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Editor's Note

Herding, Performance Chasing and Committee Structures: The Three Maladies of Institutional Investing

Particularly since the global financial crisis, institutions find that they have more or less made the same investments with the same, brand name managers. How could such a level of herding have happened? Which investor groups have invested differently, and how and why?

The other malaise that affects investors more often than not is performance chasing. If you go beyond the surface, investors' reasons to invest or not to invest with a certain manager in many cases boils down to chasing past performance. Often the investor is both not conscious about it, and also not equipped with the proper know-how and procedures to invest rationally.

For most institutions, the rate of return (even risk adjusted) is not the only criterion for making an investment. If you look more closely, there are many different utility functions that come into play, like adjusted career risk, or the element of second guessing, particularly in committee-based investment decisions in large, complex organizations. This is totally understandable – there has been a lot of stress in these organizations over the last four or five years: many people have lost their jobs, and the usual organizational reshuffling and uncertainty creates stress and nervousness:

"You have this individual responsible for manager selection. His job is to recommend a new investment opportunity to the CIO. He does not want his recommendation to be rejected, so he will second guess the CIO's reaction and recommend the manager that, in his opinion, is most likely to be accepted. That means he is not only evaluating the manager, he is also evaluating or anticipating the reaction from the CIO. And the CIO in turn may be second guessing the investment committee who may be second guessing the board of directors, who is second guessing the media and politicians they are responsible to. So everybody is second guessing up the food chain, and that is normally not the best way for rational decisions to be made", says RPM's Mikael Stenbom.

This second guessing theory may also help explain why established managers with lots of assets under management tend to perform at best averagely, because they also have that committee structure internally. In fact, studies showed if you bring a question to a group of individuals, and then contrast their decision – as individuals – against a committee, the result the group comes up with typically underperforms the average result of the individual decisions.

The Opalesque 2013 Nordic Roundtable was sponsored by Estlander & Partners, Eurex and Taussig Capital and took place in September 12th in Stockholm with:

1. Martin Estlander, Estlander & Partners
2. Mikael Stenbom, Risk & Portfolio Management (RPM)
3. Peter Seippel, Optimized Portfolio Management (OPM)
4. Karl Trollborg, Wassum
5. Joe Taussig, Taussig Capital

The group also discussed:

- **What is the demand for and the current use of alternative investments by Nordic investors?**
- **How relevant is Solvency II for investors? Why is IFRS a challenge for institutions?**
- **To what extent does modeling work? Why is "physics' envy dangerous to your wealth"? To what extent should correlation assumptions play a role in proper risk management?**
- **How can asset managers keep innovating?**
- **Why the *organizational distance* between the actual owner of capital and the decision maker about the investments determines if the investment decision will be conventional or not**
- **In which phase of an asset manager's corporate life cycle should you invest in him?**
- **The evolution of the CTA industry: what's coming after Transtrend, AHL, Winton, or Aspect?**
- **Why many managers will in fact choose not to comply with the AIFM directive, and instead go for the UCITS fund format solely.**

Enjoy!

Matthias Knab
Knab@opalesque.com

Participant Profiles

(LEFT TO RIGHT)

Matthias Knab, Christoffer Dahlberg, Joe Taussig, Martin Estlander, Peter Seippel, Karl Trollborg and Mikael Stenbom

Introduction

Peter Seippel
Optimized Portfolio Management

My name is Peter Seippel, I am representing Optimized Portfolio Management. We are an alternative investment management firm set up in 2003. We run funds of funds and also single strategies, for instance a listed private equity fund for people that are interested in this asset class but without the traditional lock up there.

We also run a CTA strategy which is of course purely systematic. We won't run single strategies that would interfere with our main business, which is the fund of funds side. In total we manage approximately 2.5 billion Swedish Krona with a team of five investment professionals. We like to outsource a lot of other the non-investment aspects of our business in order to focus solely on the investment side. I've been working in the industry since 1999 focusing on risk management and alternative investments (mainly Hedge Funds and Private Equity). I have a Licentiate degree in Financial Economics focusing on option theory from Stockholm University and Cass Business School. I've been working for some of the largest financial institutions in Sweden, amongst others Nordea Investment Management and Länsförsäkringar Investment Management.

Karl Trollborg
Wassum

My name is Karl Trollborg and I represent Wassum, an investment consultancy active in Sweden, Norway and Denmark. We were established in 1996 and have a very strong position in the Swedish market. Our clients range from some 100m Swedish Krona up to a few billions, typically pension schemes within larger companies, other types of pension trusts, municipalities and family offices. Our total assets managed are about 45bn Swedish Krona, and we advise on approximately another 45bn, so in total about 90bn.

We also offer a fund platform to pension insurance companies, and a few fund of funds. In total about 20-25 employees are involved with the investment side of our business. I work as a fund analyst within the hedge fund and absolute return area.

I started my career as an option trader focused on market making in the late 80s, when the option market was developed in Sweden after studying at the Royal Institute of Technology. I have later studied at the Stockholm School of Economics and at that time I worked as a journalist as well as a copywriter, freelancing. After finishing my studies at the Stockholm School of Economics I worked for KPMG for nine years, doing various types of corporate finance assignments.

