Opalesque

Opalesque Round Table Series '11

AUSTRIA

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Editor's Note

Dear Opalesque Reader,

Austria has a considerable history in alternatives. The country is internationally considered to be a CTA country and to be strong in quantitative strategies. Over the more recent years, Austria's alternatives has grown and matured, and many different strategies are run out of Austria as of today.

This new Opalesque Roundtable delves into the history of alternatives in Austria, which already started in the 80s and 90s. Early on, at a time when CalPERS for example didn't even consider investing into hedge funds, Austrian institutional investors favored the development of alternatives, because "they believed in it."

The Opalesque Austria Roundtable was sponsored by Salus Alpha Group and took place June 28th 2011 in Vienna with:

- **Mark Cachia,** Head of Alternative Investments, Erste Group
- **Martin Greil,** Co-founder and Secretary General of the Alternative Investment Association VAI
- **Günther Herndlhofer,** Investment Manager, VBV Pension Fund
- **Oliver Prock,** CEO and CIO, Salus Alpha Capital
- **Marie Milford,** Managing Partner & CEO, Asset Allocation Alpha
- **Günther Kastner,** Managing Partner, Absolute Portfolio Management

We also thank Opalesque Roundtable Series Sponsor Custom House Group for their continued support. The Austrian alternatives experts also discuss:

- **How Austrian pension funds allocate to hedge funds and alternatives**
- **Why it is easier to sell hedge fund products in Austria than in Germany**
- **How the global hedge fund industry split into two different manager universes, and why investors should allocate to both**
- **Why the role and influence o advisors and consultants will continue to grow**
- **Europe's AIFM Directive came into effect on July 21, 2011 – what opportunities lie in AIFMD?**
- **Once again, Opalesque Roundtable participants are sharing vital insights about the UCITS framework and funds.**
    - **Why do so many UCITS funds involve high degrees of financial engineering?**
    - **What coronary risks are created by financial engineering?**
    - **Did the regulators understand the implications?**

Enjoy "listening in" to this new Opalesque Roundtable!

Matthias Knab

Director Opalesque Ltd.
Knab@opalesque.com

Cover Photo: Hofburg Imperial Palace - Vienna

Participant Profiles

(LEFT TO RIGHT)

Matthias Knab, Martin Greil, Mark Cachia, Maria Milford, Günther Kastner, Oliver Prock, Günther Herndlhofer.

Introduction

Mark Cachia
Erste Bank Group

My name is Mark Cachia from the Alternative Investments Portfolio Management Division of Erste Bank Group. Erste Group has been investing in hedge funds or alternative investments since 1997. This was originally a way to extend proprietary trading capabilities. The unit survived 1998 - which as you know was a difficult year for the financial markets and most investment strategies – with positive results. In 2000 the proprietary portfolio was opened up to external investors as a way to generate fee income from what proved to be a successful undertaking.

I joined the group in 2003. At that time, a period of very strong growth was just beginning, not only for Erste Group in Alternative Investments, but really for the industry in general. At the moment, we manage roughly $650 million in a series of funds of hedge funds, managed accounts, and seed investments.

Martin Greil
Alternative Investment Association VAI

My name is Martin Greil. I am the co-founder and now the Secretary General of the Alternative Investment Association VAI. Our trade association represents about 40 members. Among them are local managers, local banks, and also international asset managers. Our main efforts are to improve the regulation and the tax regime in Austria and Europe for our members. We claim competitive regulatory requirements enabling the European, hence the Austrian, alternative investment industry to perform its important role as innovator and stabiliser for the financial market, so as to permit new products consistent with investor protection principles.

Currently VAI's activities focus on the Alternative Investment Fund Managers Directive (AIFMD) entering into force presently on July 21st with a transposition deadline of two years after that date. By November 16th the EU Authority ESMA will deliver technical advice on an extensive set of implementing measures to complement this directive. VAI is a member of ESMA's Consultative Working Group of the Investment Management Standing Committee and is preparing a response to the recently presented draft advice.

VAI supports its members in specific legal and tax matters and informs them continuously about developments concerning the alternative investment market. In certain cases specialists of our member and partner companies form a group of experts to concentrate on topics as MiFID, Basel II/III/IV, Eligible Assets Directive und Hedgefunds Indices Guidelines. In this way we have achieved sustained success for the Austrian Alternative Investment Industry since 2003.

Our public relations make efforts to increase the awareness of alternative investments as an asset class. In 2011 we continue our alternative investment events for institutional investors like pension funds and family offices in Austria.

Oliver Prock
Salus Alpha Capital

My name is Oliver Prock. I am CEO and CIO of Salus Alpha Capital. In my prior work life I have been with Erste Bank. About 10 years ago I set up Salus Alpha. As a firm, we wanted to be different actually, and right from the start we focused on liquid alternatives that we actually offered in 2003 in the UCITS I format and now offer in the UCITS III format. With the recent credit crisis in 2008, we believe our philosophy was confirmed. We had and have the right strategy, which many people now copy. At the moment, we manage about US-$ 1 billion in 13 strategies.

We also manage multi-manager products where we invest in other fund managers, but going forward our core focus will be to continue building our in-house strategy capabilities. At the moment we run long/short equity in-house, we also run a CTA, a commodity arbitrage, a real estate long/short equity fund, an Alpha replication strategy and very soon a credit arb strategy.

In terms of distribution we currently concentrate on CTA strategies, because we believe this area will see a lot of growth in the next few years. 95% of our investors are institutional, 5% are family offices. However, the family office share is significantly increasing in our investor base.

