR-denominated equity indexes and fixed income derivatives. Our diverse offering also includes on and off-exchange trading opportunities in single equity derivatives and alternative asset classes.

Henning von Issendorf
Tungsten Capital Management

My name is Henning von Issendorf, Founding and Managing Partner of Tungsten Capital Management, a Frankfurt-based investment management company. We have essentially two lines of business. One is asset management where we run UCITS absolute return funds. Our second role is to advise two captive family office clients on a broad range of questions regarding financial markets and financial market products.

Roland Schulz
Aquila Capital Institutional

My name is Roland Schulz. I am one of the Managing Directors of Aquila Capital Institutional which is the division within the Aquila Group in charge of market development activities. The Aquila Group specializes in asset management and investments services. One of the businesses that is part of the group is Aquila Capital, which is the asset management division with a focus on alternative investments. Here, over 60 investments specialists manage a diversified family of absolute return and real asset funds with a total of approximately US $4 billion assets under management. Another business division of the group is Alceda Fund Management S.A., which is a Luxembourg-based structuring specialist with over US $6 billion assets under administration.

Dr. Werner Goricki
Prime Capital

My name is Werner Goricki, and I am CIO at Prime Capital. We are a Frankfurt-based asset manager and structuring specialist for alternative investments, targeting European institutional clients. We focus on hedge funds, commodities, and renewable energy. Our assets under management are Euro 1.4 billion, and we have structured approximately Euro 5 billion over the past 5 years. We offer our various services and platforms as an extension of our clients' own investment capabilities, aiming to enhance and enable their existing competencies, infrastructure, and systems. In that respect, we are a collegiate "workbench" for our clients rather than a pure out-source proposition.

Hans Metzler
Conservative Concept

My name is Hans Metzler. I am the CEO of Conservative Concept based in Bad Homburg. We are managing funds with exchange traded equity index options since 2002. Our main focus is clearly on market neutral volatility trading strategies. We have around Euro 800 million assets under management.

Claudia Roering
DB Advisor

My name is Claudia Roering. I am in-charge of fund & manager selection at DB Advisors, the institutional arm of Deutsche Asset Management. In terms of investment decisions I have two hats: one role is manager and fund selection, and the other is implementing tactical asset allocation calls within our segregated funds, which we run for institutional clients. Our multi-asset business is roughly Euro 15 billion of which Euro 1.5 billion are in fund of funds type structures that are managed by my team.

Matthias Knab **Where are alternatives in Germany at the moment? Can you share with us what are some of the recent developments and trends, and what do your clients want?**

Claudia Roering How do our clients approach alternative investments? Looking at the money we run, most of that is still in traditional asset classes. Many of our clients, however, do have, at least a strategic asset allocation portion that is allocated to certain types of less correlated products. Most of them have commodity related exposure and some also do have hedge fund exposure, which is usually - if it is part of the mandate - less than 5%.

The client with the highest exposure to alternatives is currently running an alternative bucket of 20% in his overall global pension related mandate, but usually the allocation to alternatives would not exceed 5%. Most of the funds we run are German Spezialfonds or similarly regulated international formats. Therefore we focus predominantly on UCITs compliant vehicles to implement hedge fund type strategies in our clients' portfolios.

Claudia Roering

So, alternatives are still a niche here, and we mostly only add alternative investments to the funds that we run. The client with the highest exposure to alternatives is currently running an alternative bucket of 20% in his overall global pension related mandate, but usually the allocation to alternatives would not exceed 5%. Most of the funds we run are German Spezialfonds or similarly regulated international formats. Therefore we focus predominantly on UCITs compliant vehicles to implement hedge fund type strategies in our clients' portfolios.

Dr. Dieter Kaiser From the 14 billion we run, roughly 1 billion is in long/short strategies that are roughly equally split among offshore structures and UCITS products. We mainly see many new entrants into the long/short space via the launch of UCITS products, and also more investors start using UCITS and integrating long/short strategies to their portfolios.

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Dr. Dieter Kaiser

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We also have demand on the consultancy side around investing in traditional offshore multi-strategy funds of funds. Here, we help clients find solutions to invest into offshore structures, managed accounts, as well as UCITS structures. We find that there is a broad and slowly growing demand for these types of products out of Germany.

Matthias Knab **What are the client groups? What types of clients are now moving into these UCITS alternate funds?**

Dr. Dieter Kaiser They are mainly German institutional clients and corporate pension funds.

Claudia Roering You mentioned that German clients are also investing into offshore or say Cayman domiciled funds. How will they cope with the upcoming regulation?

Dr. Dieter Kaiser At this point in time we would set up a local fund of funds type solution, say an onshore, like Luxembourg based platform that will be investing in Cayman vehicles and providing the necessary information to deliver German tax reporting, if required. Depending on the structure of the investors themselves, we may still need a wrapper structure around the onshore fund of funds, but that depends on the type of client.

Dr. Werner Goricki Also on our end, we see a revival of interest for alternatives by German clients. You could say that German investors are still a bit behind the curve when compared to global activity, but people go back into the asset class, given the need for higher returns in a low-yield environment. We also see a revived institutional demand for non-German and Anglo-American managers with typically offshore structures, notwithstanding a continued strong focus on structuring aspects, taxation, regulatory requirements, balance sheet considerations etc.

One demand flow goes towards UCITS funds, which you can say is the easy way to implement an allocation; it also opens the door for easy distribution of the products. The other route more sophisticated institutions take is investing via managed accounts. Setting up parallel structures to the offshore fund, ideally within the European Union, suits many investors, as they achieve an unprecedented level of transparency and control over their assets.