Then I worked for six years for a Swedish foundation as a venture capitalist/private equity manager investing the foundation's assets, after which I finally moved to Wassum a year ago.

Martin Estlander
Estlander & Partners

My name is Martin Estlander. I am founder of Estlander & Partners, a CTA we started in 1991. I studied computer science and industrial management at the Helsinki University of Technology and later at the Swedish School of Economics. During my studies, pretty similar to Karl. During my studies - I started trading equities - I fell completely in love with the financial markets. Soon we founded an options market making firm here in Stockholm. During that time I met Karl for the first time. I also met Mikael, who at the time, working for the exchange, approved our firm as members of the stock exchange

Trading options led me to start systemizing trading strategies and subsequently forming the CTA that has been running ever since. We run three distinct stategies. One is the quantitatively driven trend following strategy that we run in a dedicated fund called Alpha Trend. Secondly, we run systematic macro strategies, i.e. strategies that are driven by other factors than price and that we utilize combined with price driven strategies in our other program that goes back to 1991 called Global markets, and thirdly we do short term intra-day. trading, which is ran in a fund called Presto.

We offer all these strategies combined in a product called Freedom fund, which is offered in both a UCITs and non-UCITs format. Our main clients are pension funds, family offices and also fund of funds and specialist CTA investors. In total we are 35 people, nine in research and the rest focus on trading, IT which involves infrastructure, data management including data cleaning, and admin.

Mikael Stenbom
RPM, Risk & Portfolio Management

My name is Mikael Stenbom and I represent RPM, Risk and Portfolio Management, here in Stockholm. I am the Founder and the CEO of the company and I have been that since the company's inception in 1993.

RPM is a CTA specialist. We offer our clients multi strategy CTA solutions through funds or other types of investment vehicles that can be customized or standardized. Our clients are typically institutions and corporates. Historically, we have had a large share of investment banks as our direct counterparties that have outsourced the construction and the ongoing management of multi strategy CTA portfolios to us, while they distribute products to their own client base.

In addition we offer risk management services for banks, institutions and even CTAs that wish to have a third party assessment of the risk taking and wish to offer their clients full transparency via web-based reporting on their investments.

In total we manage and advise about $3.5bn. We are 20 people here in Stockholm, divided between investment operations, investment research and IT. We have also representation in Japan, the UK, Holland, Germany, Austria and in North America.

I am a Graduate of the Royal Swedish Naval Academy and the Stockholm School of Economics. I was on the founding team of OM derivatives exchange which was later to become NASDAQ OMX. I also had a few years as a CEO of a management consultancy company before forming RPM.

Joe Taussig
Taussig Capital

We work with asset managers to create or acquire reinsurers where the asset manager gets to manage all of the reinsurer's assets. This idea was originated by Warren Buffett and has more to do with his success than his stock picking does.

14 other high profile managers have followed Buffett's lead. Two of these reinsurers, Greenlight Re and Third Point Re are publicly traded on NASDAQ and the NYSE respectively.

Investors choose to invest in these reinsurers for three reasons: (1) they are virtually certain to outperform the asset manager's funds; (2) if publicly traded, the investor gets daily liquidity, instead of lockups, periodic redemption restrictions, notice periods, and possibility of gating; (3) better tax treatment for taxable investors in most jurisdictions.

In addition to delivering outperformance, the asset manager gains significant assets that would not otherwise be available and all of the assets are permanent capital.

We are launching a new platform called Multi-Strat Re that is targeted at managers from $50m to $1bn of AuM (although our second manager has $8bn of AuM), which will permit these asset managers and their investors to enjoy the benefits the benefits that Einhorn, Loeb, Cohen, Paulson, and their investors enjoy.


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Matthias Knab What is the demand for and the current use of alternative investments by Nordic investors at the moment?

Karl Trollborg: I see two clear forces that stand out at the moment driving institutional investor behavior. One is Solvency II and the other IFRS. Both push some of our clients into more absolute return type of investments from equities or any other volatile investment.

I don't know the details of Solvency II, but one aspect of those pension regulations is to try getting less volatile returns and match it with their liabilities. According to IFRS, pension trust assets should be valued marked-to-market. That means the pension schemes' volatility is documented in each quarterly report, they basically get it into the quarterly profit and loss statement, which the corporates don't like. And their banks seem not to like it either.

So, it's an issue for them. I mean, it's a fluctuation that's only on paper really, but it's an issue anyway. That phenomenon pushes them to look for more absolute return type investments. So one sector that has become attractive to some pension trusts is the hedge fund industry, which traditionally has been well developed in Sweden. The investors also look at absolute return products provided by major international actors like Standard Life, PIMCO etc. labeled "unconstrained bond", "total return" or "absolute return", for example.

Those absolute return products can be very large strategies. For example, Standard Life's absolute return strategy is at EUR 35bn. In my view it is actually a hedge fund, though it is not sold as a hedge fund. Those products do also enjoy a strong demand, I can say that our clients like them.

Peter Seippel: A theme that we have been communicating for about one and a half years now is that at some point, the interest rate cycle is going to come to an end, and many investors are going to have a problem with their fixed income exposure since it is not going to act as a cushion versus their equity exposure.

