OPALESQUE

Opalesque Roundtable Series '15

LIQUID ALTERNATIVES

Opalesque Roundtable Series Sponsor:

eurex

opalesque.com

Editor's Note

The second phase of evolution for liquid alts

In Europe, the original UCITS framework for mutual funds came into effect in 1985. The regulations have been continuously developed since then. Hedge funds started using the UCITS format in earnest after the financial crisis when many investors wanted onshore, regulated vehicles. Also in the U.S., liquid alternative products have been around for about a decade. Liquid alts are currently entering a second wave of evolution, as the quality and the access to the managers have increased over the past two years. The first wave was primarily long-only managers extending themselves into the liquid alts space. The second wave are hedge fund managers who are now willing to offer their products within this framework, which makes the liquid alts space much more interesting. In fact, AllianceBernstein for example has defined liquid alternatives in the U.S. as "hedge fund managers who have offered their strategy in a daily redemption environment."

Although there have been large flows into the space it is still very concentrated across a limited number of funds. Participants at this Roundtable do not believe that investors fully understand their investment objective, how to allocate and source the allocation. So from that perspective, liquid alts are still in the infancy stage. It seems the majority of the advisors have tended to pick a few managers but still require more education to fully understand the benefits of the strategies and limitations. Education remains a challenge.

Education remains a challenge, also for institutions

But it's not only just the retail space that doesn't understand liquid alts; the institutional space doesn't understand liquid alts either. It may also have to do with the way that people have been trained for such a long time to think about the investment process. They tend to think about things in terms of stocks, bonds, and "other". And they think about the investment process from a long-only investment strategy or asset allocation, and not as a risk allocation or by the risk factors involved. That doesn't mean that investors don't construct hedges or that they don't play around the edges with short strategies, but the reality is that in order to truly harvest some of these return streams in the liquid alternative space requires a dedicated long/short, or a distinct alternative-type of approach. And then you still need to combine them into different types of portfolios: just adding one liquid alt fund won't do the job.

Performance has been very divergent for alternatives and in fact, much greater than it is in traditional asset classes. Selecting a traditional fixed income manager, their dispersion is relatively low. When you look at dispersion for along/short equity, multi-alternative, or non-traditional, the dispersions are very large. Therefore, understanding manager selection quality and access is really key. Probably investors are just at the start of getting to know the impact of the manager selection decision in alternatives.

Early stages means they bear risks

Therefore the development and application of liquid alts is still in the early stages. The early stages though means that it bears risk. We are not pointing here to the risk associated with the investment but rather to the fact that there are many firms rushing to the market to offer liquid alts. Sometimes those products can appear more like an experiment – they may be well-done, but sometimes they are not. As a starter, many strategies can be done in a liquid format, but also a lot of them that can't. Maybe we are about to enter a period where the market is going to tell us much more about how these liquid alts are really going to function. This Roundtable elaborates in great detail the risk dimensions of liquid alts.

On top, investors as well as product providers and distributors should really find out what the end client is exactly looking to get out of this alternative investment? Are you worried about market volatility? Are you worried about downside? Are you worried about improved diversification? Is it a return product? Or is it about fees or about structure?

This inaugural Opalesque Liquid Alternatives Roundtable was sponsored by Lyxor and tool place end of January 2015 in New York with:

1. Christine Johnson, Managing Director, Alternative Investment Product Development, AllianceBernstein
2. Andy Weisman, Chief Investment Officer, Liquid Alternatives, Janus
3. Richard Lindsey, Chief Strategist, Janus
4. Barry Seeman, Global Head of Derivatives Structuring, Aegon
5. Jared Cornell, Managing Director, Alternative Investments, Charles Schwab
6. John Grady, Chief Strategy and Risk Officer, RCS Capital Corporation
7. Will Hogan, First Vice President, Investment Management, Amalgamated Bank
8. Nathanaël Benzaken, CEO, Lyxor Asset Management

The Roundtable also discussed:

- Why are insurance companies looking at liquid alts?
- How to deliver liquid alts for a Taft-Hartley clientele and defined contribution plans?
- Why should every LDI program be using alternatives?
- How can you deliver value at an "okay" risk for size?
- What are the three drivers of investment returns in CTAs?
- Why are bigger sophisticated investors making now more risk-based investment decisions rather than asset-based decisions?
- Why and when will investors pay investors several hundred basis points per year in costs for netting risk?
- When will the 2 & 20 hedge fund fee model make the manager richer than the investor (60% vs. 40% of gains)?
- What's the Richard Petty school of investing?
- Are fees an issue for 40 Act funds? Is liquidity an issue for liquid alts?
- Did the Peso Problem resurrect as the Swiss Franc? And what does this mean to your risk management?
- What's the appropriate role and extend of due diligence required for successful liquid alts investing?
- How to best educate the market on liquid alts? Which distribution channels work best?

Enjoy!

Matthias Knab
Knab@Opalesque.com

Participant Profiles

(LEFT TO RIGHT)

Nathanaël Benzaken, Andy Weisman, John Grady, Will Hogan, Richard Lindsey, Matthias Knab,
Jared Cornell, Christine Johnson, Barry Seeman, Michael Bernstein.

Introduction

Barry Seeman
AEGON USA Investment Management

I am Barry Seeman from AEGON USA Investment Management, LLC where I head up Global Derivatives and Hedging for AEGON insurance companies, here in the United States. Our book runs approximately $70 billion notional exposure on any given day. AEGON is primarily a large international life insurance company offering variable annuity and other life insurance products, for which I oversee the hedging activities for their US insurance companies and the international variable annuity businesses.

I have spent the last 27 years in both derivatives trading and alternative asset management, having traded and structured derivatives for major sell-side firms, and running hedge fund and fund of funds operations at buy-side institutions.

I should also emphasize that my comments reflect my opinion and not those of AEGON.

Christine Johnson
AllianceBernstein

Christine Johnson from AllianceBernstein. I joined the organization about a year ago as Managing Director to head the Alternative Products Group and further develop the platform that has now grown to over $20 billion globally.