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A key driver behind the institutional move into managed accounts is Solvency II. Solvency II will become a game changer for alternative investments in Europe. For the time being, we do not have the impression that all market participants, be it on the investor or product provider side, are prepared in an appropriate way. Setting up a fund of funds in Luxembourg that invests in offshore funds will not be sufficient anymore. You will have to change the structure as such and not simply put a wrapper on top of it.

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On the other hand, we see a strong interest in the fully illiquid side of things, which – apart from certain credit strategies – include illiquid real assets that pay constant cash flows, without mark-to-market valuations. Once again, getting the structure right is key. A traditional wrapper is not sufficient anymore; you have to set up the whole product in a way that it will be suitable for the German clients. You may get the impression that investing in Germany is primarily driven by structuring issues. Unfortunately, that's quite right and upcoming regulation is likely to reinforce that.

Roland Schulz

I think that in general, German investors have always preferred liquid or transparent investments, however as we know hedge funds of funds experienced a number of problems during 2008. As we said, there is demand from German investors for alternative investments, however one of the key questions is how will offshore hedge funds, which are not actually that liquid, survive in the long run? I am pretty sure that they will continue to play a role in Germany, but at present we see significant growth from new client groups that were not looking at hedge funds previously, with investors preferring investment solutions that are regulated, absolute return, transparent, and liquid.

Offering absolute return UCITS does open up almost a new market, because those products were not available in Germany before to that extent. We also see significant growth on the real asset side. One of the reasons behind this new investor interest is a recent change in the law for insurance companies. Whereas previously, they could only make small allocations into an existing vehicle, this has now been changed, which may well result in real assets to gain in popularity especially on the institutional side.

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Henning von Issendorf

I agree, real assets have become a huge topic for German investors, also among the family office investors, which is one of the areas we are familiar with and have good insights into their thinking processes and fears.

When it comes to UCITS III funds, which I always thought would be something like a mega trend and super product – fully regulated onshore funds with a quasi-hedge fund strategy embedded - that product has yet not really taken off as I thought it would, and I believe one the reasons for that is precisely the big trend into real assets.

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Henning von Issendorf

A good portion of the money that probably would naturally flow into UCITS are actually going into real assets, and I believe this trend will probably persist for a while. The second reason, let us face it, is that investment returns have been moderate. Of course, UCITS funds' returns have not been disastrous, especially if you adjust them by volatility - looking at risk adjusted returns they are probably okay, but they may be viewed as a little bit disappointing and therefore a number of investors are still holding back.

On the other hand, the amount of interest for UCITS is immense and a lot of people are looking at the asset class and are monitoring them. Over the next couple of years, I do believe the momentum will accelerate and we will see big waves of money flowing into those sectors.

Matthias Knab **What exactly do you think will be responsible for this acceleration of the momentum you are talking about?**

Henning von Issendorf I think there will be a number of waves of uncertainties in the financial markets, which will bring a lot of investors to the final decision that they have to allocate certain parts of their liquid assets into less correlated products. Of course, as the last crisis has shown, markets will still be correlated, but the key here is to find a reduced correlation to the main markets.

On top, investors will continue to increasingly ask for liquidity and transparency, and of course the industry has to cater to that demand of the investor base. But everyone should be aware that liquidity can and should cost performance when a manager has to abstain from perusing opportunities related to clipping liquidity premium, as such represent a good part of the return contributions of certain off-shore hedge fund strategies. That is one of the reasons why we have less volatile structures and results, but in many cases the UCITS returns are not comparable to offshore hedge fund returns. In fact this bodes for all cases were "liquidity premium", a high level of "leverage" or "concentration risk" represents a meaningful contribution to the return potential of a strategy.

Dieter Kaiser Adding to that, other reasons why the UCITS area did not take off yet are that 1. there are only short track records, 2. there are additional costs, 3. there are high tracking errors, and 4. it is a limited. Only recently have top international hedge fund organizations started offering UCITS products.

Other reasons why the UCITS area did not take off yet are that 1. there are only short track records, 2. there are additional costs, 3. there are high tracking errors, and 4. it is a limited. Only recently have top international hedge fund organizations started offering UCITS products.

Dieter Kaiser

Claudia Roering I fully agree, that tracking error, costs, and a lack of transparency with how UCITS funds are actually created – for example via dedicated UCITs hedge fund platforms, which may result in certain caveats – have a negative impact on the demand for UCITs vehicles.

I think one needs to differentiate if tracking error comes as a result of the structure or if it is due to the restrictions related to the types of instruments a manager is allowed to use in the UCITS wrapper. This means that some strategies cannot be adequately replicated or may not be suitable for a UCITs fund at all, e.g., liquidity constrained strategies. I believe that hedge fund managers will continue to offer their strategies in UCITs format. Facing tighter regulation of offshore funds they are building track records in this more transparent wrapper.

Investors have to be aware that they need to do a standalone due diligence on each product and to make a conscious choice when going into a UCITS fund.

Henning von Issendorf One thing that is often overlooked in this discussion about UCITS tracking errors is that in some cases the UCITS portfolios can be different because of the fact that inherently portfolios contain less concentration risks, because this is the nature of the UCITS framework. Higher portfolio concentrations can definitely lead to higher returns, as any added risk factor should provide such benefit! Equally less concentration means less risk and reflects the investors' preference of UCITS over, lets say an unregulated off-shore strategy. In other words this actually reflects the investors' original preference for a regulated vehicle over an unregulated. In those cases, a tracking error has to show up, because investors asked for it.