Actually all high net-worth families that are invested with us are Austrians. So we love Austria. Also a lot of people may not be aware that Austria actually played a significant role in the process of formulating the eligible asset directive within the European UCITS framework. Therefore, it was just normal for us to have all our funds structured as Austrian funds, as we realized quite early that the typical off-shore products were difficult to sell in Europe especially in the German speaking area.

At the moment we are 50 people in Salus Alpha. We have offices in Singapore, Hong Kong, Sweden, Liechtenstein, Austria, and Switzerland and a couple more. We are in the process of opening more offices within the European area to further boost our distribution capabilities. UCITS funds are around 30% of our total asset base, and we also do managed accounts, structured products, customized mandates and special funds.

Günther Kastner
Absolute Portfolio Management

My name is Günther Kastner, Founder and Managing Partner of Absolute Portfolio Management.

Absolute Portfolio Management is an independent asset management company in the German speaking region which specializes in asset allocation, analysis and management of alternative investments. Our investment philosophy does not measure success in comparison to other investments styles or indices but purely based on its real positive return – Absolute Return.

Absolute Portfolio Management was founded in 2006 with the focus on managing absolute return fund of funds for institutional clients. We have expanded into commodities by launching a Gold Resources funds, and for five years we have been managing micro finance funds.

We operate an office here in Vienna and one in Frankfurt, our client base is mainly institutional but also includes family offices and private banks. Going forward we aim to include retail investors through distribution partnerships with banks.

Maria Milford
Prime Capital

I am Maria Milford from Asset Allocation Alpha. I founded Asset Allocation Alpha ten years ago in order to serve institutional investors, that is the larger portfolios, banks, insurance companies, pension funds, corporate endowments, etcetera.

Hedge funds always had been a very important member of a portfolio for us at Asset Allocation Alpha, and this goes back to the years when I managed parts of the österreichische Postsparkasse (PSK) portfolio, which was my last position on the institutional investment side of the market. This was 1999 and we decided to start using hedge funds, which at that time for a large European institution was a very niche and innovative policy, and honestly it paid very nicely for us, because we all know what happened with equity market in the year after that.

Therefore, hedge funds worked for us, we and so I started to develop my business idea, which was focusing on intelligent asset allocation and investment possibilities all over the world, including portfolio construction, from setting up fund of hedge funds portfolios to restructuring whole bank portfolios.

We just finished restructuring one bank portfolio introducing our multi-asset, multi-strategy using external managers. On the investor side, we still see hedge funds are somehow perceived as mystique or esoteric, however for us, and for many years now, hedge funds have been a very good investment. The investor perception is changing slowly as institutions want to further diversify their portfolios, but all of us have to continue working on it.

Günther Herndlhofer
VBV Pensionskasse

My name is Günther Herndlhofer, I represent VBV Pensionskasse, the largest pension funds in Austria. I'm the investment manager for alternative investments. Hedge funds and alternative investments are and have been part of our strategic asset allocation.

The target is to achieve a positive absolute return and to pick the right managers at the right time. We use a style driven approach, which means for us that we make our decisions based on which parts of the financial markets we believe present the most attractive situations and where we can participate in order to gain performance. We invest in different vehicles, reaching from fund of funds to single hedge funds.

Matthias Knab

Most people are not really aware that alternative investments have a long history and strong roots in Austria. Oliver, can you please give the historical perspective on alternatives in Austria?

Oliver Prock

Indeed, Austria has a considerable history in alternatives; abroad we are actually considered to be a CTA country and to be fairly strong in quantitative strategies. Over the more recent years, the industry here has grown and matured, and many different strategies are run out of Austria as of today. Of course, back then the barriers of entry in managed futures were not as high as we find them nowadays.

In the early days it was possible in Austria to establish different onshore structures for alternatives. That was quite favorable for the development of a small niche industry here.

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It is also important to notice that the Austrian institutional investors also favored the development of alternatives, which was due to their innovative asset allocation and a focus on performance and diversification. We do a lot of business in Germany, and just as a comparison, their institutions only recently started to include a 5% alternatives basket. The Austrian investors were a little bit ahead of that because they believed in it.

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It is also important to notice that the Austrian institutional investors also favored the development of alternatives, which was due to their innovative asset allocation and a focus on performance and diversification. We do a lot of business in Germany, and just as a comparison, their institutions only recently started to include a 5% alternatives basket. The Austrian investors were a little bit ahead of that because they believed in it. People like Maria, at her previous work at PSK, or myself at Erste Bank at that time all had an alternatives allocation. However, the bad thing was that even though all of this favored the development of a local industry, foreign funds definitely got a bigger chunk of the money than the local funds.

Maria Milford

In order to understand where we are today, let me go even a bit further back in time to the mid 1980s when the whole banking industry went through profound changes. At that time the - let's call them - "old boys" were retiring, and a new breed of CEOs and Boards of Directors emerged, who were instrumental in using and even creating some of the instruments which were new then and are today standard tools and investments. I remember for instance, when I started in the Economics Department, one day I saw my boss drawing squares and arrows, and I asked him: "Walter, what are you doing here?" and he said, "Maria, look, that is very interesting. It is called Swap! You have here a bucket of money and there a bucket, and then you just exchange the interest payments!"

And soon after that, he actually traded one of the first swaps in Austria. The next step for us then was to invest part of the bank's book into futures. Again, at that time, this was frontier territory. There were no screens or direct access, we had to send faxes of our orders to JP Morgan in the U.S., and the next day we received the confirmation from them. Maybe this is a feature of Austrian corporate culture. If we had good ideas, we could actually realize them.