I have been in the industry for 22 years. I began my career at Bankers Trust, I was at Deutsche Bank and Deutsche Asset & Wealth Management for a number of years before moving to AllianceBernstein.

The AllianceBernstein platform has grown through strategic acquisitions of teams and talent since 2009. Our focus for the alternative business has been twofold. One, we focus on liquid alternatives, and secondly on private credit. We see both of these areas of emerging opportunities within the Alternative space.

Michael Bernstein
Lyxor Asset Management Inc.

I am Michael Bernstein. I am the Managing Director and Head of North American Business Development for Lyxor Asset Management, Inc., which is the U.S.-based subsidiary of Lyxor Asset Management S.A.S. in Paris.

Lyxor S.A.S. is the asset management subsidiary of Société Générale which has, together with its subsidiaries, approximately $110 billion in assets under management. The global firm has been around since 1998 and is best known for being a leader in the field of liquid alternatives, including managed accounts. It also has a very strong business in ETFs and growing range of proprietary investment strategies.

I have been with Lyxor Inc. for five years and before that I was at FRM in a number of client-facing positions. Prior to that I had a first career in management consulting.

Will Hogan
Amalgamated Bank

I am Will Hogan from Amalgamated Bank where the main hat that I wear is Director of Product Development for our Investment Management Division.

Amalgamated Bank is a unique institution. We were labor-founded in 1923 and continue to be a majority-owned union bank. The group that I am a part of serves predominantly Taft-Hartley clientele.

We have been working to add alternative investments to our line up in the last few years.

So we tend to focus on the balance between liquidity, yield and overall return when it comes to our services and products.

I have been in and around the securities and investment industry for 20 plus years, with particular focus in alternatives for most of the last 10.

Our product set is predominantly outsourced to subadvisors. We have a series of collective investment trusts that is called the LongView Family of Funds and we have some internal passive equity and fixed income management capability, so most of our assets are outsourced to third party managers.

Richard Lindsey
Janus Capital

My name is Richard Lindsey. I am the Chief Investment Strategist for Liquid Alternatives at Janus Capital. Together with my colleague Andy Weisman, I have been at Janus for about three years where we build liquid alternative investment products.

Prior to that, I was President of Bear Stearns Securities Corp., where I ran the prime brokerage business for Bear Stearns. Before that I was the Director of Market Regulation, which is now called Trading and Markets, for the SEC.

Andy Weisman
Janus Capital

My name is Andy Weisman. Like Rich, I am one of these guys that stayed in school too long. I went to Columbia forever. My first real job out of graduate school was running the Quantitative Trading Group in the Foreign Exchange Division at Bankers Trust. I ultimately became the Chief Investment Officer on the international side of the company for Nikko Securities, and then Chief Portfolio Manager for all the hedge fund offerings at Merrill Lynch. At Janus I am now the CIO for Alternatives.

I have won some research prizes that my mom is real proud of, including the Bernstein Fabozzi prize. I am on the Editorial Advisory Board for the Journal of Portfolio Management, Board of the International Association for Quantitative Finance, where Rich is actually the Chairman of the Board.

Let me add that Rich has been a bit humble in his intro here, because he also has a PhD in Finance from Berkeley and used to be on the faculty at Yale. He now teaches Quantitative Portfolio Construction at the Courant Institute, as well as working with me.

The focus of our firm is a theme that has been coming to the forefront of asset management, which is simply a deep realization that you can have many different products but it doesn't mean that you have a diversified product offering.

When you ask the critical question how many truly independent sources of variance, or risk, are there in a portfolio, what you will typically discover is that in excess of 90% of the risk emanates from a single source, and it's basically equity beta.

So we were brought in to Janus to think long and hard about how you can provide other well-known, well-documented risk-factor exposures that basically don't require the stock market to go up to make money. Such exposures, to use a $10 word, should be relatively orthogonal or statistically independent. That's what we are up to.

Nathanaël Benzaken
Lyxor Asset Management Inc.

I am Nathanaël Benzaken. I am the Chief Executive Officer of Lyxor, Inc. here in the U.S. I took over the CEO role in New York in August 2014, but before that I was with Lyxor S.A.S. for 14 years in Paris.

Moving to Lyxor U.S. was for me an interesting move in the sense that I joined Lyxor on the hedge fund management side and helped to develop our managed account platform. In North America, we want to continue developing our managed account and liquid alternatives business, and we also want to expand our product range beyond that.

Before Lyxor S.A.S., I was at Arthur Andersen as a Manager in their Financial Risk Consulting division. I started my career at Crédit Agricole as a Treasurer in France.

John Grady
RCS Capital Corporation

I am John Grady. I am the Chief Strategy Officer for RCS Capital Corporation. RCS Capital owns a number of firms, including one of the larger wholesale broker dealers in the non-traded REIT space called Realty Capital Securities, as well as one of the largest independent retail brokerage firms in the country called Cetera Financial. I also head up our liquid alts initiative, which includes the ARC Income Funds, encompassing both open-end and closed-end funds, as well as the Hatteras Funds based in Raleigh, North Carolina, which we acquired midway through last year.

Jared Cornell
Charles Schwab

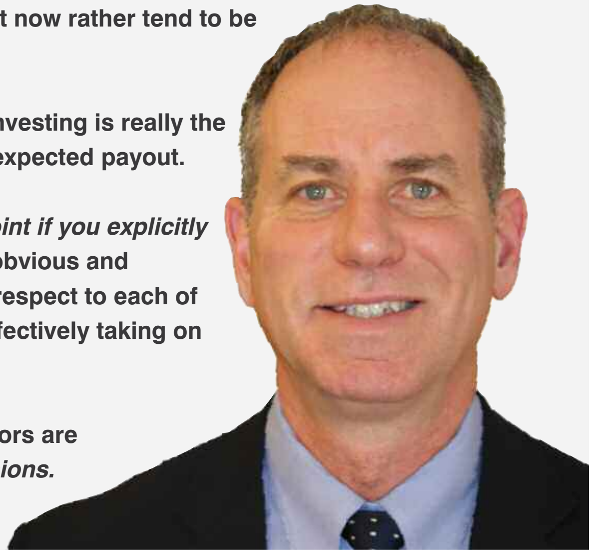
I am Jared Cornell, Managing Director of Alternative Investment Platforms for Charles Schwab. I manage Schwab's Alternative Investment OneSource™, which is a platform designed to deliver registered alternative investment fund solutions to clients of independent Registered Investment Advisors.