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The other point which I have heard so many times now, and with which I do not agree, is that tracking error is created by higher costs, or that UCITS funds in general come at higher costs. We have been now running a UCITS III absolute return fund with a strategy we more or less had applied in our hedge fund before, and my cost base differs maybe by four basis points.

Henning von Issendorf

The other point which I have heard so many times now, and with which I do not agree, is that tracking error is created by higher costs, or that UCITS funds in general come at higher costs. We have been now running a UCITS III absolute return fund with a strategy we more or less had applied in our hedge fund before, and my cost base differs maybe by four basis points. Well, for me, a four basis points difference is irrelevant in terms of an absolute return strategy. I don't dispute UCITS funds often come at higher cost, what I am saying is that they don't have to. Possibly a number of asset managers have not cared about building their own structures, and therefore if they go with a fully hosted investment banking structure, they may get a lot of things straight off the shelf, but they, or their investors, end up paying a lot for that. If you do the work yourself, you do not need to pay those high costs.

Dieter, you mentioned before one of the reasons why investors have not fully taken up UCITS funds is their short track record. At our shop, we have our second year anniversary this month, but I think the big step will be reaching the third year anniversary when a lot of institutional investors usually start to seriously look at your fund...

Dr. Dieter Kaiser

Well, it always depends on the investor what is considered a "short" track record. We recently had a meeting with a client who wanted to draft an absolute return UCITS structure. We presented him various possibilities or single manager funds where he could invest in and started the presentation with a fund that had a three-year plus track record. His comment was "why do you show me such a young fund, I want to have something with a ten years plus track record"... So, it always depends.

Coming back to the cost discussion, I agree with you that many hedge funds take shortcuts. They tend to go to the big investment banks' platforms that use total return swaps for the existing structures in order to minimize tracking errors. Hence, the bulk of the UCITS funds do come with substantial additional costs. However, some of those costs can be avoided if the UCITS funds hold the assets or the security themselves.

Roland Schulz

Investors should keep in mind that just naming or branding something as a UCITS is just not good enough – they really need to look deeper into the UCITS and understand how it is put together. Running a fund under the UCITS regime does not automatically remove the risk we have seen in hedge funds previously. In 2008, some funds of funds with monthly liquidity got into trouble because liquidity dried up completely in the underlying funds and strategies. The same risk remains, so that even a UCITS with monthly instead of daily liquidity may not be appropriate enough for certain strategies. Asset managers should always explain and name what they actually are doing, and adapt the fund structure to the liquidity the markets actually provide.

Investors should keep in mind that just naming or branding something as a UCITS is just not good enough – they really need to look deeper into the UCITS and understand how it is put together. Running a fund under the UCITS regime does not automatically remove the risk we have seen in hedge funds previously. In 2008, some funds of funds with monthly liquidity got into trouble because liquidity dried up completely in the underlying funds and strategies. The same risk remains, so that even a UCITS with monthly instead of daily liquidity may not be appropriate enough for certain strategies.

Roland Schulz

A lot of liquid hedge funds and liquid strategies can be structured into UCITS. There will be certain limitations to leverage, exposures, or value-at-risk, but at the same time a manager does have a lot of possibilities to adapt. But, if you look at other strategies, like credit for example, where you are actually getting a premium for holding something, those are not suitable as a UCITS vehicle. I would guess that a lot of investors who hold hedge funds with monthly liquidity might not be even aware that they are still running this illiquidity risk.

Investors should always clearly state what they want, and we as the asset managers have the obligation to inform them of and consult with them about what our products are like, addressing issues such as the instruments used and the underlying liquidity.

Dr. Werner Goricki

We talked a lot about liquidity and transparency, but what investors typically look for is control over the assets, which they seek from a UCITS structure that offers them a more substantiated regulatory control. But, as Roland mentioned, a UCITS structure as such, without looking under the hood, does not necessarily give you more control. In fact, it can give you less control by introducing swap structures etc. – they can be good or not.

We talked a lot about liquidity and transparency, but what investors typically look for is control over the assets, which they seek from a UCITS structure that offers them a more substantiated regulatory control. But, as Roland mentioned, a UCITS structure as such, without looking under the hood, does not necessarily give you more control. In fact, it can give you less control by introducing swap structures etc. – they can be good or not.

In our experience, investors typically buy UCITS funds only when they have to, because they cannot buy offshore funds for regulatory or internal institutional reasons. Larger institutional investors tend to move to managed accounts.

Dr. Werner Goricki

In our experience, investors typically buy UCITS funds only when they have to, because they cannot buy offshore funds for regulatory or internal institutional reasons. Larger institutional investors tend to move to managed accounts. That way they achieve a maximum level of control over the assets – conditional on setting up the managed accounts in the right way – along with suitable liquidity. We tend to call managed accounts the “UCITS for grown-ups”. When investors are able to do it, they go for managed accounts and don’t buy UCITS.

Henning von Issendorf

The other huge advantage that managed account investors have is full transparency - you can see what you have. I have been a non-executive director of a couple of off-shore funds and during the 2008 crisis luckily those funds were in fairly good positions. But talking to some of my colleagues, I was shocked at what people found out was actually sitting in some of the portfolios. One example was long/short equity managers with weekly liquidity that invested a couple of percentage points of their assets into East European power plants. You basically had physical assets in a long/short fund, which resulted in huge issues when they had to de-lever suddenly and those positions were not tradable. There were many other examples like that.