That means they need to find something else that will work as a hedge against equities in their portfolio. I agree with Karl's previous comments, however from our perspective, when selling hedge funds, we see it as a way to keep the equity exposure by adding low correlating strategies. These low correlating strategies should have a positive carry and produce returns when it's needed the most i.e. in a crisis situation.

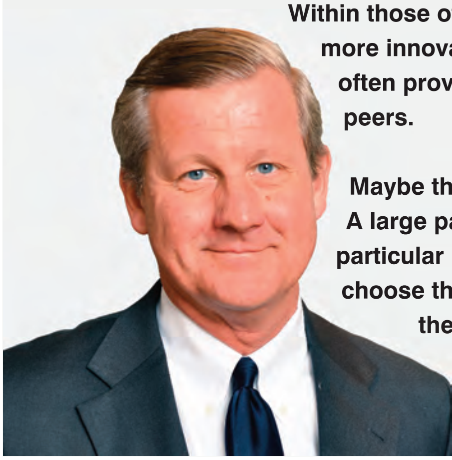
From the beginning of the year fixed income (bonds and bond funds) have given negative returns and that is of course a problem for investors relying heavily on bonds. That has pushed some clients to reallocate and start increasing allocations towards hedge funds again, taking the fund of funds route to get this exposure, on the back what's going on in the interest rate markets. So there is currently a higher demand in the market for hedge funds.

Martin Estlander: A trend here in the Nordics already over the last few years has clearly been that pension money seems to look more towards alternatives, so this is obviously very positive. It also seems to us that there is an increasing preference among institutions towards onshore solutions versus offshore solutions.

Mikael Stenbom: I agree with what all of you said, but let me add another perspective or perhaps a divergence. The father of management consulting, or perhaps one of the few management consultants worth listening to, Peter Drucker, once said that it is an illusion to believe that a CEO and the Board of a large corporation perform independent analysis and forms its own opinion on strategy – that is far too difficult and complicated he said. Instead, they look to see what their peers are doing and basically do the same thing or something very similar. This "herding into ideas" is also common among institutional investors that represent large complicated organizations and larger pension funds.

So while currently there is again a trend towards alternative investments and absolute return strategies, it seems many of those investors tend to go in the same direction: they typically choose the same managers or the same providers, probably because it feels safer and is perceived as less politically controversial and risky.

But at the same time we can also observe a divergence between the large investors, the complicated organizations, and the smaller family offices, high net worth individuals and independent asset managers. The latter seem less preoccupied with following the herd. This second group seems to be doing more independent analysis that leads them to making independent investment decisions where they often end up with entirely different managers, providers and strategies.



Within those often smaller organizations we see a strong trend towards investing in smaller, more innovative managers, trading new strategies that are less time-tested in the markets, but often providing a significant alpha, at least as compared to their larger and more well known peers.

Maybe there is a shift going on among the larger institutional investors in Scandinavia now. A large part of them entered the alternative investment industry and the CTA world in particular in 2010 or 2011 and they all more or less made the same investments. They choose the same three, four managers and most of them have been disappointed with both the absolute and relative return and we do see an increased interest to learn more about managers and strategies that have been off the institutional radar screen.

Martin Estlander Most of those investors started off investing in fund of funds, and have since moved their holdings to direct single manager funds, mainly larger names. So what you are saying is that the next trend might be that investors will start looking a bit deeper for a more diverse set of providers with more diverse strategies, rather than going with just a few household names.

Mikael Stenbom Yes, and one can also describe this as a kind of tug-of-war between maximizing a simple utility function: the investments contribution to the overall portfolio's risk adjusted rate of return, and a much more complicated one involving not only risk-adjusted return but a lot of other factors like political considerations, media considerations, organizational interests, etc.

Joe Taussig: We experienced what you were talking about already in the 70s. We had eight specialist posts and we allocated equally to them. When I became the CFO of the company that didn't make any sense to me because our top two guys returned 400% on our capital per year.

While we couldn't reinvest or top up their asset base because of the rules of the stock exchange for specialists, I did shift some funds towards the two really good ones. What you saw next was that their returns started to deteriorate, but the whole department gained. In other words, some guys were already at capacity. And when you tripled their capital, they start losing money too. I always said, size kills and absolute size kills absolutely.

Logically you have another aspect to that phenomenon of the deteriorating returns. If you have more ideas than you have money, you'll rank your best ideas and allocate to your best ideas. But if you are a Long Term Capital and you have 7000 trades on, you can't tell me that number 6991 to 7000 had the same potential as those from one to 10. If you have more money than ideas, you are going to have diminishing returns.

When ranked this way, your next idea shouldn't return as much as your previous idea. There is a lot of academic support that the young emerging managers tend to outperform, they work harder, they don't have distractions and for many other reasons, but in my view the primary factor is that they have more ideas than they have money, and not the other way round.

Mikael Stenbom: When we studied performance data from all CTAs since 1990, we used the old corporate life cycle as model for classifying the managers: start-up, growth, maturity and decline/rejuvenation.

It turned out that, generally speaking, a CTA typically follows this path. The question is that where, as external investor, you want to be invested? Of course, you will want to be invested in the growth phase, when their product and their ideas have been tested in the markets, they have proven themselves to be able to develop and manage a business. You want to invest when they are starting to take off, you don't want to invest when they are at the peak of their assets or the peak of their powers.