Schwab is a very large retail broker dealer and provider of financial services. We have more than $2.4 trillion in client assets and about half of that is in accounts that are run through independent registered investment advisory firms. Schwab's Alternative Investment platforms are primarily oriented towards the end clients of these advisory firms. We strive to provide high quality third party alternative solutions for those clients. With the exception of the Schwab Hedged Equity mutual fund, Schwab doesn't manufacture or white label any of its own alternatives.

Matthias Knab Let's look at these liquid alternatives, their development and history and where this asset class is heading, in more detail.

Andy Weisman: I have done a lot of traveling in the last couple of years. In fact, it seems I have travelled so much that I received a personal email from Jeff Smisek, the CEO of United, thanking me for my patronage, and I now have this double secret probation status with the airline, where I now board alongside uniform military personnel and the elderly; literally.

In any event, I had the opportunity to meet with probably 30% of the world's money at this point, many of the sovereign wealth funds across the globe and major pension plans. The one lesson that seems to be emerging is that people are really thinking differently now about how they make their investment decisions, where those investment decisions aren't at their heart asset allocation decisions but now rather tend to be risk allocation decisions.

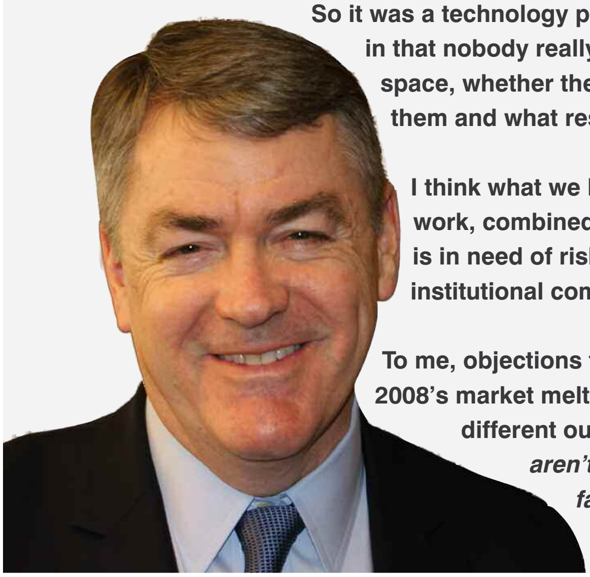


What is clear is that more and more people have come to realize that investing is really the assumption of risk, where we assume units of risk in exchange for an expected payout.

The idea is that you can do a lot better job from an investment standpoint if you explicitly think about what the risks are that you're assuming. Is there really an obvious and identifiable intuition driving why you deserve to be compensated with respect to each of these risks? Is there a disutility transfer taking place, where you are effectively taking on someone else's problems?

And that really seems to be the big lesson; bigger sophisticated investors are making *risk-based investment decisions rather than asset-based decisions.*

John Grady: My perspective on the question was formed in part by the fact that, as a lawyer, liquid alts long felt like something that existed on paper, but couldn't be brought to the marketplace. We didn't have the tax laws we needed, and we didn't have the technology to bring the complex strategies that make up the liquid alt space: strategies that are not just long-only and not just correlated to the equity markets.



So it was a technology problem and a legislative problem, and it was also a regulatory problem in that nobody really knew whether liquid alternatives should be introduced into the retail space, whether they would work, and if people would understand why they were buying them and what results they should expect from them.

I think what we have seen is an increased appreciation of the idea that liquid alts can work, combined with the idea that from an investment perspective, the retail populous is in need of risk mitigators and alternative sources of return as much as the institutional community.

To me, objections to liquid alts have fallen by the wayside, particularly in the wake of 2008's market meltdown. Portfolios that included alternatives provided dramatically different outcomes for investors. That really caused the retail world to say, *"if we aren't in the liquid alt space, then we are literally at the risk of one or two factors driving our client relationships and satisfaction with what we do – particularly the traded equity markets in the U.S."*

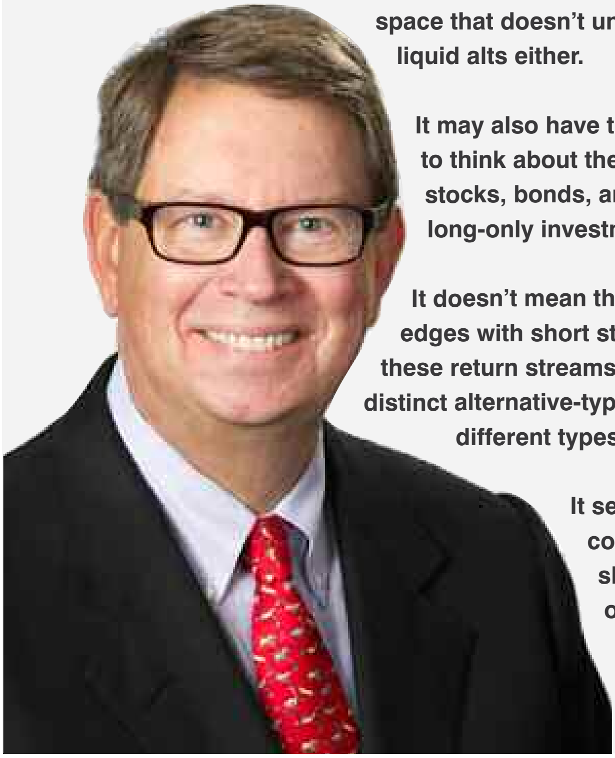
The desire to have alternative products that could be delivered to retail investors drove several fund companies to put such funds on their menu, even if it meant they had to do it by trial and error, or even if it meant they had to focus on just one strategy to start.