From the asset managers’ side, maybe some of them are concerned to the point that they cannot bear the optionality of the owner to take over control, if they are not happy with performance, the structure or the portfolio anymore. However, going that far is and should be really the exception for any investor. Taking over a complex portfolio, which has been structured by someone else, is a very difficult task, particularly in moments of stress. In such moments, the investor will additionally be confronted with the main and most pressing decision to be taken: “put up new capital” or “de-lever”. Experience is, that most people are just going to try to sit put and hope to muddle through.

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From the asset managers' side, maybe some of them are concerned to the point that they cannot bear the optionality of the owner to take over control, if they are not happy with performance, the structure or the portfolio anymore. However, going that far is and should be really the exception for any investor. Taking over a complex portfolio, which has been structured by someone else, is a very difficult task, particularly in moments of stress. In such moments, the investor will additionally be confronted with the main and most pressing decision to be taken: “put up new capital” or “de-lever”. Experience is, that most people are just going to try to sit put and hope to muddle through.

Henning von Issendorf

In 2008, while managed account investors did have the added benefit of transparency and of fewer surprises, in many cases they still were sitting put, because they did not know what to do with the managed accounts. They felt that they wanted to take them over, but in reality they discovered they could not.

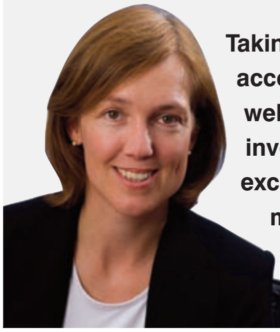
Dr. Werner Goricki

This is an absolutely valid point. Another issue in that context, especially for German investors, is setting-up the managed accounts in the right domicile and in the right way, so that the specific requirements of German investors are taken care of. For instance, we were the first to set up managed accounts in Luxembourg last year, because Cayman-based managed accounts are not so suitable for many German institutional investors and for all those affected by new regulations such as Solvency II.

Claudia Roering

Taking into account costs, transparency, liquidity, and who is in control of the assets, managed accounts are probably the best way to go. However, there is a well-defined role for UCITs funds as well, particularly when it comes to extending hedge fund type or alternative strategies to a broader investment base. Then, size will matter: the required minimum size for managed accounts will exclude many, even larger institutions, from using them. Even if you have the critical mass for one managed account, you would not be diversified. Therefore, UCITS are a very viable alternative when it comes to really putting your feet in the water. Of course investors have to consider the costs, but still the main advantage is to be able to allocate to multiple less-correlated strategies. For the investors that we cater to, UCITS are a very valid and a good way to get them to include more alternatives in their allocations.

When it comes to investing in real assets, while I believe they are a very valid investment proposition, the upcoming regulation and liquidity requirements will make it quite difficult for many investor groups like insurance companies and pension funds to engage in real assets and even hedge funds.



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Claudia Roering

There are very few unregulated investor groups in Germany, e.g. foundations are among them and corporates to some degree. For me it is sort of unfortunate seeing how the hands of many investors are tied taking on certain types of risk that could help diversify their portfolios and enhance their returns.

Werner Goricki

It's a fact that German investors face particular regulatory issues, and that simply putting a wrapper on top of the product will often not work anymore. This is especially true for real asset portfolios. They typically need to be set up in a completely different way from scratch, which will then make them suitable for institutions. For example, we have just structured an offshore wind park investment, where the product itself is set-up in a specific way instead of just putting a note on top.

Henning von Issendorf

When people talk about allocations to alternatives, hedge funds and even a UCITS funds, there seems to be this perception that the art of doing those investments is mainly to pick the best managers. I agree it is an important factor, but there is more to the art of investing into alternatives. I believe another success factor is to have a global asset allocation view and to think about asset classes & strategies within the alternative space and their different cycles.

Another success factor is to have a global asset allocation view and to think about asset classes & strategies within the alternative space and their different cycles.

If you do that, you would also tell your investors to go in and out of your strategy, you would talk about when it is more or less attractive. And I believe managers should do that to a certain extent. For bigger institutional clients or family office investors it may be very attractive to set-up a flexible managed account strategy. You then fill it up at the opportune time, and when the specific opportunity is gone, you put it silent for a while and if a new opportunity arrives, you will fill it up again.

More precisely: investors ought to buy distressed loans when they have been distressed, not after a five year or three year bonanza in the credit market. You ought to buy convertible arbitrage when you have a steeply inverted vol curve and convertibles are trading cheap to the underlying or cheap to the historic volatility. You ought to buy long/short equity when interest rates are rather high, because the arbitrage corridor is larger and volatility is bigger, and so on.

Of course, allocating and managing assets in such a way is something that hedge fund managers do not like at all, and I can totally understand that, because we are sitting on both sides

Henning von Issendorf

If you do that, you would also tell your investors to go in and out of your strategy, you would talk about when it is more or less attractive. And I believe managers should do that to a certain extent. For bigger institutional clients or family office investors it may be very attractive to set-up a flexible managed account strategy. You then fill it up at the opportune time, and when the specific opportunity is gone, you put it silent for a while and if a new opportunity arrives, you will fill it up again.

More precisely: investors ought to buy distressed loans when they have been distressed, not after a five year or three year bonanza in the credit market. You ought to buy convertible arbitrage when you have a steeply inverted vol curve and convertibles are trading cheap to the underlying or cheap to the historic volatility. You ought to buy long/short equity when interest rates are rather high, because the arbitrage corridor is larger and volatility is bigger, and so on.

Of course, allocating and managing assets in such a way is something that hedge fund managers do not like at all, and I can totally understand that, because we are sitting on both sides. Individual investment managers would like to have their clients give them money and "take an long-term, stable allocation view"." But, as an end investor, that is not what is winning you the price. What is winning you a price is to look for the right kind of opportunities in the global markets and then adapt to it with alternative strategies, selecting the most appealing alpha and alternative beta opportunities next to good managers.