By using age and assets under management, we can define four development stages; Emerging, Evolving, "Large-Cap", and Matured. That way we create dynamic sub-universes of managers. We focus our attention and our due diligence process only on the evolving phase, where managers typically offer their best risk adjusted rate of return.

We launched this fund here in Europe this spring. According to our data, the evolving CTAs have historically outperformed the large cap managers by about 3 % per annum at 10% volatility. Half of that is the result of a higher alpha and the other half of it originates from a lower average pair-wise correlation within that universe.

So we expect to be able to outperform major indices with at least 3%. It remains to be seen what our selection due diligence can add to that. Currently, after five months of active trading, we are about 6% above the indices.

Karl Trollborg: Mikael mentioned that certain investors are resisting the herding and often invest differently than the larger investors. It would be a great thing to say as a consultant, that all our best ideas would come from us, but the reality is that often the family offices are the ones finding new ideas or themes. They are at the front line and in many cases have deep industry knowledge, usually in the industries they made their fortune, but also through their contact network. They also tend to be very active investors, keen on following through and deploying their money smartly.

Now, contrast this to the more institutional type of clients, Even though they are professional managers, they are facing certain kind of organizational obstacles to take on new or different types of risk. As we discussed, that makes it easy for the larger type of funds to make their inroads to that investor base on their own or with our assistance. But as a consultant we also look for the smaller managers. They are much harder to evaluate, it takes a lot of time and a lot of hard research, and they are difficult to sell on the clients. But it is normally there we find the best performers.

Joe Taussig: Karl, you had a really interesting comment about IFRS and Solvency II. This statistic will surprise people: there is more equity capital in the hedge fund business than the life and annuity, P&C, reinsurance, and banking industries of North America combined. Again, this is equity capital, not assets.

All those investors made a free decision to invest in some kind of fund as opposed to buying the stocks of insurance companies and banks. The assets of insurance companies and banks are highly leveraged. That means there are around $60tln of assets that these people manage very inefficiently. They not only have lousy returns, the other aspect is the enormous headcount they have.

Opalesque published an article one time that the top 10 hedge funds earned more in absolute dollars than the top six banks America did, with like 1% of the employees.

We have a similar analogy in our business. If you take Greenlight or Third Point Re. against Swiss Re., Swiss only has 30 times the capital but 500 times the employees. That just can't be right.

I am optimistic about this industry because what you are talking about is Solvency II which is something I live with all the time.

It surprises people, but insurance companies don't mark their bond portfolios to market. So, if you put everything in the 30 year treasury, regulators pat you on the back and say, wow that is really safe. Well, it's safe, if you need the money in 30 years, but it's not so safe if you need it next year because of a Katrina, Sandy, 9/11, or Fukushima and interest rates have gone up a point in the mean time.

Generali is levered 40 times. You can't tell me those Italian bonds and the European sovereigns aren't impaired by 2.5% if they had to mark to market.

So, that's what's happening with these pensions and the IFRS is to mark to market, the Solvency II is mark to market. I think that's going to be good for our business, because I don't think these guys are going to have any choice, but to start coming more to our model. We are coming from a different standpoint bringing hedge fund managers to run the industry as opposed to the industry adapting to the strategies, if you would.

But somewhere these things have got to merge because they can't operate the way they are, so not only insolvent, but they are just inefficient. I mean these guys are just picking up 2 to 3%, that's the industry norm on the whole portfolio, with lots of people.

Matthias Knab **Martin, you mentioned that there may be a preference from European investors for onshore products. Can you elaborate on that, and where do you see this development heading?**

Martin Estlander: Particularly in the Nordics we have had legislation that provides for onshore vehicles for alternative investment managers already for a number of years. For example, there is a Swedish Special Mutual Fund and a Finnish Special Mutual Fund which have less constraints on the investment strategies than what is the case for a traditional mutual funds. Of course, there are some constraints on investment strategies but some hedge fund strategies fit quite well into them. Therefore, with several few years of regulated, onshore funds in the market now, the perception of hedge funds is more positive here in the Nordics than in many other parts of Europe. We can see a number of institutions having a preference for the onshore format over say Cayman funds.

Matthias Knab What is your view on other ongoing regulations in Europe, for instance AIFMD?

Mikael Stenbom I guess the positive side of AIFMD is that it is a shift towards a more coherent and consistent regulatory framework throughout the European Union, and it will reduce a lot of the uncertainty that has prevailed for some time now. But it will also drive business into banks and other large providers and probably also reduce diversity and innovation.

And I can't help thinking about what consultants, auditors, law firms etc. have been charging in order to assist people navigating in this ever changing landscape and providing advice and interpretation of all the new regulation. Those costs must be staggering.

And at the end of the day it will be the consumer – the man on the street – that will pay for it.

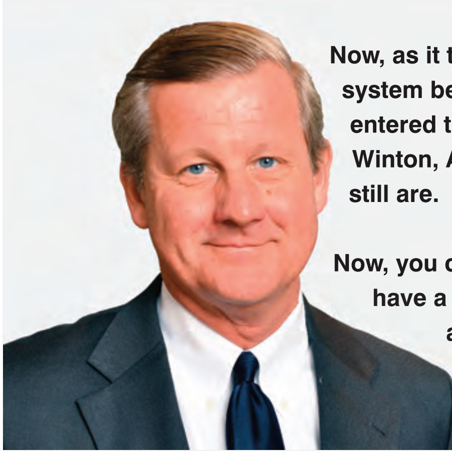
Martin Estlander: I fully agree with this. I also believe many managers will in fact choose not to comply with the AIFM directive, and go for the UCITS fund format solely.