Another illustration of that was when the Board of Directors asked me to set up a portfolio with each and every risk except fixed income, and they actually expected me to start an equity portfolio. I said that it was not wise to start an equity portfolio at that time. I suggested a move into hedge funds instead, and the two people in charge on the Board thought for some time and came back to me and approved it. You have to be aware that this happened at a time when CalPERS for example didn't even consider investing into hedge funds.

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I think the hedge fund industry is split up in two parts. On one side you have the large mega hedge funds that are preferred by the institutional investor market. I think they are very useful, they are a good thing to invest into, but because they are so large they operate by certain rule: you have to look at year end figures, and your terms regarding liquidity and transparency have to correspond to what your institutional investor base expect.

And on the other side there is still a very small market out there that are very interesting, you find still some of the let's call it "old style", or the "old hedge fund boys" who really arbitrage this mainstream market. Because they are free, they do not have to look at year-end and so on, they can be much more niche and opportunistic. Don't get me wrong, the institutionalized market is a good development and we need investments there. But at the same time, they are not the same as what we have seen 15 years ago or more; these firms are different.

Maria Milford

As one of the first movers, at least here in continental Europe, we always liked the hedge fund industry as a real boutique and niche industry. Things changed when in 2002/2003 the whole alternatives industry moved out of niche into mainstream, which in the end has become less and less entrepreneurial, in my view. After 2008, things got even worse, and to a certain extent some investors may even be reluctant to invest what should be their alternatives diversification into another mainstream world or mass market.

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Matthias Knab **You invest into both kinds of hedge funds?**

Maria Milford Yes, because both are interesting and as I said before, we are mostly focusing on institutional investors, but I would say our heart is more with the smaller scale managers, because here is often where the really new ideas are.

Günther Kastner Most of the asset management industry in Austria is dominated from the banking industry, even the insurance companies and pension funds are bank dominated. It was only this year when the first pension fund not owned by an Austrian bank was established. This means that 90% of the asset management industry or more is owned by banks, so there is only very small independent market here in Austria. I was wondering if here the banks will be the last ones standing, should another crisis hit the industry as it happened in 2008...

Mark Cachia As in most other countries, Austria has single managers and allocators. As a fund of funds, we are on the allocator side. The alternative investment industry is once again growing, but a lot of the inflows have been direct and not through allocators. As far as the banks being the last standing or the strongest ones - who knows? This is a tough question. Some other Austrian banks have actually left the alternatives asset management space, although I hear that some are reopening AI departments. Basel III requirements will make it much more complicated and in the end more expensive to invest in alternatives for bank proprietary portfolios. That does necessarily mean the banks will be going away, just that the access vehicle may change.

As everybody knows, it will be difficult to maintain the proprietary side, so the banks have to find other revenue streams. In asset management that revenue could be secured via management and performance fees from the fund of funds, or engagement in seeding. In fact, our fund of funds has now been going for a while, and we have very good results.

Banks can also engage on the advisory side. Also here we see quite an upside as a consequence of the new rules, including the new insurance company solvency rules. Basically those firms now need an advisor, and if they do not have an advisor they need sophisticated in-house risk management tools. Usually the groups that invest in alternatives as part of a bigger portfolio do not have the resources to do that.

While advisory is a much lower margin business, I do think it is a real growth sector in our business going forward. It is interesting to study how pensions in the U.S. manage this process. Many pensions use consultants in different forms. For example, one large State Fund is an interesting story. I think they have about $5 billion in hedge funds and were paying in the neighborhood $1.5 million a year of advisory fees. On a $5 billion portfolio, this isn't really that much. Still, they fired that consultant and hired another one that just provided them with due diligence reports for a smaller fixed fee. I am not so sure about that approach where, in order to save $1 million on a $5 billion portfolio, potentially tens, if not hundreds of millions are put at risk. I am therefore not sure if this is such a good value proposition.

Mark Cachia

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Günther Herndlhofer

It is true that the pension funds and all the large institutional asset management firms are owned by banks in Austria. However, we are able to act independently, in order to achieve the best results for our clients.

Günther Kastner

This is certainly correct on the asset management side, however the banks dominate the pension fund sales side, the distribution and asset raising side. That is why I said before that on the asset raising side it is not easy for an independent company to find a niche in Austria to raise money.

Compared to other countries, the consultants are not that influential in Austria, whereas in the UK or U.S. the alternative investment market is completely dominated by them. You cannot sell a hedge fund to a pension fund without talking to his consultant. I would agree that going forward a consultant market will develop in Austria and also Germany. The large consultants will come here, and also we may see the development of an independent consultant market.

Matthias Knab

What are the usual development phases of an alternative asset manager based in Austria?

Oliver Prock

Austria is definitely a difficult place for a hedge fund to start when it comes to asset raising. We started here but immediately started to raise money from abroad. Of course, there is money in the region, for example from Eastern Europe, but this is mainly going to the private banks and not necessarily to hedge funds.

Our growth started in Europe and is now enhanced by Asia and in our next stages maybe is enhanced by Latin America and the U.S.

Günther Kastner

Getting access to the general market with an alternative product is not easy, so I believe the task here is to create products that also fit for the general market. This has become much easier with the UCITS structure, which for example, is also fit for German institutions, private banks, and family offices. Another factor is that those institutions may be much larger in Germany or in other countries than in Austria.

Günther Herndlhofer

It is all about being the best in class. If a manager has created a compelling product, it does not matter if he is domiciled in Austria, the UK, or is coming from the States. It is about survival of the fittest and that usually means performance and absolute return, it depends on the skills of the manager and not where he is coming from.