Another quick word about the enigmatic German investor we have mentioned here a number of times. In general, we can agree that those are less sophisticated generally than the Anglo-Saxon decision makers, but oddly enough that trait has saved them from some harm, but also given them sort of too much complacency over their own lack of sophistication. That is why they tend to move slower, and also why over the long-term the UCITS product range actually is what they are exactly looking for: the regulatory regime will tick a lot of the things they require, the volatility will be reduced, and the returns are more stable but subordinate to the offshore hedge fund world.

Hans Metzler

I am happy we are having this Roundtable in Frankfurt here today, because I do believe that the German hedge fund industry has had some very successful years. To be precise, we have had five very successful years. For example, our firm grew from from 100 million to 800 million within two-and-a-half years. A lot of things changed, and I agree that especially UCITS III helped a lot.

We also found that setting up and running an UCITS III fund is less expensive for us than any offshore fund. The German fund vehicle "Spezialfonds", which in my understanding is a managed account, is a success model for alternative investment strategies. A lot of institutional customers are working with Master KAGs and Spezialfonds investing in different alternative investment strategies. It is a big story in Germany now.

The German hedge fund industry has had some very successful years. To be precise, we have had five very successful years. For example, our firm grew from from 100 million to 800 million within two-and-a-half years. A lot of things changed, and I agree that especially UCITS III helped a lot.

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Family offices have been the first investors into hedge funds historically, and they were also the first investors in German hedge funds. But: our firm lost 100 million in our offshore product, especially from family offices. However, all of them moved their funds to the UCITS III product because – in our case - of the better performance, lower cost and higher liquidity.

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There are also some interesting technical developments. For example, Eurex will change the interval of the strike prices from 50 basis points to 25 basis points. Eurex is a leading international exchange, but interestingly they changed those strike prices following the request of German managers trading Euro stock options. This is also a proof about the growth that is happening in the country. German managers are doing most of the volume of active trading on Eurex options. This was not the case three or five years ago.

Our capital base is 100% German. Just out of interest, does anyone of you have U.S. customers?

Roland Schulz

As a German-based manager, Aquila naturally has a lot of clients from Germany and Austria. However, we also have significant investments from outside Germany, including Italy, the UK and Spain. In addition, we have started seeing the first investments from Asia and have also received some inflows from the United States and the Middle East.

UCITS funds have an international format and structure that is globally accepted. In Hong Kong, Singapore, and Taiwan, for example, the percentage of Luxembourg UCITS Funds in the market has grown to a staggering 75%, with four out of five funds in Hong Kong now being structured using the UCITS wrapper.

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Dr. Randolf Roth

Coming back to trading at Eurex Exchange. Our customer base is very international and most of our volume actually comes from outside the European Monetary Union (EMU).

One of the big trends we have been observing is that asset managers increasingly use exchange-traded derivatives. This is viewed as a consequence of alternative asset managers looking for liquid instruments in response to the financial crisis, as all trades transacted at the exchange are secured by Eurex Clearing, our renowned clearinghouse of course, many of the derivatives traded at Eurex Exchange are among the most liquid instruments in the world.

Another area of growth is traditional asset managers. For example, in Germany, until 2002 most of the traditional asset managers were not even allowed to use derivatives. As their level of comfort and experience in using derivatives has risen and the regulatory and market environment has changed, they have become significant derivative users as they have substantially more assets under management than alternative asset managers. In other words, as of today, their derivatives share is not as high as the share of alternative investment managers, but as they have significantly more assets, the overall number of derivatives used by them may be even bigger.

Most of the buy-side firms engaged in derivatives trading are indirect users of Eurex's diverse offering. So they use brokers to access our market. However some buy-side firms are exchange members, the most prominent of which may be Citadel.

Matthias Knab

Let us now touch briefly on the topic of high-frequency trading. Just this morning I read another opinion about them being the bad guys, they would manipulate markets, reduce liquidity, 95% of their orders would be cancelled before execution, and so on. As a leading exchange, what is Eurex' experience with high frequency traders? What about this discussion is reality and what is misperception?

Dr. Randolf Roth

This is a very complex issue, and a lot of stakeholders are involved in this discussion. Most prominent are those outside the markets, such as regulators, which are thinking about regulating high-frequency-trading, politicians who feel that it cannot be healthy for the marketplace that investors release hundreds of orders per second, and there is the general public which has also taken an interest. But also among market participants there are diverging views on the usefulness of companies applying high-frequency-trading models.

What surprised me was that some of the buy-side firms recently voiced concerns in the political and regulatory debate, that high-frequency trading would a) actually remove liquidity from the market and b) that these high-frequency trading firms would quickly figure out the buy-side's trading interest and trade against them. As a consequence, those buy-side firms rather preferred dark pools or some of the bank owned systems which the banks seem to promote with slogans such as "Know who you trade with".

It puzzles me, as this perception of these buy-side firms is in contrast to academic findings according to which liquidity has actually increased in the last years through high-frequency trading models. Besides, it also objects to our own findings on that matter. Moreover, I have difficulties to see how the buy-side is better off when trading against one or two banks, rather than using the overall markets' neutral and transparent liquidity. What are your views or experiences?

Dr. Randolf Roth

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Henning von Issendorf

We are not a direct participant in the Eurex, but we have direct access and of course full transparency as any sophisticated trading firm would have. I have to say it is sometimes amazing to see some huge order blocks in the book, and if you approach the level, they get withdrawn... I have not figured out what the reason behind that is, but actually, it does not bother me.