We know that financial engineering has solved some of the restrictions within UCITS. For us as managers, the AIFMD directive is complex and even creates restrictions that you can only address by operating as two different companies. One of them under the MiFID regulatory framework, and the other under AIFMD, because the regulator has figured it out that you can't have one company under both frameworks. This has in my view gone too far.

As said before, our experience with proper onshore vehicles here in the Nordics has been very positive and good for both investors and managers and for the general perception of hedge funds.

Matthias Knab Let's look at the evolution of the CTA and the hedge fund industry. All of you have been for decades in the industry, what do you see?

Mikael Stenbom: RPM have spent 20 years in this industry. When we started in the early 1990s, the CTA industry was dominated by U.S. based classical trend-followers. Most of them had this mantra: "Never touch the system."



Now, as it turned out in mid-90s, perhaps it would have been a smart idea to touch the system because markets were and are changing, and that was when the European CTAs entered the stage with a more scientific approach. In Europe we had Transtrend, AHL, Winton, Aspect who quickly started to dominate the industry and, at least in terms of AuM, still are.

Now, you could argue that a new breed of managers is emerging. These managers do not have a background in trading the markets or from economics or financial studies. They are often engineers, mathematicians or physicists, their passion is technology more than trading, and they have acquired sets of skills that could be applied to solving all kinds of complex problems.

Peter Seippel: Regarding CTAs, I agree with Mikael's observations. We have also seen engineers coming in and solving problems, in essence they are high frequency problems which economists have had problems solving. We have also seen that traditional CTAs have started to expand their business offering and include bespoke mandates or modules that give investors the choice to trade equities, bonds, currencies and commodities separately.

In general, the last couple of years have provided a challenging environment for CTAs. However, we firmly believe that the trend will turn in their favor again. It is like volatility – it comes back. Due to exogenous factors such as new instruments introduced into the markets or policies implemented by politicians it looks as if it has gone away, but then it comes back, just look at the years preceding the 2008 turmoil. Markets will move back to a trending fashion. The hard part is the time frame, which is of course always unknown.

I started working in this industry in 1999, and at that time I found there was a totally different approach to investing. The portfolio construction was punchy, using high volatility strategies that were completing the other assets an investor had in his balance sheet. Over the years, volatility decreased, the industry became more institutionalized, diversification ruled and the “double digit” returns disappeared.

What we see now is that some of the investors at the forefront of the industry are playing with the idea of going back to investing more punchy. If you think about it, in the current markets hedge funds also need to increase their returns and revenue target somehow, either by going for beta in one way or other, or through leverage or through concentration.

Diversification was a good idea, as there is still a lot of alpha out there, however with both falling volatility and interest rates maybe it wasn't the ideal approach. Therefore, we see concentration coming back and that will help creating products that are really much more complimentary to the investor's portfolio.

This is also our offering, to offer investors complimentary products to existing portfolios that are packaged in a flexible and proven hedge fund format. In a way, we aim to build a hedge with a positive carry. For example, take the insurance most people have on their houses where you pay a premium upfront for the whole year. No one really skips the insurance since the price you pay is far lower than the alternative, i.e. rebuilding a house at full cost. With CTAs the potential is even greater. Here, you can actually get paid a carry for holding the insurance. Given the environment investors will be facing for next couple of years, with low or negative returns from fixed income, CTAs as a concept is still very attractive.

Matthias Knab Peter mentioned how hedge funds have changed over the years. At your own firms, tell us more about how you adapt to changing markets, how do you keep innovating? Tell me about your new products?

Martin Estlander: Innovation is extremely important. We have a strong philosophy in our company that we need to inspire our staff, not just motivate them. If you want to motivate people you can bribe them with money to do what you want them to do, but if you want them to stay creative and bring their heart to the work they do, then you have to inspire them, you have to offer them something else.

The way we try to offer that “other dimension” is through a very defined and strong corporate culture that includes a clear corporate vision and mission, and where the values of the individuals match those of the firm and where the values reinforce each other. Then you get a real upward spiral where you have a strong base to work from and can

keep the creativity in the firm high. With the values, the vision and mission guiding the staff, it is easy and fruitful to give your staff a lot of latitude to be creative and make their own decisions. This again gives people more inspiration and so on, the spiral works upwards

When it comes to new products, we are actually launching a fund shortly which will be more in the short term space. This is the result of many years of research and as a response to client demand. The strategies have been a part of the multi strategy funds for a longer period of time, and hence they have a track record.

But again, the demand comes from the clients who, as Peter also mentioned, have been through a challenging cycle with volatility basically falling since 2008. I believe a lot of investors are today quite aware that CTAs and other long volatility strategies, can make money when markets will be exhibiting larger moves again, and they want to capitalize off them.

One of the challenges that CTAs have had over the past few years is that the "price if being in the game" or the price of maintaining the CTA exposure has been high, due to the high and falling volatility. This has now normalized and hence the opportunities look much better now, or let's say, as soon as we again start seeing some more volatility over the longer time frame .