Again, speaking mostly from the retail standpoint, the drive to have these products has then been accentuated by the entry of firms to offer and manage such products as well as the desire of brokers and platform to bring those products to their clients.

Christine Johnson: I began developing liquid alternative products in 2006. So I think we can say that this asset class has actually been around for a while.

In my view, we are now in the second wave of evolution, as the quality and the access to the managers have increased over the past two years. The first wave was primarily long-only managers extending themselves into the liquid alts space. The second wave is now hedge fund managers are now willing to offer their products within this framework. This makes the liquid alts space much more interesting.

In addition, although there have been large flows into the space it is still very concentrated across a limited number of funds. I believe investors still don't fully understand their investment objective, how to allocate and source the allocation. Liquid alts are still in the infancy stage from that standpoint. It seems the majority of the advisors have tended to pick a few managers but still require more education to fully understand the benefits of the strategies and limitations.



Richard Lindsey: I think I would echo Christine's comments. In fact, it's not only just the retail space that doesn't understand liquid alts; the institutional space doesn't understand liquid alts either.

It may also have to do with the way that people have been trained for such a long time to think about the investment process, and they tend to think about things in terms of stocks, bonds, and "other". And they think about the investment process from a long-only investment strategy or asset allocation, as Andy mentioned before.

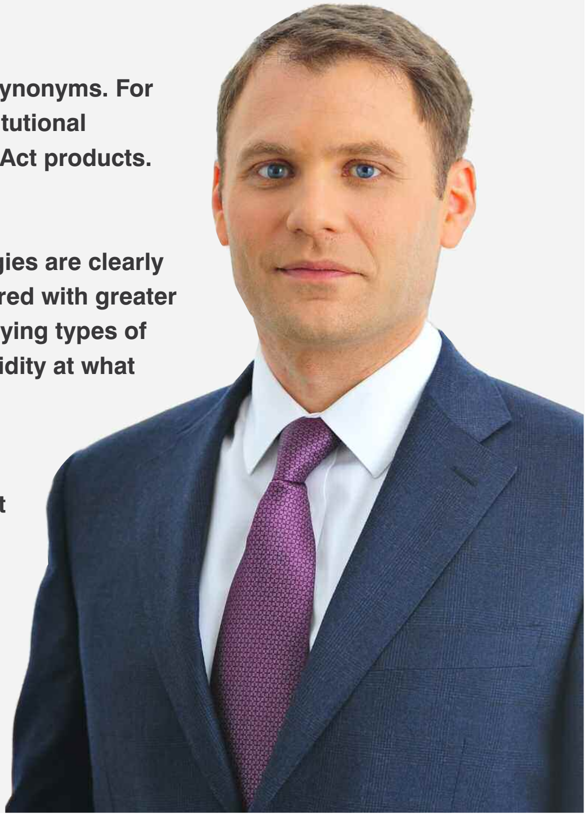
It doesn't mean that they don't construct hedges or that they don't play around the edges with short strategies, but the reality is that in order to truly harvest some of these return streams in the liquid alternative space requires a dedicated long/short, or a distinct alternative-type of approach. And then you still need to combine them into different types of portfolios.

It seems that in some parts of the world, like the Nordic European countries, they actually are getting it, with the rest of Europe maybe a slight step behind. The United States and, I am going to guess, much of the rest of the world, is even further behind in terms of their thinking about risk and in the way that they deal with the idea of liquid alternatives.

So like some of you I do think the development and application of liquid alts is still in the early stages. The early stages though means that it bears risk. Let me clarify that I am not talking about the risk associated with the investment; I am talking about the risk of the fact that there are many firms rushing to the market to offer liquid alts. Sometimes those products can appear more like an experiment – they may be well-done, but sometimes they are not. And a problem here is that sometimes I don't think that these funds are actually liquid, so you may not be able to actually liquidate them in a short time or rapidly. In addition, their alternative character may be questionable. Quite frankly, a good number of liquid alternative products are so highly correlated with the equity market that they aren't really providing the alternative diversification that investors should be getting.

Now, I am not saying equity doesn't have a place in the portfolio, it clearly does over a long term, but you also need to have diversifying investments to reduce risk.

Michael Bernstein: Just to pick up on some of the terminology issues that you raised. It's worth pointing out that typically people use the terms liquid alternatives and retail alternatives interchangeably, at least in the U.S., with regard to '40 Act funds.



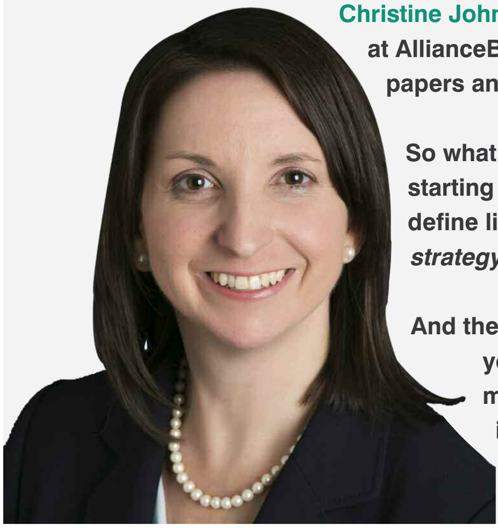
At Lyxor, we would make the point that these terms aren't necessarily synonyms. For example, we can talk about a place for liquid alternatives within an institutional portfolio, and those liquid alternatives don't necessarily need to be '40 Act products. E.g., they can be managed accounts offering weekly liquidity.

When we look at alternatives along the liquidity spectrum, some strategies are clearly extremely illiquid and should stay that way, whereas others can be offered with greater liquidity. Sometimes there is a tradeoff between returns or truly diversifying types of exposures and liquidity. So at some point it becomes a question of liquidity at what price?