Of course, what happened at the Flash Crash was frightening. It was certainly not good for markets, but in the day-to-day business it does not bother me that much. All in all, any kind of liquidity is good. I have not figured out whether those approaches make a lot of money or not and really have heard both sides.

Algorithmic trading is similar - certainly algos are a very comfortable way for institutions to trade blocks through the market. It is a totally legitimate and efficient approach. We have tried and used algos, but I personally do not like them. We have certain spread algos, which sometimes work for us; but we have actually used them more some time ago than we do now.

Hans Metzler

We are trading Eurex and Eurex products and I share your view that any trading, including high frequency trading, definitely adds to liquidity. Of course, nobody likes people that kind of just run computerized money making machines, but they do add liquidity. When it comes to the Flash Crash, I believe such events have more to do with pushing the wrong buttons than algo trading.

Dr. Dieter Kaiser

As a consultant and investor, we have had a look at a couple of these high-frequency trading funds. I believe answering the questions do they add to liquidity or detract from liquidity is rather difficult. What we learnt from these managers is that high-frequency trading is pretty much a technology game and not an investing game. It really depends on where you have your servers, and not only does it matter if you have your servers co-located with the exchanges, it also really depends on where your server is located next to the rest of your peers, for example.

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Dr. Dieter Kaiser

Matthias Knab

Dieter, do you think the high frequency trading model is sustainable as a style for certain asset managers or hedge funds?

Dr. Dieter Kaiser

We have been observing that the alpha decay or the performance decay of these strategies is immense. We did not find any fund with a sustained performance over a couple of years. There were always some funds that had short periods of time where it was attractive to invest in them, but nothing we found worth investing in, yet. If there is someone out there, please contact us.

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Matthias Knab

What are some other opportunities you see in the markets right now?

Henning von Issendorf

I am confident that uncorrelated market neutral strategies should right now be appealing to all kinds of investors. This unfortunately has not really been the case during the past 18 months. But now things are changing. Of course this is good for us as it represents our daily bread and butter business, but we are now also starting to point at this opportunity with increasing confidence to our advisory clients.

I do think that rates will rise, liquidity will dry up at some point and volatility will rise. This will even be the case should we see a new QE3, only then with a little more of a delay. In summary we are currently entering a much better environment for pure alpha strategies vs. such that rely on contracting or flattish risk premiums.

A new product that we are currently launching is a global listed real estate fund that will invest into listed real estate companies. This will be a JV between Tungsten and one of the biggest real estate developing, management and research companies in the world. They are going to provide part of the specific macro and bottom-up research on the individual real estate markets and also engage with the distribution, which is great for us. We will be looking specifically at companies which are trading attractive to their book values and follow a kind of absolute return strategy in a sector which people find generally attractive.

The fund will pursue an absolute return strategy as we will run a delta of between 10% and 70% and use a multi asset/instrument approach. For example we will have a pure alpha portion in the portfolio – applying simple long/short strategies. Further we will use convertible bonds to create favorable risk/reward positions both on the long and on the short side. Also we will probably use multiple option strategies to improve the risk profile of the portfolio. Finally we will run a currency overlay, as the underlying universe contains several different currency exposures, which may or may not coincide with our currency view. It will be a complex product, which we hope to be launching by the end of September, but we are already getting more positive feedback and attention than we have ever seen before. .

Apart from that, one of the bigger, specific opportunities we see at this point, in early June 2011, would be going long volatility. Volatility is probably quite cheap, given the uncertainties and trends in the markets. I think volatility is cheap because the markets are flooded by cheap liquidity, which compresses what is called the arbitrage corridor and squeezes volatility off the market.

If you want to buy volatility at this moment, you may try to trade some of your carry via delta trading. I think a lot of the smart people have done that, specifically now and then in the last couple of months as we are coming up to the end of QE2. I am not certain if there will be more (liquidity) drugs for the markets, and if the drug dealers in New York or Washington are going to open up the gates again. But at the time when you take the (liquidity) drugs off the street, we may see a lot of nervous people running around Wall Street and the City, and volatility will certainly be picking up.

Hans Metzler

Regarding volatility, I want to stop back and look at the actual description of volatility, which I believe has become a main issue and in fact very important issue in respect to the functionality of markets. In fact, I believe we have a sort of chicken-or-egg-problem. For the last thirty years, volatility was an instrument to see if option prices are expensive or not. Volatility was used to help pricing options. Now, it is the other way around, or you can get the feeling it is the other way around. Today, it looks like the option price has nothing to do with volatility anymore, volatility has become a product itself.

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You have different volatility ETFs, volatility futures etc. I believe these things really need to be discussed intensively. If volatility comes first, then also option pricing has to come the other way around. But that is not a good way for how markets should work. I think that volatility will at sometime make new all-time highs and maybe new all-time lows, but that the markets themselves are not properly functioning at this moment. I see this as a real risk, where going forward an event like the Flash Crash may have been only the small initial adventure and worse events may be coming down the road if this development around volatility is continuing.

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Dr. Randolf Roth

Has the market structure around volatility derivates changed fundamentally? I am not sure if I can answer that, but there is a lot of demand for products like the VIX®, the VDAX® and the VSTOXX®. I think an option trader always used to make first an assessment of the volatility and then priced the options. Trading these instruments has become easier due to the fact that volatility derivates are around, and there is more volume. Obviously, many asset managers go out-of-the-money volatility calls long in order to hedge against sharply declining equity markets. We just see a lot of demand in this direction, which involves buying calls, selling puts and trading volatility futures.