So, I am returning to our short term strategy that has performed quite nicely in this environment with short lived market moves. The strategy has allowed us to capture these short term moves which usually turn out to be rather costly for the medium to long term strategies.

Matthias Knab **So you have been experiencing inflows from investors into your CTA strategies?**

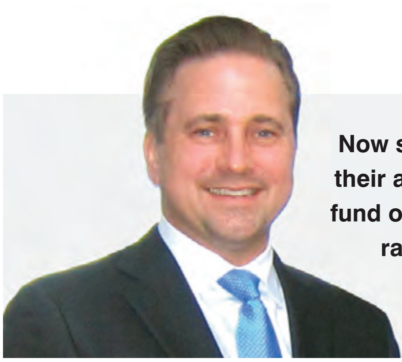
Martin Estlander We have seen positive inflows here in the Nordics, while from central Europe the trend was more towards the other side, i.e. outflows.

Mikael Stenbom We know that the majority of the Nordic CTA investors are invested with a fairly limited number of very well known, big names. Over the last year or so, we have seen a rather significant outflow of assets from these large managers. To what extent this is driven by Nordic investors or by others I cannot tell.

But there are also inflows to local Scandinavian managers. For example, we have one very prominent CTA right across the street here that has enjoyed fairly consistent inflows – probably driven by retail demand through fund of funds vehicles.

Karl Trollborg Our clients are primarily invested in one CTA, the Swedish one, so while I have a kind of a limited vision, I do try to persuade clients to look at CTAs and trend followers. While this is not always an easy task, my perspective is that they are in fact one of the cheapest ways to provide some tail hedge for hard times, particularly for equities, which should be part of the purpose of an absolute return portfolio. But CTA performance over the last year or overall since 2008 has not been that attractive, so it's a hard task.

Peter Seippel: I agree that the environment has been difficult over the last couple of years. I also believe that some of the in and outflows into CTAs is partially a kind of rotation and coincides with the "do it yourself" phenomenon that emerged after 2008.



Now some of these investors have realized that the problem may not be the asset class but their allocation process and are scaling back their direct investments and using bespoke fund of funds programs instead. So over time the allocation towards CTAs, in my view, is rather static. Investors tends to stay with CTAs because it provides them with a crisis alpha, this has been proven, in theory and practice.

Karl Trollborg: From the investor perspective, there is one major issue with CTAs: they generally add a lot of volatility to the portfolio. The resulting higher value-at-risk numbers add a lot of perceived risk, but in reality it is less of a problem since the risk is fairly uncorrelated, especially when the hedging effect is most needed. Maybe we should call it "value-at-chance" to focus on the positive side of volatility.

Martin Estlander: Well, on the other hand, one of the arguments why people invest in CTAs is obviously non-correlation to risky assets. So if investors are looking for non-correlation, by default they require volatility to actually cause that non-correlation to come through. And that is, as you say, the perceived volatility.

Let me also add one further comment on the environment and CTA performance that actually applies for the entire investment universe. I already mentioned the change in the price of being in the game, and another development we have seen recently is the change in the correlation patterns and how that has also affected investments in general.

The equity/bond relationship is completely turned around and while some strategies were able to adapt to the sort of new correlation regime, a good number of others got hurt. The other factor is the risk on / risk off behavior that as we know started after 2008 when many investors had to deleverage. The risk on / risk off affects the price behavior, but we can also see that in the recent months we seem to be back to sort of pre-2008 levels, which is a clear sign that we are out of this deleveraging cycle and this has also very specific implications for correlations and in some can greatly improve the diversification possibilities for CTAs and related strategies.

In my view, there are a number of really positive signs out there right now when looking forward, but I guess most people tend to look backwards instead.

Matthias Knab **Instead of performance chasing, how should they select their investments, where is the solution?**

Mikael Stenbom You have to do your analytics. You have to visit the managers, you have to do the due diligence, you have to have the experience and the skill, you have to do all the work, and most importantly, you have to understand the manager.

Matthias Knab **Can you elaborate on that - "understanding the manager"? What is involved with that?**

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Mikael Stenbom: The first step is of course to have transparency in the trading idea. As allocators to CTAs, we need to understand why the manager is making or losing money. And the manager has to be able to answer that question. Next, you need to be able to find ways to correlate the managers' performance with the behavior of markets.

That means you need to understand in which market environment you can expect this manager to make money, and in which he would struggle to perform. That means you should also be able to explain drawdowns. For us, an explained drawdown is mostly quite okay to us, but an unexplained drawdown as well as unexplained gains, are warning signals.

When you feel you understand the manager and how returns correlate to market behavior, you also have to have methods and courage to act anti-cyclical. For example, I met this well-known institutional investor who decided to follow the "do it yourself approach" and invested lots of time and resources into performing due diligence on a well known large manager. When he was almost finished with the due diligence process I met the investor and he said that he was so far very pleased with the manager and extremely impressed with the organization, with the research effort, with the infrastructure, with the risk management, with the institutional pedigree and all that, and that it was a perfect match.

Then I met him again one month or so later, and I asked him if he invested in this manager? "No", he said, "he is in a drawdown, so I will wait until he shows some performance again." Can someone please explain the logic behind this to me?