Pushing all the way to daily liquidity sometimes costs you a lot, and if you pull it back maybe a little bit, let's say weekly or monthly, you might be getting a little bit more of the type of exposure and returns you want without necessarily going all the way to daily liquidity. And for some investors that tradeoff makes a lot of sense.

So we evaluate and consider liquidity amongst a broader spectrum of terms, and again, make the point that liquid alternatives don't always mean '40 Act funds or UCITS funds for that matter.

Matthias Knab Alternatives in general have this problem that some people still and actually all the time benchmark them against the equity markets, like the S&P500. How do you deal with that? How do you address this whole educational challenge?



Christine Johnson: We have spent an enormous amount of time on education on dual fronts at AllianceBernstein; we have built a dedicated website for advisors and produced white papers and educational supplements as well.

So what we have focused on specifically is first on definitions as a neat and clean starting ground. What's the common definition of liquid alts? For us, we have come to define liquid alternatives in the U.S. as *hedge fund managers who have offered their strategy in a daily redemption environment.*

And then second, we are looking at the broader framework and application. What are you looking to get out of this alternative investment? Are you worried about market volatility? Are you worried about downside? Are you worried about improved diversification? That is important because various alternatives will fit those objectives very differently.

Barry Seeman: If we look at it from an insurance company standpoint where liquid alternatives have sort of crept into the product mix of variable annuities, this is something that many of you have probably looked at, and over time those offerings have taken on a couple of different forms.

I think after the credit crisis, you saw a plethora of volatility-controlled funds come out, and one could argue that those fit somewhat into this category of liquid alternatives. Then, of course, we also see variable annuity platforms that offer daily liquid hedge funds in either single or multi-manager type programs.

Insurance companies can analyze these products and suggest, *"we could probably lower our hedging cost associated with the variable annuity product because we have perceived less gamma risk in our hedging or daily hedging with volatility control."* But, we also notice that policy holders have really moved into these products, because after the credit crisis, liquid alts and their strategies were a lot easier to sort of stomach long-term. As they invest in an annuity product, investors are viewing the long-term nature of their investments and want a level of assurance that their money is there for the future. So I think that these volatility control funds can serve multiple purposes, jointly on the retail and institutional side.

Matthias Knab Right, in Europe by the way, a lot of institutions are investing into UCITS because first, they appreciate the liquidity; and second, because as a consequence of regulations, certain institutions like insurance firms or pensions only have UCITS to get some sort of alternative exposure.

Jared Cornell: Schwab is obviously very focused on the needs of the individual investor; our reason for being is to provide services and solutions to these types of clients.

Some of you may recall that when we rather famously tried to exit the alternatives business back in about 2008, we were swiftly informed by our advisor clients that that decision was not going to work for them. And so ever since we have been trying to work out how do we want to approach the obvious need for diversified sources of return in terms of being non-correlated, or at least having some sort of downside protection, and to what extent do we want to be involved in this advent of liquid alts.

And whether you are talking about daily liquid mutual funds or whether you are talking about sort of the registered non-traded monthly or quarterly-type liquidity vehicles we make available on the AI OneSource™ platform, they are clearly more suited for most of our investors than your average qualified purchaser type of product.

So as I look at the landscape of products that are available and how the are presented, I worry a bit about how the daily liquid mutual funds are being marketed and to clients.

I agree with Richard's comments that we are still in the infancy of the liquid alts development. There is a lot of work left to be done in terms of categorizing these funds properly, as well as developing useful transparency into what they are actually doing. How do we educate the advisors and the clients as to what these funds actually are, how to use them properly, and ultimately, how to expect them to behave in certain market environments? The multi-alternative bucket at Morningstar is mystifying to me, let alone to your average investor. It's a very much moving target.

I also believe we are about to enter a period where the market is going to tell us a lot about how these liquid alts are really going to function. And more to the point, whether the people who are running them actually know what they are doing. I must admit that I harbor certain suspicions, sadly, that many of them don't. I hope that I'm wrong, and I hope that we won't see a total bloodbath, but I think there will be a shakeout in the market coming at some point as this bull market comes off the boil.

Nathanaël Benzaken: At Lyxor we are in this interesting position because we have been investing in hedge funds for the last 16 years, or longer. I would say that we have: a) expertise in selecting hedge funds and b) expertise in managing risk via our managed account platform.

So what Jared just said about the risks of alternatives or specifically liquid alternatives is something we kind of predicted earlier already for Europe's UCITS market. We think of various long/short credit funds dealing on a daily liquidity basis. Sooner or later, there will be liquidity issues, even though there is this perception that regulated liquid alts are not supposed to gate or blow up. This is not true, they can.

We are in this unique position where we want to leverage on our parent's experience in Europe with UCITS, and apply it here in the U.S. in the '40 Act format.

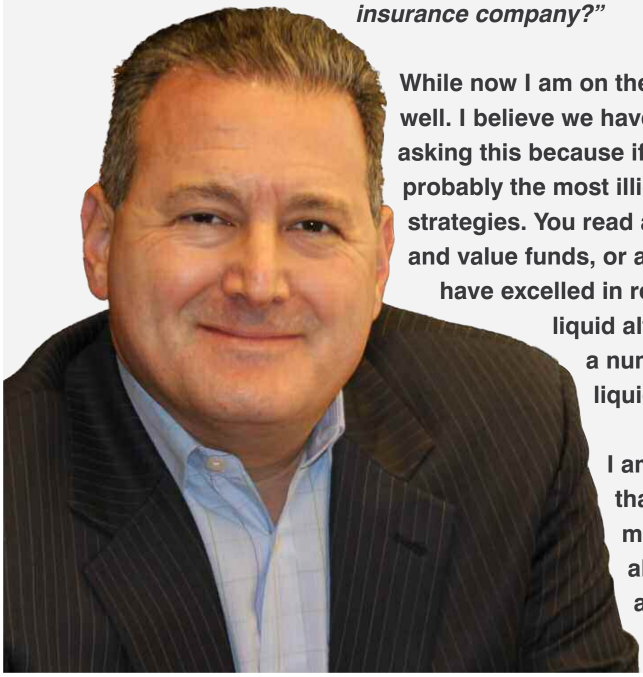
And we come into that business being cognizant of the risks, having a manager selection hat, but also being a manager ourselves. We have internal strategies that we are considering to propose to the market.