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Dr. Randolf Roth

Henning von Issendorf

Do you think volatility is cheap or expensive?

Hans Metzler

It is a good question. I think it is cheap also from a relative point of view. Investors should avoid risky assets if they are not able to stand the volatility taking that risk, and I believe risk is increasing everywhere... On the other hand, we may end below ten again. Right now, we are not in a good market environment, because you have no risk premia. You need risk premia again if you are investing in risky asset classes.

Henning von Issendorf

Hans, you are saying that at the moment all this demand for volatility is driving down option prices. Is this not a good reason to buy options now?

Hans Metzler

The question is, for example, if you would buy puts in a short-term bearish market environment: would an ongoing decreasing market raise the volatility and the skew, which was the case in 99% of all situations before. Right now, we have a 6% markets loss with put-call ratios above 1.30, which is a very high put-call ratio. But you have sideways volatility with a flattening skew. So that never happened 30 years ago.

Henning von Issendorf

Absolutely, but is that not what you love, because you guys are playing with smiles and skew and stuff like that...

Hans Metzler

We like volatility, we like market movement and steep volatility smiles; we do not like sideways situations and a flat skew.

Henning von Issendorf

Correct, and let me point here to another recent event that I thought was pretty amazing, yet very few people talk about this. The last month – May - the markets sold off, I think in the end the EURO STOXX 50 Index was down roughly 5%. Intra-month we were down more, but in the last day of trading we had a big recovery or rebound. Maybe it was window-dressing, I do not care, but the fact that despite markets selling-off quite viciously, volatility did not rise? Nor on an realized level, nor on an actual basis, nor at the spread of implied over realized.

Dr. Randolf Roth

Two observations: I think the decline was relatively controlled. We did not have a day where a market would drop 2% or more, but instead it kept going down in small steps. My second observation was that the U.S. markets, to which we are heavily related too, lost more modestly, which also reduces the level of fear.

Matthias Knab **What else is happening in Germany?**

Dr. Dieter Kaiser

A really important trend on the investor side is their growing, huge interest in adding strategies that really diversify. Many investors ask us these days to limit their long bias and even long/short equities strategies, because they already have equities exposures at a much cheaper price in their long-only portfolios. Let me add to that the fact that I also have seen that much progress has been made in terms of education and the institutional investors' approach to hedge funds. There is a very high interest or demand for macro strategies, including trend following strategies and long/short strategies in the commodity space, as a lot of funds in those fields were able to generate positive returns in 2008.

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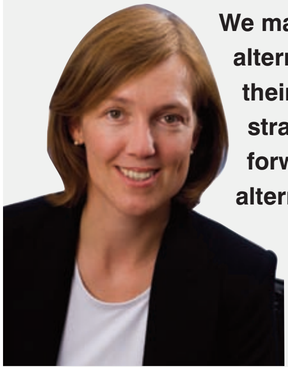
Dr. Dieter Kaiser

Claudia Roering

We make tactical asset allocation calls not only on traditional asset classes, but also when it comes to alternative asset classes and strategies. We see investor demand to add uncorrelated strategies to their overall allocation. We have built a range of proprietary models to provide investors with strategic as well as tactical asset allocation advice. One of the main developments I see going forward is the broader use of such advanced models to examine the impact of various types of alternative strategies in the portfolio context. Our models are capable of determining in which specific market environment certain alternative strategies really can enhance returns and add uncorrelated alpha.



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Claudia Roering

During times of higher uncertainty, investors tend to shy away from long-only or pure directional strategies but instead are looking for either market neutral strategies or completely uncorrelated asset classes. The demand for those will further evolve, but, again, just selecting managers is not enough. Our starting point is always the asset allocation call, strategic as well as tactical.

Roland Schulz

2008 really highlighted which funds had higher correlations and which had less. Not being correlated has helped our cause in raising assets significantly. Investors are looking for absolute return. Our AC

Risk Parity Fund, which was one of the first absolute return funds in a UCITS fund format and now has approximately US $1.5 billion assets under management, has been very successful, because it is not correlated to other asset classes. Our liquid funds are completely systematic, we do not have a view on the market. What is more important is the result you achieve in any market environment.

On the real asset side we see significant growth in various parts of the world that are based on economic development and changes in demands and habits. For example, we are quite keen on agricultural and timber investments. The other area is renewable energy, where after the nuclear accident in Japan, some countries, and Germany in particular, have started to change their energy policies. In Germany alone we see a huge demand for renewable energy, and possibly other countries will follow.

Dr. Werner Goricki

We talked a lot about UCITS and onshore funds, but let me also add here that traditional offshore hedge funds, particularly the large established offshore hedge funds have continued to deliver top performance. They are important performance drivers in our mandates, and we would expect them to keep delivering. Many of these managers do not start up UCITS funds, nor are they necessarily available for managed accounts. So in our view there should also be a place for the consistently performing traditional offshore hedge funds in a proper client portfolio, as long as the client will not be banned from investing into such funds by regulators.

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Apart from hedge funds, we also see the biggest opportunity in renewable energy, where lots of projects are available for development. The sector has suffered from a lack of capital over the last several years, so there is huge choice of project to select from.

Dr. Werner Goricki

Apart from hedge funds, we also see the biggest opportunity in renewable energy, where lots of projects are available for development. The sector has suffered from a lack of capital over the last several years, so there is huge choice of project to select from. Some of these projects are of very good quality, and given their stable and high cash flows plus a long investment horizon, we see very strong interest from German institutional investors. On the side of the projects available for development, we see more opportunities within Europe generally than specifically in Germany, which is a fairly mature market for renewable energy. Outside of Germany you see double-digit percentage IRRs on the projects, which for institutional end investors are very attractive returns.