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Günther Herndlhofer

Matthias Knab **Do you also allocate to local managers in Austria?**

Günther Herndlhofer Yes we do, following exactly the best in class approach I just mentioned. Austria is for example quite well known for its CTAs, we have established and globally acting CTAs in our country with a long track record, so why should not we chose the Austrian solution if we look for investments in that area?

Maria Milford I agree with Oliver, it is not easy to start a hedge fund boutique in a small country like Austria, and another reason is that the high net-worth network that usually support start ups is not as tight or large here compared to London or New York or Hong Kong. If you start out on your own and are not backed by a bank or coming out of a bank, there will be challenges.

When I started my firm in 2001, I did come out of a bank. Investors were interested in hedge funds, and basically I just walked around Austria and collected quite an interesting amount within a couple of weeks. Remember that was 2001, and for sure after that it got more and more difficult to establish yourself as a manager.

Martin Greil When we founded VAI - the Alternative Austrian Trade Association - in 2003, we had an idea or a vision that the Austrian alternative investment market would become so attractive that also foreign managers would launch their funds here. Of course, we are not there yet as the legislation still has to be developed.

First of all, the historic development as described by Oliver is one reason for the status quo here in Austria: we just have a couple of independent managers, larger firms have not yet developed.

Second point: compared with traditional funds - the uniform format of open-ended mutual funds - I think the different structures of alternative investment products are a problem. And because of this problem, you have different agreements and declarations with a lot of different managers. There is not one single unit that sells different alternative investment products.

The third point: we are still missing incentives. In my opinion, each product or each range of products needs some incentives to experience growth. For example, fifteen years ago, the introduction of the withholding tax for investment products in Austria became a big thing and we saw a rapid growth of mutual funds mainly in the retail sector.

And these three points I think are also responsible for the actual situation of the market here in Austria. We have quality managers and seasoned investors, but the market is still very difficult, as you said.

Maybe we could discuss later also the new alternative investment fund manager directive, the AIFM. Maybe this directive will bring the solution.

Matthias Knab **Oliver, you are a pioneer in setting up liquid investment funds and started doing this with UCITS I and even before UCITS. How do you see this European framework further developing?**

Oliver Prock When we started, a lot of products were structured with a capital guarantee, at that time this was not too difficult to set up and everybody wanted this capital guarantee: institutional investors loved alternatives, but still did not want to take any career risk.

Later, UCITS was for us really an easy decision in 2003, given all the advantages around distribution. We started with UCITS I and then converted to UCITS III. Structuring a fund in UCITS IV is not different. The differences to UCITS III are more on the passporting side of the management company. There is also a new document for the retail investor called KID, it is like the short prospectus basically.

I do see both alternative investment managers and also mainstream hedge fund strategies further moving towards UCITS. Convergence is going on. Mutual fund companies will go towards hedge fund mainstream strategies and the mainstream hedge fund managers will go towards UCITS. We kind of anticipated this already early in 2002-2003 – that was a bit too early then, but it is certainly happening now.

The more difficult strategies will probably remain in offshore structures, which may put them at a disadvantage from an asset raising standpoint compared to UCITS, at least in Austria or Europe. This is what forward looking asset managers have to consider when they decide to structure their fund.

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Many investors are not really clear about the amount of financial engineering that can happen in an UCITS funds. Particularly for U.S. investors, this is a new concept, because this does not happen in U.S. mutual funds. However, if for example your UCITS includes commodities, you have to do some financial engineering i.e., structure an index and include an index swap to get the exposure into the UCITS fund.

As long as e.g. commodity futures are not allowed directly in the UCITS, this financial engineering will go on. Even UCITS IV still excludes for example commodity futures directly in the fund, and I believe the argument here is the perceived threat of a physical settlement, however if all those contracts are cash settled then there is no threat. Maybe UCITS V will solve that, but I am not sure about that and if it will happen.

Oliver Prock

Another frequent discussion relates to tracking error and the performance lag of UCITS funds. There is confusion out there, although there will be tracking error, there will not necessarily be worse performance in UCITS funds versus offshore funds. It could actually be the opposite. I don't think this discussion has been decided yet, it is still open.

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Martin Greil

If you remember our lobbying work for the eligible asset directive, we saw a lot of barriers against our efforts, and so I am not sure that UCITS V will bring a more open gate for alternative investment managers in this field.

Mark Cachia

We launched a UCITS fund of funds this year. We set up the fund in January and fully populated the portfolio by April. To me, the UCITS rules are very interesting. Of course, pure equity funds have no issues, but just limiting yourself on those will leave out a lot of the things people would consider to be part of alternative investments.

In my view financial engineering only becomes necessary to get around the rules of the UCITS. I do not think there is another way to explain it, because that is in effect, what it is. As an investor, I do not agree with the rationale regarding those rules. Like we discussed, you are not allowed to have a commodity future, but you can have a structure created by a bank to get that exposure, which in fact adds basis risk and credit risk and potentially liquidity risk. But that is allowed.

I do not know the basis of the rule, I understand that they don't want someone ending up with a delivery of some gold bars or oil in a UCITS fund, but as Oliver said it's cash settled anyway. I could have futures in a personal account, and I would never have a settlement through delivery, because of arrangements with a broker to close the position automatically before expiry. Why couldn't the UCITS rule have that instead of forcing complicated work-arounds?

It remains to be seen whether UCITS will end up with lower performance than, let's call it, "traditional alternatives". What I do believe though is that UCITS will generally have a higher correlation with the markets because UCITS rules are long-biased. If equity markets are up a lot, UCITS have the potential to outperform traditional alternatives. However, everything else being equal, if you compare returns for a fund under the UCITS rule against the offshore structure, the UCITS will probably underperform because just having the UCITS structure is an expense of about 30 to 50 basis points and more if a big investment bank platform is used.