The question we are working on now internally is how we can come up with a product that is well received, that creates value for the client with a good understanding of market risk and volatility?

What is less understood by the market participants is the need to be scalable. I can tell you that scalability was the first issue our parent company had in Europe when it launched its first UCITS fund (a risk arbitrage strategy) that was really a success. After a billion, we had to consider closing at this new capacity. Just one billion! Whereas if ’40 Act funds are successful, and this “Liquid Alts” proposition takes off nicely, there will be much more AUM in it.

So, how can you deliver value at an “okay” risk for size? I think this is a question the market hasn’t resolved yet. We are currently looking internally at quantitative, futures-based strategies. Hopefully the scalability is there. But I think this is a general comment and a question that the industry should ask itself, because quality doesn’t come with scale usually in the hedge fund industry. Actually size generally is the enemy of performance.

Barry Seeman: I sit on the side of the table where I am looking at the risks associated with using liquid alternatives within variable annuities, particularly around hedging issues associated with them. We question: *“How does the insurance company model these underlying assets? How should we provide risk management to the insurance company?”*



While now I am on the buy side, I have been on the sell side as a product provider as well. I believe we have to ask: what are we trying to achieve in liquid alternatives? I am asking this because if we look back on 2014, the headline returns have come from probably the most illiquid alternative strategies; especially event-driven and activist strategies. You read articles about Pershing Square and their returns; about activist and value funds, or about obscure mortgage-backed or CDO securities funds. These have excelled in returns, but do not have the liquidity for products offered in the liquid alternatives space. At the other end of the spectrum, we have seen a number of CTAs that have done well in 2014 and offer the type of liquidity sought after.

I am wondering, from your standpoint, have you looked into what it is that the clients are really looking for in this product? Is it a risk mitigation product? Is it a return product? Or is it about fees or about structure? That’s where I haven’t been able to get my head around how this product eventually evolves.

Richard Lindsey: Well, these are good questions, and I think that there are probably products that are oriented towards each one of those different items.

The way that I personally think about it is that liquid alts really should be diversifying products. They should be something that takes risk out of a portfolio rather than exposing the portfolio to some unknown or uncertain risks. In that way I would say it’s really meant to be a diversification play and much less about *“is this going to get me great returns?”*

You mentioned Pershing Square, and we could clearly all think of other names. You are right, those are very illiquid and the investments that those managers make are very idiosyncratic types of choices.

Those investments are not going to be replicated very easily in a liquid form, whether we are talking about weekly or even monthly liquidity.

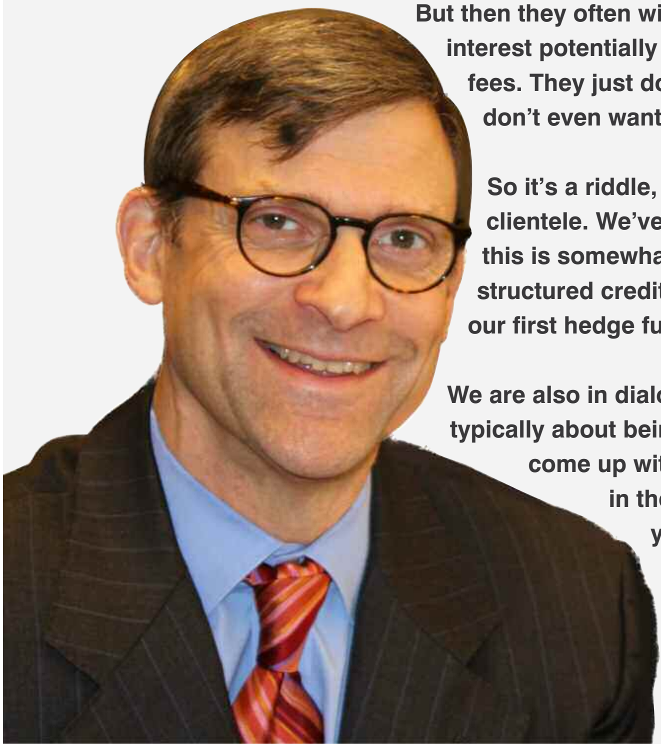
So if somebody is looking for very outsized returns, which is part of human nature, so many people do, I don't think liquid alternatives should really be designed for that, because I think that path imposes way too much risk, particularly in a retail space.

Coming back to your question, Barry, I do think that liquid alternatives provide a complex problem for insurance companies, because of the regulations associated with insurance companies and hedging requirements, how essentially everything has to have a hedge. So, if you have an investment that diversifies risk and hedges the rest of your portfolio and you are required to look at it as a product that must be hedged, what do you do? If you hedge it, you are just back to the risk that you started with and I am not sure you really want to do that.

Barry Seeman It may in fact reduce the risk for us, which is potentially good.

Richard Lindsey Right, but if you are required to hedge it, then you have a problem.

Will Hogan: This might wind up being another question still. Our clients in many instances are not yet invested in hedge funds or alternatives; they are still in more of a sort of traditional 60/40'ish allocation, so rather on the orthodox side. They are certainly very interested though in enhancing returns. So our motivation is to find opportunities for them to enhance returns as well as add to their risk control.



But then they often will come back to us with concerns about liquidity, hence the interest potentially in the so-called liquid alts, but they are also concerned about fees. They just don't like the headline of hedge fund fees. In fact, oftentimes they don't even want us to call what we bring to them a hedge fund.

So it's a riddle, a puzzle to try to come up with solutions that fit that type of clientele. We've have had a bit of luck doing spadework with some clients, and this is somewhat opportunistic on our part due to the relationship in the structured credit space, which might strike you as an odd place to start, but it is our first hedge fund offering.