Dr. Randolf Roth

Examples of products that offer potential for algorithmic trading firms are mid-liquidity products like the (long-term) Euro-BTP Futures, which are 10-year Italian bond futures. These Italian bond futures are seeing increased interest and activity as a result of the ongoing sovereign debt crisis. In addition, in the last few years we've seen substantial growth in dividend products, with the EURO STOXX 50® dividend index as the benchmark. Do you see that as an opportunity? Would you engage in forecasting dividends or is that more the field of the banks that issue those products?

Dr. Werner Goricki

We see the demand less for dividends but more for coupons on the credit side. According to our experience constant cash flows from assets with limited market-to-market volatility face more interest on the client side than dividend strategies.

Henning von Issendorf

One of the problems around dividend strategies, and this became very obvious in 2008, is that no matter if you were long or short a dividend strategy, you would run into problems at the moment you wanted to take position off in a distressed market. The kind of structures you would be using are usually OTC, which means their liquidity will dry up totally in times of stress.

That brings me to my view of the world. I think fear is ruling, which drives people into both liquid as well as real assets. I believe people don't invest in real assets because they expect a superior return, but rather out of fear. The world might change.

As a friend of mine a week ago made this an amazing comment, he said, "Henning, I cannot understand financial markets at all right now. It feels like we're dancing a step dance in a mine field and still listening to Frank Sinatra and are surprised we still can hear him." That is basically what happens. Everybody knows that we are in a very unsustainable situation, but we do not know how long it is going to last.

Matthias Knab

Henning, can you be more precise – what are the risks you are referring to? Are you talking about the debt overload in the developed world?

Henning von Issendorf

Yes, the debt is part of the picture but the more immediate threat is really the excess liquidity that has been pushed into markets by central banks, and which has been done to distract people and in the end prolonged structural unbalances much longer than they were sustainable. One QE came to the next, and whole countries took turns with their QE, and in the end things just end up getting worse and worse. I believe that everybody knows that the situation is not going to last forever, and that is the reason why wealthy families and now institutional investors are looking in real assets and similar other options, because they know the world may not be the same in a couple of years. We just do not know when it is going to happen. That is why I feel liquidity is so important.

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In fact, right now I started to be a little more careful with regard to this turn to real assets, because it has become such a trend.

Another key issue people need to focus on in this changing world is foreign exchange. We are embarking into an era where your view on foreign exchange is going to be one of the most important factors of your portfolio on an absolute return basis. This goes beyond having a lot of individual asset managers in the portfolios who are trading FX. In the future, investors need to take more of a view and have a strategic foreign exchange allocation.

I believe that for at least the next five years, foreign exchange will be one of the most important decisions on a global asset allocation level.

Henning von Issendorf

In fact, right now I started to be a little more careful with regard to this turn to real assets, because it has become such a trend. Investors who shifted into real assets say two years or even three years ago, out of the gates of the 2008 financial crisis, they have taken the right timing. If you talk to people who invest in that area now, you will hear how the competition has gone up immensely, which means that probably some of those asset prices, at least the most accessible ones, are probably already inflated. So, this is a new risk which one has to bear in mind.

I also agree totally with Claudia's statement about asset allocation. It's the most important success factor, together with staying liquid as we probably face a massively changing world. Another key issue people need to focus on in this changing world is foreign exchange. We are embarking into an era where your view on foreign exchange is going to be one of the most important factors of your portfolio on an absolute return basis. This goes beyond having a lot of individual asset managers in the portfolios who are trading FX. In the future, investors need to take more of a view and have a strategic foreign exchange allocation.

I believe that for at least the next five years, foreign exchange will be one of the most important decisions on a global asset allocation level. No matter if you are an institutional or a family investor, you need to think foreign exchange. It will be much more important than a lot of other factors because, that is where the huge rifts in the markets will happen.

Roland Schulz

Our liquid funds are all systematic, meaning that we do not really have any shorter-term market views. We actually anticipate markets being more or less random and therefore our clients get to choose what sort of assets they actually want to buy. Being systematic has helped us significantly in 2008 and also since then, including this year. We feel very comfortable with our approach.

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In the real asset space, as mentioned earlier, we are still very much convinced that investments into areas like renewable energy, agriculture and other areas are very attractive. The motivation for us is not, as Henning called it, fear, but rather diversification.

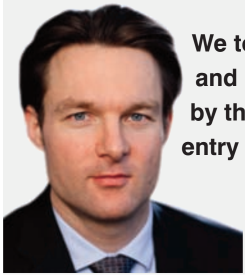
Roland Schulz

In the real asset space, as mentioned earlier, we are still very much convinced that investments into areas like renewable energy, agriculture and other areas are very attractive. The motivation for us is not, as Henning called it, fear, but rather diversification. Investors need to ensure that they don't put all their eggs into one basket. And when diversifying their assets investors should ensure that their investments don't just have different names, but that the specific assets are actually uncorrelated to each other.

Matthias Knab **Any other final comments?**

Dr. Werner Goricki

We touched on the regulatory issues and specific requirements of the large German institutions before, and indeed, if you are a product provider or manager based outside of Europe, you can often be puzzled by the demands from German and European investors. Even though these issues may look like market entry barriers, I would like to make the point that there are solutions to these problems. There are providers with a solid track record that help solve these problems. And not only ourselves, but of course also others including some at this Roundtable can help international product providers to cope with the specific issues in this region.



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