The real question is "What is the threat of underperformance in a flat to down market, like we are experiencing right now?" As the UCITS industry is just developing, there is no comprehensive index available yet. Looking at May and June, which were very tough markets for equities and moderately tough markets for the alternative industry, our UCITS underperformed our traditional portfolios. In our regular portfolio we are able to add certain elements like specific tail risks, which were working very well during those months. However, UCITS cannot include those, as such a derivatives-heavy construct won't fit in it.

I do believe it is very important point out once again that one of the most risky investments you can make is getting into a normal equity mutual fund, which at the same time is probably the easiest product for retail to invest in.

Mark Cachia

In my view financial engineering only becomes necessary to get around the rules of the UCITS. I do not think there is another way to explain it, because that is in effect, what it is. As an investor, I do not agree with the rationale regarding those rules. Like we discussed, you are not allowed to have a commodity future, but you can have a structure created by a bank to get that exposure, which in fact adds basis risk and credit risk and potentially liquidity risk. But that is allowed.

I do not know the basis of the rule, I understand that they don't want someone ending up with a delivery of some gold bars or oil in a UCITS fund, but as Oliver said it's cash settled anyway. I could have futures in a personal account, and I would never have a settlement through delivery, because of arrangements with a broker to close the position automatically before expiry. Why couldn't the UCITS rule have that instead of forcing complicated work-arounds?

It remains to be seen whether UCITS will end up with lower performance than, let's call it, "traditional alternatives". What I do believe though is that UCITS will generally have a higher correlation with the markets because UCITS rules are long-biased. If equity markets are up a lot, UCITS have the potential to outperform traditional alternatives. However, everything else being equal, if you compare returns for a fund under the UCITS rule against the offshore structure, the UCITS will probably underperform because just having the UCITS structure is an expense of about 30 to 50 basis points and more if a big investment bank platform is used.

The real question is "What is the threat of underperformance in a flat to down market, like we are experiencing right now?" As the UCITS industry is just developing, there is no comprehensive index available yet. Looking at May and June, which were very tough markets for equities and moderately tough markets for the alternative industry, our UCITS underperformed our traditional portfolios. In our regular portfolio we are able to add certain elements like specific tail risks, which were working very well during those months. However, UCITS cannot include those, as such a derivatives-heavy construct won't fit in it.

I do believe it is very important point out once again that one of the most risky investments you can make is getting into a normal equity mutual fund, which at the same time is probably the easiest product for retail to invest in.

Matthias Knab **Mark, you run a UCITS fund of funds and also what we called here a "traditional" hedge fund of funds. How do those two vehicles differ?**

Mark Cachia The benefits of UCITS fund of funds are mainly liquidity and onshore jurisdictions. They key difference is that some of the less liquid strategies are not appropriate for UCITS, like distressed or event driven. It is very hard to offer weekly or even semi-monthly liquidity in such strategies. On the other hand, there are examples of firms doing just this, for example a multi billion dollar hedge fund firm runs a large UCITS fund, it is probably the biggest event driven UCITS fund, but how event driven is it really? They cannot replicate the portfolio in its entirety, so I would guess the UCITS portfolio may be pretty long-biased. Interestingly, the performance of that UCITS has been good and in some cases even better than the main fund. And this outperformance of the UCITS could be based on the rules related to concentration – possibly some of their concentrated positions in the offshore fund did not play out that well, and UCITS outperformed as the concentration there has to be limited. All these are interesting questions and it will be fascinating to see how other investors deal with them.

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Mark Cachia

Therefore, coming back to your question, running a UCITS fund of funds is largely different from running a typical offshore fund of hedge funds, and of course on top of that, with UCITS you deal with a much more limited and still relatively new investment structures. For example, if you want to have a credit fund, there is only a handful to pick from right now. Credit arbitrage is very limited, as CDS is very difficult to incorporate into a UCITS fund, however this is how the credit arbitrage guys invest. Therefore, you lose that strategy along with distressed and the more concentrated long term holding period strategies.

Oliver Prock Obviously there are two kind of investors: the traditional hedge fund investor and the new entrants for which UCITS is a very important structure, I think it is very important for the European market because at the end it is about distribution, right?

Mark, you said before CDS is not possible in a UCITS funds. However it is possible, it is just not well known. It is possible, because CDS through the eligible asset directive were basically approved long before hedge fund indices got their approval. For a CDS long/short single name product you would need to construct your own index and swap this portfolio than into the UCITS. Therefore, you can have credit default swaps in a UCITS fund. I believe these things are not well known because the whole alternative UCITS sector and everything around it is still in its infancy.

Sometimes I think the real issue is: did the regulator understand or not? In my view, the regulator did understand what it really meant to include these new kinds of structured indices in UCITS. If you look back a couple of years, UCITS III was then sold as the new innovative regime following UCITS I, it was sold as the innovation package, and they would have lost this claim if structured indices were not possible. Missing out that innovation would have been a pretty bad think for the hedge fund industry, the mutual fund industry and for everything in between.

Therefore, I am happy the rules were done that way. Costs have also come down but a lot depends on specific domiciles. Let me give you an example. For the Swap we now pay one third compared to what we paid in the credit crisis. And that is not actually additional cost, because you can save it in the UCITS structure. In general I think it is straight forward that a standardized fund package like UCITS should be cheaper than a custom made offshore structure.