We are also in dialogue with some direct lending managers. In that case it's not typically about being the most liquid, but maybe there are some opportunities to come up with structures that have a combination of public and private debt in the underlying portfolio, providing some liquidity as well as cash yield.

So that may be a broad statement but it can give you a sense of what we are doing with our predominantly Taft-Hartley clientele.

Matthias Knab Let's look again at these dimensions; fees, performance, range of strategies and the extent of the alpha capture of these strategies within the liquid alternatives space. My question to you now is if you are happy with the status quo, no matter if you are a product provider or investor?

Andy Weisman: I have an odd perspective on this. The second stop in my career was a place called Commodities Corporation, which was the entity that ultimately turned into Goldman Sachs Alternatives Group. There was an interesting study done at the time, where they were trying to figure out, what, for example, looking at CTAs, what makes one better than another? It turned out that about *65% of the variation in performance was a function of asset allocation,* which in most cases was really an artifact of their history.

So for example, if they had grown up as FX traders and there was a big trend in the FX markets that year, they were the genius. If they grew up as grain traders and there was a drought, they were the geniuses that year. If they are a really, really big CTA, then guess what, you don't decide what your asset allocation is; it's given to you as a function of the liquidity in the futures market, so it's going to be dominated by fixed income futures.

And to the extent that rates go on hold for two or three years at a time, you are basically buying high and selling low, replicating a straddle-like payout and effectively paying away premium.

About 30% of the variation in performance was a function of fee structure, so that's the one variable that you could control, and magically enough, if you pay lower fees, on balance you do better.

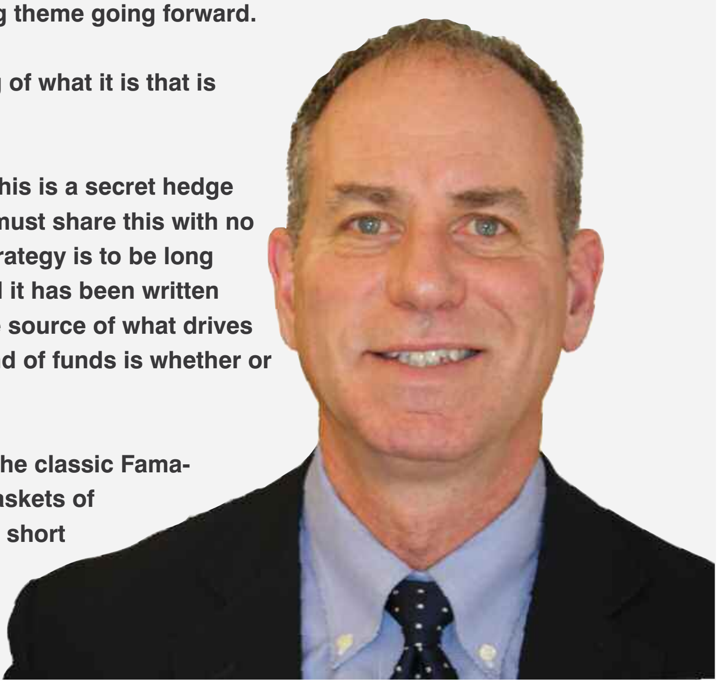
About 5% of the variation was due to one guy having a slightly better model than someone else. That was a very humbling experience.

It remains to be seen where the market is going to go. However, people are going to have a deeper understanding that there are risk factor rotations taking place in the market. They will have a clearer sense of what's driving such market risk factors, and that it's not necessarily the extraordinary wisdom of the people managing the money that's determining investment performance, but *rather the assumed risk factors and the fees they pay to access them.* Subsequently fees will be under pressure. Fees will be a big theme going forward.

The other big theme is about getting a better understanding of what it is that is driving the returns. It's not always altogether obvious.

So one example of a risk factor that you can take on – and this is a secret hedge fund strategy that I will tell you about, but once again, you must share this with no one – is that stocks are more volatile than a T-Bill. So the strategy is to be long stocks. That of course is called the equity risk premium and it has been written about for decades, and everyone understands it. That's one source of what drives returns. Quite honestly, the dominant risk factor in most fund of funds is whether or not the stock market is going up or down?

There are other well-known, well-documented risk factors; the classic Fama-French risk factors, such as "value," where your are long baskets of stocks that are cheap relative to their fundamentals and the short baskets of stocks that are rich relative to their fundamentals.



That's another big source of return over time.

Size is a well-known factor where you own a basket of small cap stocks while being short a basket of large cap stocks. You tend to be compensated for assuming the lower liquidity and the left tail skew of small cap stocks. So there's a bunch of these well-known, well-documented risk factors.

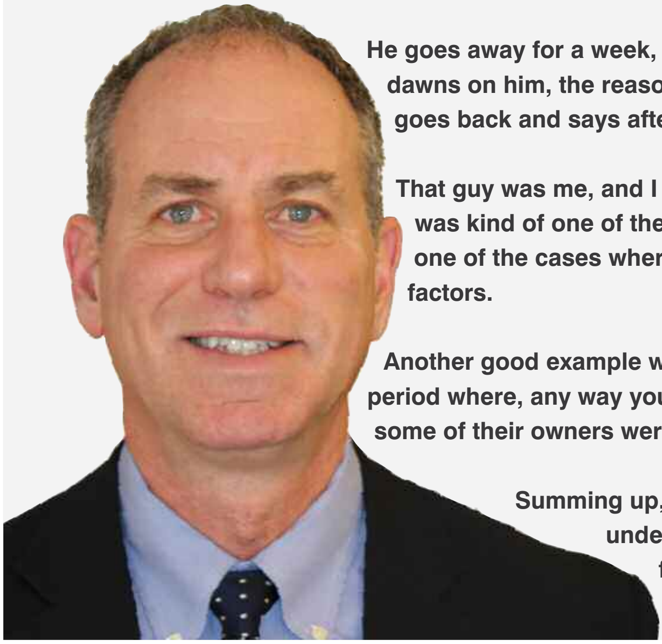
By and large, you can take them and set them up as a collection of independent investment portfolios. I have had very few situations where I was unable to explain a manager's return as a function of a collection of relatively well-known and well-documented risk factors.