Martin Estlander I am afraid that this is just human behavior, nothing more, nothing less....

Matthias Knab So what you are saying is that the rate of return is not the only criterion for making an investment, and that there are many different utility functions you have mentioned. For example, adjusted career risk or career development is probably a very relevant utility function in this mix.

Mikael Stenbom: Correct, and there is also a lot of second guessing when investment decisions are made, especially in large, complex organizations. This is totally understandable – there has been a lot of stress in these organizations over the last four or five years, lots of people have lost their jobs, there has been organizational reshuffling and uncertainty, and this creates stress and nervousness.

So, you have this individual responsible for manager selection. His job is to recommend a new investment opportunity to the CIO. He does not want his recommendation to be rejected, so he will second guess the CIO's reaction and recommend the manager that, in his opinion, is most likely to be accepted.

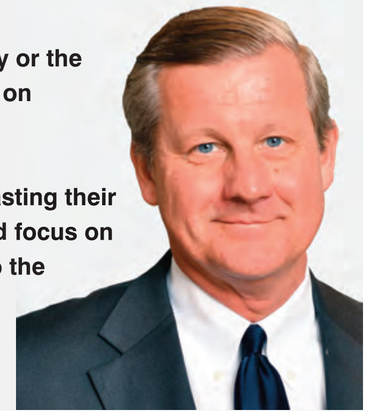
That means he is not only evaluating the manager, he is also evaluating or anticipating the reaction from the CIO. And the CIO in turn may be second guessing the investment committee who may be second guessing the board of directors, who is second guessing the media and politicians they are responsible to.

So everybody is second guessing up the food chain and that is normally not the best way for rational decisions to be made.

Karl Trollborg: This second guessing theory would probably also help explain why many established managers with lots of assets under management perform at best averagely, because they also have that committee structure internally.

Martin Estlander: We talked about social sciences before and that they may be holding certain keys also for the future of investing... in this context, there are in fact some well known studies that showed if you brought a question to a group of individuals, and then contrast their decision – as individuals – against a committee. The frightening thing is that the result that the group comes up with typically underperforms the average of the individual decisions, which is probably not a good case for committee decision making.

Mikael Stenbom: We found an interesting phenomenon. We clearly see that the larger the organizational distance is between the actual owner of capital and the individual making a decision or influencing a decision to make the investment, the more likely it is that the decision will be conventional.



If that organizational distance is short, for example if the decision maker is actually the guy or the woman who owns the capital, the probability of making an unconventional decision based on rationality is vastly higher.

That also has another implication: smaller or emerging managers can comfortably stop wasting their times with large pension funds because they will not invest with them. Instead, they should focus on high net worth individuals, family offices, or independent asset managers who are close to the source of capitals and who are ready and able to make decisions that are not influenced by politics, organizational secondguessing, media, career considerations etc.

Martin Estlander: Can I ask you a question, Mikael? When I arrived here in Stockholm on this trip, I heard a rumor in the industry that RPM is adding exposure to CTAs after three or four months of bad performance. Is that correct and this is based on your homework?

Mikael Stenbom That is correct. At the end of August, we increased our target volatility in all our mandates by 20%. The reason is simply that all the indicators we have developed signal that we were entering into a positive period for CTAs. It remains to be seen if we are right, typically such a cycle can last between four and six weeks.

Matthias Knab **Let us look further at the opportunities down the road. Can you share more insights about the opportunities you see ahead?**

Martin Estlander: We are entering the fall, which is typically the season for increased volatility. If you see volatility going down as much as it is has done lately, and you are entering September and then the last quarter of a year, typically an old options trader like me starts kind of by design to feel like acquiring more volatility in such an environment. But this is just my personal prediction, which is never affecting how we operate our models.

I am not here to make macro projections, but one thing that one can conclude is that a lot of natural resources are traded very cheaply at the moment compared to production cost. Other recent news and data point towards a possible pick up in China, the U.S. is looking rather good, so from that side the global economy may enjoy a positive outlook. That then translates into good opportunities in the natural resources sector going forward. If on top of all of this you add the discussion about the forthcoming inflation tendencies etc. – again, I am not forecasting this

there are a couple of signs that could point people towards starting looking at the world with different eyes. this again could mean interesting opportunities for many strategies, including CTAs.

Mikael Stenbom: I fully agree with Martin. If you look at the MSCI World Total Return Index and you go back say 30 years, you will find that virtually all net return from MSCI World is made from 1st October to end of April every year.

Our industry follows a similar pattern: on average, the net return in the industry as a whole is earned from September to December. It is not true every year – 2012 was an exception – but over time the pattern is clear.

Karl Trollborg I am not saying this may be a big factor, but at least in the Northern hemisphere people are usually away in July and/or August, and after that they tend to come back fresh, full of energy, and start acting, whatever that means.

Mikael Stenbom Apart from that, usually a lot of things go on in autumn. Political elections typically happen in Autumn in United States, in Germany and in many other or the European countries. Also, usually towards the end of the year the phenomenon that we call the stress factor kicks in, at least for asset managers. Usually towards October people are looking around at their peers to see if they are ahead or behind the crowd. They are evaluating if they need to take some action or clean up their books before the end of the year. This also increases liquidity, volatility and general activity in the marketplace.