But generally, it is maybe unfair to compare the five decades old hedge fund industry with UCITS III alternative funds. Even though the first UCITS directive was published in 1985, innovative funds are being launched only now under UCITS III. Salus Alpha actually launched the first CTA in UCITS III format – and that was 2008. We also launched the first commodity arbitrage fund in 2009 which actually is doing quite well: YTD performance is around 9%, which for a half year performance in this strategy is very tough to find in hedge fund land.

I remember a conference call with an allocator some time ago. They tried to figure out if the universe was big enough to actually launch a UCITS fund of funds. The underlying business question here is: Do you want to be part of the innovation and not too late, or are you in this too early? Considerations like the UCITS liquidity rules also come into play.

Oliver Prock

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Allocators looking at their choices regarding hedge funds and alternatives can, on the one hand, use the offshore hedge funds that may be illiquid and may come with certain strings attached, which the legal department then needs to clarify, or they can go with a standardized package – i.e. UCITS III.

I do not understand an allocator's strategy that does not for example, allow him to include UCITS alternatives into his fund of hedge fund. I think it is a mistake not to allow it.

Martin Greil

Günther, you are actually a pension fund manager - how important is the UCITS III structure for your investment decision?

Günther Herndlhofer

Austrian pension funds are not forced to invest into hedge funds via UCITS structures at the moment. Therefore, we have to evaluate each investment where and with which format we see the most value-add for us. The UCITS structure does not solve the problems you have as an investor regarding the classic conflicts of interest like liquidity, the terms of transparency and so forth.

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Therefore, as Mark said before, it is a question of making a full evaluation of the styles or strategies together with a holistic view on the risk. For example, if you use a certain wrapper or swap in your financial engineering in order to make your investment UCITS-conformable, you are adding credit risk amongst others.

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Martin Greil

If an institution like a pension fund would use UCITS for such liquid investments, would the invested assets be then larger than if it went to traditional alternatives? Would the bucket be bigger?

Günther Herndlhofer

I do not think so, no.

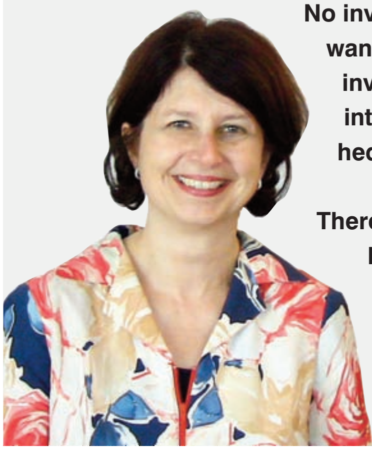
Martin Greil

I am asking because I believe this is what is going on in Germany. They see UCITS as part of the mutual fund bucket, which is a much larger one than say an "alternatives" bucket...

Maria Milford

Possibly there are also some political motives behind this. No investor is really able to mention the word hedge fund in Germany, because they do not want to invest into "locusts", as one politician there named hedge funds. I talk to a lot of investors and consultants there, and yes correct, many of them add UCITS III hedge funds into the portfolios. So, when I tell them, "but these are hedge fund strategies offered by hedge fund firms", they kind of say "we know, but don't mention this word..."!

Therefore, the fund is often just a normal offshore hedge fund swapped into a UCITS III bracket and then distributed to institutional investors. I would say we are very lucky here in Austria that we still have investors who invest into classic hedge funds and really discern between the package and what is inside. And right, as Günther said there are many strategies that cater to UCITS, it is okay to use them but I always say not to put long-term investments into short-term structures. You always will have problems with that.



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Günther Herndlhofer

Well and on top of that, don't forget that the UCITS structure also costs you money; the opportunity cost could be 50 basis points. Long term investors are asking themselves why they should pay those 50 basis points for getting the same exposure to a strategy he can also have cheaper?

Mark Cachia

I completely agree. Why would you invest in UCITS unless you have to, but some people have to, and that is one of the reasons why UCITS will be a growth industry. The other reasons are the easy distribution throughout Europe, and the ability to reach the retail investor. For an asset manager, UCITS makes sense, these are the reasons why we launched UCITS funds. We did not create the UCITS to target pension funds. We didn't do it for our own profit either, because everything else being equal, we invest in offshore structures where we have a wider variety of strategies and funds to choose from at usually less costs.

Günther Herndlhofer

That is correct.

Matthias Knab

Do you think the AIFM Directive can help the development of the local market? How will it influence European managers?

Oliver Prock

In terms of distribution it probably does, but in terms of production I do not think so. For Austria, AIFMD would not be an advantage, because we are lacking new legal structures for production e.g. compared to Germany.

AIFMD is an ongoing thing and actually Martin can maybe chat about this.

For Austria it really depends how AIFMD is implemented and if this brings also some kind of innovative hedge law to Austria or something like that which would then be needed to have Austria participate in the production side, not only in the distribution side.

On the distribution side I think it will help, but the funny thing is that AIFMD is actually protecting institutional investors, which raises the question why do institutional investors need protection?

Martin Greil

In my view, not all facts are clear about how the AIFMD will finally be implemented and also about some possible consequences of UCITS V.

After more than 2 years of negotiations and counseling, Europe's new directive on alternative investment funds managers will finally come into effect on July 21, 2011. As required by EU-legislation, all member states are obliged to transform the directive into national law within the subsequent two years, so until July 21, 2013.

In essence, the successful adoption of this directive reminds us of Europe's central objective to thoroughly regulate and harmonize the common financial system. Managers of alternative investment assets will have to pass through an admission procedure that includes factors like auditing, minimum capital requirements, liquidity and managerial transparency. Besides, the directive comprises a behavioral code, with which alternative investment funds mangers will have to comply.

Passing the admission process will grant EU-domiciled managers access to a special "passport" that enables them to market their products throughout the Community. Should the system prove itself in practice, it will be expanded to managers located outside the EU by July 21, 2013.

It should be pointed out that due to numerous inexplicit formulations in the AIFM directive, member states will have some leeway to fine-tune the regulation when transforming it to the national legislation. For example, when it comes to liable equity, the directive does not indicate up to which limits managers can be held accountable, hence it will be the task of national legislators to formulate the specifics.

The potential of these types of fine adjustments that can be realized on the national level should not be underestimated. As a matter of fact, Austria, as well as each individual E.U. country can view this process as a unique opportunity to create the infrastructural prerequisites that could help the national market to become a true financial center for alternative investment products. That is why for Austria we recommend an Alternative Investment Act separated from the Investment Fund Act.

Summing up, I see a great potential in the new Alternative Investment Fund Manager Directive. The Directive can actually help setting up and running a good range of alternatives products in a coherent framework, which I believe investors may appreciate more than just putting wrappers around certain strategies in order to distribute them to certain institutions.

Martin Greil

Concerning the national implementation of AIFMD, our Austrian association VAI has intensified the dialogue with the Ministry of Finance and the Financial Market Authority in Austria. It should be pointed out that due to numerous inexplicit formulations in the AIFM directive, member states will have some leeway to fine-tune the regulation when transforming it to the national legislation. For example, when it comes to liable equity, the directive does not indicate up to which limits managers can be held accountable, hence it will be the task of national legislators to formulate the specifics.

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Günther Kastner

Some strategies can even be cheaper when run in an UCITS format. For certain equity long short funds where you may go long equities and short CFDs, which is something that is also common around offshore funds, UCITS can be cheaper if you take the right domicile and the right administrating custodian.

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There is a certain dynamic now coming from offshore managers who, together with their prime brokers, try an UCITS wrapper around their hedge funds mainly using swaps or through some other sophisticated techniques. I am not sure if this is the right approach. On the other end of the spectrum you find the long-only managers who, motivated by 10 years of disappointing performance, also look to the UCITS construction in order to create absolute return funds.

All in all, it is vital for asset managers to fully understand UCITS structures and figure out where their company has an advantage in managing a UCITS fund to achieve absolute returns. Instead of trying to replicate an offshore hedge fund strategy one-to-one into UCITS structures, the way forward may be to focus on strategies that better fit UCITS. This also includes the firms that come from the long-only side; they will also be able to create interesting absolute return products that way.

Günther Kastner

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Oliver Prock

Yes, also long only firms now push into absolute return, just as some years back you saw the large hedge fund powerhouses actually launch long-only products because of capacity. Remember that? They sold basically the long book of their long/short hedge fund strategy, which ended up in the long-only space because of its good performance, and of course, it wasn't sold as beta but as something else.

Matthias Knab

Who of you is launching new products? And, if you are an investor, what opportunities are you looking at?

Mark Cachia

We have a portion of our portfolio dedicated to emerging managers. We either help seed managers or provide acceleration capital for smaller strategies. We tend to find most of our investments in the “emerging markets” area: we deal with firms that are either based or invest in Brazil, Asia and also Central and Eastern Europe.

These emerging market strategies are much different to what they were in the past. As a matter of fact, they are becoming more and more mainstream, they can display much better macro fundamentals than the developed markets, with much less debt and more growth, better demographics. The world has become more level, and emerging markets are a completely a different story now.

Günther Herndlhofer

We reduced our hedge allocation at the beginning of this year and are monitoring the markets and the behavior of the portfolio at the moment. Probably by the end of the year we will see what we will do next, but for the current phase we stepped a little bit back and just observe our investments.

Matthias Knab

Where did you move it to?

Günther Herndlhofer

The risky money went into the equity markets. But that is not expressing my personal view, because I think there are currently some very interesting investment opportunities in the alternative investment space.

Günther Kastner

We stick to the same ideas we had five years ago when we founded the company. The markets still display low interests of around 1% and we believe that it is much more attractive to find alternative investments which deliver absolute returns, the much needed excess returns. We are still in this environment where institutional investors basically must allocate to alternative investments.

Coming back one more time to UCITS, we really found it important to provide UCITS for our German clients who are very restricted in investing into offshore funds, and maybe the same development may happen in Austria. We already mentioned the requirements for a dedicated risk management division or using consultants, or the other way to go can be UCITS, because they are not judged to be a hedge fund and therefore do not need all these structures.

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So again, certain German investors are required to have their own risk manager or a special legal framework to invest into hedge funds, and then the maximum is around 3%, depending if they are a pension fund or an insurance company. If instead they invest in a UCITS fund, it is seen as part of the long only universe and therefore at least for Germany the future is definitely in UCITS if you want to sell more hedge funds.

Six months ago we launched a microfinance fund that invests in local currency. This fund combines the ideas of growing emerging markets and the expansion in the microfinance field. Investors can have upside on the currency on top of the steady, uncorrelated returns from the microfinance market.

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Regarding new launches, well, about five years ago we started to engage in microfinance in emerging markets. Six months ago we launched a microfinance fund that invests in local currency. This fund combines the ideas of growing emerging markets and the expansion in the microfinance field. Investors can have upside on the currency on top of the steady, uncorrelated returns from the microfinance market.