Karl Trollborg: Michael, you talked about the performance patterns of CTAs and also mentioned that last time was an exception to the rule. This is a problem for me, because then I tend to think it will probably happen again, this exception. We have had a few bad years for CTAs since 2008, will we have another few bad years? I don't find the answers to this type of question, but rather a lot of difficulties. Very few things look like a sure bet, even if history seems to tell us it is.

Mikael Stenbom You are right, but isn't that the name of the game in asset management – we don't know for sure. We can't forecast the future.

Instead, we take the information and experience we have and we try to use it in the best way possible, acknowledging that we may be wrong and taking precautions against that eventuality.

So will the historical pattern repeat itself this year? I don't know. I can only observe that there has been a pattern and make a controlled, small bet on it.

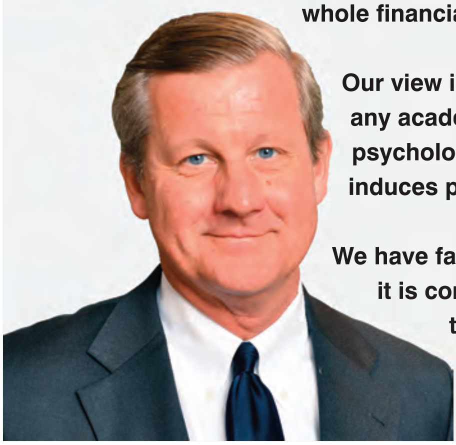
Martin Estlander That is exactly one of the fascinations of our industry. Our job is not to forecast the future, rather to respond to what's happening, and that is exactly what we do.

Joe Taussig You really can't forecast the specifics of the future, but all of you are taking bets. You both have businesses that have been going and growing for over 20 years. So over time what you are doing has value, and that value compounds over time. It is not so important whether you are right with just this bet or just this quarter.

Karl Trollborg: **Martin explained before how the correlations are different now than what they used to be, and that possibly there will be an end to the risk on / risk off pattern. Also here, I don't really agree to that. It might happen just again, just think about what was going on at the end of May or June.**

I brought with me a question about correlations. As we know, correlations are based on the normal distribution, which is not the way markets work. The normal distribution is just a bad assumption about how markets should work. Parameters like value at risk, correlations or whatever similar tools are gaining ground, yet at the same time there is kind of a knowledge gaining ground that those parameters are based on a paradigm that is not only useless but actually dangerous. What are your views on this issue?

Mikael Stenbom: **Andrew Lo wrote in one of his papers that "physics' envy may be dangerous to your wealth", and I fully agree that not only our own, the asset management and risk management industries, but the economics and the whole financial sector in general has suffered a great deal of this envy for quite a few decades.**



Our view is that the world is far too complicated to allow itself to be modeled. If there are any academic disciplines that we should study more, it is sociology, psychology, social psychology, in order to better understand what drives people, how people interact, what induces people to change their behavior etc.?

We have far too little understanding of this. The world is extremely complicated, dynamic and it is constantly changing. The challenge for an asset manager and for a risk manager is to not be lured into a feeling of security because you have mathematical models that you understand. Your model might be absolutely worthless the next morning when you wake up.

Martin Estlander

I agree with you. Karl, regarding our discussion about the risk on / risk off, what I meant was that when you do a principal component analysis by which you try to describe the behavior of the market, and one of the components is a proxy for risk on that RORO is still quite visible in the market, but just this mathematical analysis shows that it has come down. But going forward, what you might see now is more of the "tapering on / tapering off", perhaps you could measure that as well?

But I also agree with Mikael, it's very hard to predict human behavior. What goes on in the market is very emotional, and true, science knows very little about this. Science doesn't even know where emotions appear in the body.

Peter Seippel: **Martin spoke about the tapering, and I also believe that the recent correlation patterns are probably a result of the central bankers' intervention in the market. They have pushed certain asset classes and jump started the economy through printing money system to keep the economies going, and that will of course have a lot of implications in the near term future.**

For this reason, I believe the correlation patterns that we have been seeing during Spring will stay for the near future.

I believe the next period will produce managers that can combine academia with more a hands on approch to risk management ("the traders approach"). Here, risk management based on correlations and normal distributions will still influence the "alpha" engines but play lesser role to handling the risk.

Regarding the tapering on/off, we will have to wait and sees what effects it has. I looked, for fun, at an Elliott Wave graph in the morning that says we are right now in the same pattern as it was in the 70s, and if that is true, we will have a crash within six months.

I don't say we're going to have a crash in the next six months but it's very interesting to see how an environment that we believe is all new seems to have happened in the past. If you just take your time to look back in time long enough, we can see the same kind of patterns/trends coming back into the the market again and again.

Martin Estlander: I agree with Peter and also believe it is very relevant to look back 40-50 years for particular patterns in the market. It might be more relevant many times than looking back six or 12 months.

Correlations are particularly difficult to forecast. You can rely on past correlations to make future estimates, but when they change, they change very quickly, and you find them at completely new levels

Therefore, our firm, from a risk management point of view, makes no assumptions on correlations whatsoever. We just have to face reality from the point of view that when the st hits the fan, it's going to hit all over the place and on every single position and gear our exposure accordingly.**