Matthias Knab **Tell us about the currencies that you have exposure to in this market?**

Günther Kastner The really nice thing about this fund is that is actually does not pile into the usual emerging market currencies like the Mexican Peso or Brazilian Real, but offers exposure to a large range of other currencies from Africa, Asia or Central Europe like the Armenian Dram or Georgian Lari. This is a very good diversification effect for emerging market portfolios as well.

Maria Milford Many of my investors wonder why hedge funds are now so correlated with the equity markets or bond markets. Hedge funds are now more part of mainstream investing than before, they are not the niche investments they were before. With a matured, global universe and new structural options like UCITS, investors need to scrutinize carefully their investments and look behind all the funds and structures. As a side note, we also do a lot of work in the Far East and Asia, and for quite a few investors from that region, particularly retail, the new UCITS funds were actually their first investment opportunity to invest into Europe (apart from buying single stocks). But still, if it is UCITS or offshore, due diligence and astute analysis is still needed in order to assess what risk reward it is going to be.

Oliver Prock We plan to continue our expansion in Europe - we plan to open branches in the big countries like Germany, Poland, Italy, France and the U.K. for our distribution and also increase our efforts in Asia. We also work on launching three more UCITS alternative funds; one of these will be a quantitative credit long/short strategy.

We currently have 50 people in the group and I guess this will probably double in the next four to five years. At the end of the day, it is performance that sells, not just having many offices in many places. I firmly believe that institutions especially should have more alternatives in the portfolio; I do not think that they have enough, even though alternatives may have become a bit higher correlated than in the past.

If you look at it, correlation is a mathematical phenomenon that also depends on your data pool. I mean, I am sort of struggling to really understand where the correlation is coming from – is it from a factual higher sensitivity or just because now we throw more data points into the calculation? Before, we had 12 data points delivered by an offshore fund, but now it can be 250 if it is a daily liquid UCITS fund. I am not sure where correlation is really coming from - is it due to just more data points are now available for the calculation or is based on a truly different environment? I believe that these issues also drive the research and use of alternative beta hedge fund strategies.

Matthias Knab **Let us talk about the talent pool here in Austria. When your firms expand and look for new hires, is it easy to find talent here? What does the talent pool look like?**

Oliver Prock What we are typically looking for are physicists - not so much mathematicians, but more physicists. Maybe mathematicians typically try to prove something, but in capital markets you cannot prove anything. There are a lot educational programs around finance going on at the local universities.

Universities are also offering young people practical work experience besides their academic education now in cooperation with the industry, which is very helpful to find local talent.

Günther Kastner

Apart from developing local talent, Vienna is a really nice place to live and many people are more than willing to come here. For example, for our microfinance fund we hired the risk manager from the Central Bank in Armenia. Our gold and resources fund is managed by someone who actually grew up in South Africa, and of course there is also talent from Germany who moved here, so you can attract international talent to come to Vienna if you have interesting projects.

Mark Cachia

For me, the question regarding talent has two sides. One relates to finding local talent, local managers to invest with, and the other side is finding people to work with. These are two very different equations.

In terms of local Austrian groups to invest with, I think there is quite a bit of talent in the country. We talked about the CTA history in Austria - they started really well and were successful early, although they have not kept up with the biggest CTAs. One reason could be that the bigger international CTAs have deeper pockets and used that to invest into research and the organization, rather than marketing.

At our alternatives group, we base our research now in London and New York, because those are the two financial hubs and it is more effective from our perspective to have our research there, even if we are headquartered here in Vienna. We try to run a quasi-training/development program each year or every second year, depending on how much interest and talent we can attract. It is a challenge to do this here in Austria, because the pay scale here is very different than Switzerland, London or even France now.

Austria is a wonderful place - I am American and I have been here now for over eight years. I came for a one to two year period initially and stayed, because the quality of life is fantastic and my job has been very rewarding. Nevertheless, if my main focus was only to make as much money as quickly as possible, I would not be here. The very high overall tax rate is also unattractive, however a world class infrastructure and social system do not come cheaply.

Of course, you have an advantage when you run your own company as then you can get paid in dividends - those of us that work for large companies don't have that benefit. But from the quality of life, together with a great corporate management style that allows us to work responsibly and relatively independently, working for Erste Group here in Austria is really satisfying.

On the other hand, a lot of the talented Austrians do venture abroad to seek their fortunes. Top destinations are London and Switzerland.

Mark Cachia

Therefore, for an entry-level person with talent and options, why should he or she stay here and get half the money? But, as a matter of fact, there are also some other considerations. Austria is a wonderful place - I am American and I have been here now for over eight years. I came for a one to two year period initially and stayed, because the quality of life is fantastic and my job has been very rewarding. Nevertheless, if my main focus was only to make as much money as quickly as possible, I would not be here. The very high overall tax rate is also unattractive, however a world class infrastructure and social system do not come cheaply.

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Maria Milford

I don't think there will be much arguing about the fact that Austria is not quite a financial hub, and as a consequence the basic education of the people in the industry is totally different of those who grow up say in London or New York. You basically deal with different types of people. What I found is that people here are tremendously well educated. You can find excellent analytical people here who you should use and hire. These folks love to go deeply into all kinds of analysis, et cetera.

Therefore, as an asset allocator, I am very happy to be here, because you find this type of people who really want to dig into everything and analyze it. One reason for that is that in most cases they don't come from a trading floor. Their main aim was not making a lot of money on the floor, but more analysis. For us, these are good people to send out for on-site visits, to discuss with hedge fund managers. They are really interested and they want to know how this guy invests and what he is doing.

So, people here are different. I think the more trading-oriented people that want to make a lot of money go to London, New York, Hong Kong and make their money there, but if you are looking for good people to analyze things and do a proper asset allocation, this is a great place.

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