Now, there are a collection of managers who ascribe to the Richard Petty school of investing– but let me ask you here, has everyone heard of the famous stock car driver Richard Petty?

Barry Seeman Number 43.

Andy Weisman: **Yeah, exactly, there you go! Famous for saying, *"if you ain't cheating, you ain't trying!"* There was a book published in 2010 and it was called, *'No One Would Listen'*. It was not the story about my relationship with my wife, but in fact, it was a story of uncovering Bernie Madoff written by Harry Markopolos with the assistance of collection of brave muckraking journalistic types.**

Back in 2001, they are looking at Bernie Madoff's track record which was fabulous, so they figured, this can't be real. So they go out and get a guy who was theoretically good at reverse engineering trading strategies. They said to him, "look, here are the returns, here are the securities that are being traded, here are the classes of strategies that are being employed, can you make the two things on the right hand side of the equation equal the thing on the left?" And he is like, "oh yeah, absolutely, I have done this before, no problem!"



He goes away for a week, fails miserably and loses a lot of self-esteem. It eventually dawns on him, the reason he can't do this is because these numbers are bogus. So he goes back and says after a bit of prodding that this has to be a Ponzi scheme.

That guy was me, and I actually got a shout out in the book for doing that. So while that was kind of one of the cool things I got involved in early on in my career, it was also one of the cases where I just simply couldn't relate a manager's returns to risk factors.

Another good example was Beacon Hill. That fund was continuing to do well during a period where, any way you sliced it, they just had to be losing money. So ultimately, I think some of their owners were exposed and got into a lot of trouble for that one.

Summing up, we already have a good understanding about what the underlying things are that are generating returns, so one way forward is to go and access those factors directly.

Matthias Knab What are your views regarding fees and performance? In Europe, the UCITS funds tend to have lower fees than the actual flagship fund. That's something that's appreciated. On the other hand, people know they are also giving off part of the return because they get more liquidity.

How about the liquid alternative space here in the U.S. regarding the '40 Act funds and other liquid alternatives? What is the range of fees and the discussion around them?

John Grady: We try to look at it from both a product development and the retail investor standpoint. Both anecdotally and experientially, one thing seems clear about retail investors' goals: they wish to have absolute returns in down markets and relative returns in up markets. Explaining to them they have a risk mitigation fund or product is easy if it has been necessary and in fact worked as planned. But if returns lag those of the broader markets, they do not understand why they own it, or they conclude that it is not working as advertised. Accordingly, the pure retail segment is very difficult to build products for.

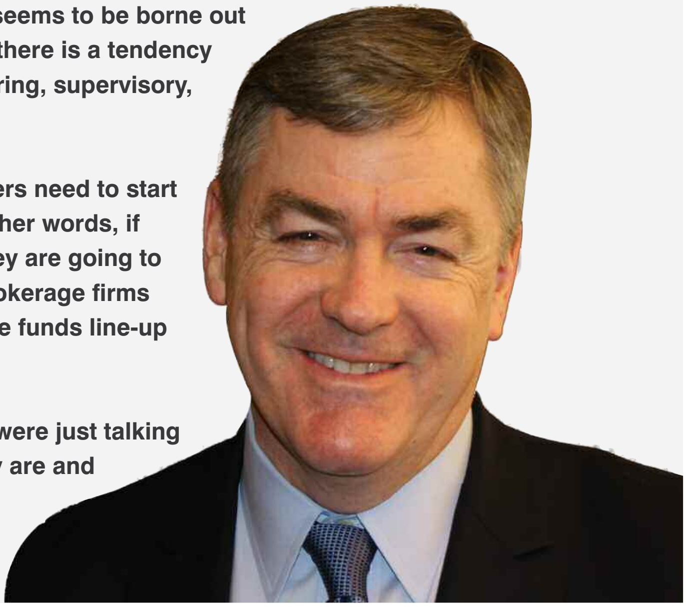
Regarding fees, I think the retail client tends is very much oriented towards a net-of-fees perspective, rather than trying to figure out what affect fees had on performance. That is of course exactly the inverse for the broker dealers and advisors we work with, because for them fees are enormously important. In particular, advisors are trying to figure out how their fees interact with fees that are charged inside the funds put in client accounts.

What we have seen from the regulatory side is a steady drumbeat of press reports and statements to the effect that "liquid alts are under scrutiny." Thankfully, when you go and look at what the regulators are saying, it's more interesting and nuanced. The SEC is saying that liquid alternatives need to work as advertised and that they cannot take liquidity or leverage risk that the 1940 Act prohibits. They need to work within the framework of the Act, clearly, and putting a focus on their operation is Chair White's goal.

FINRA came out with some interesting and different points. They said something akin to what Jared picked up on earlier - there are way too many alternatives and alternative funds for financial advisers to just state they invest client assets in alts. In FINRA's view, and as seems to be borne out by Morningstar's 500+ fund alternative mutual fund category, there is a tendency to lump funds together in categories for reviewing and monitoring, supervisory, and suitability purposes.

What FINRA has said, not surprisingly, therefore, is that advisers need to start dividing the fund world into type, goal and strategy used. In other words, if advisers have an "alternative funds" allocation or segment, they are going to have to explain what's in there and why. That should incent brokerage firms and their advisers to do more to look closely at their alternative funds line-up and to be able to explain what is in there and why.

Accordingly, I think that FINRA's goal is aligned with what we were just talking about – educating the users of these products about what they are and how they work as opposed to just saying they are alternatives and starting the conversation that way.



Jared Cornell: I don't think anybody loves the level of fees in any alts, so fees are always under pressure. As this part of the industry matures, these things have a way of weeding themselves out over time.

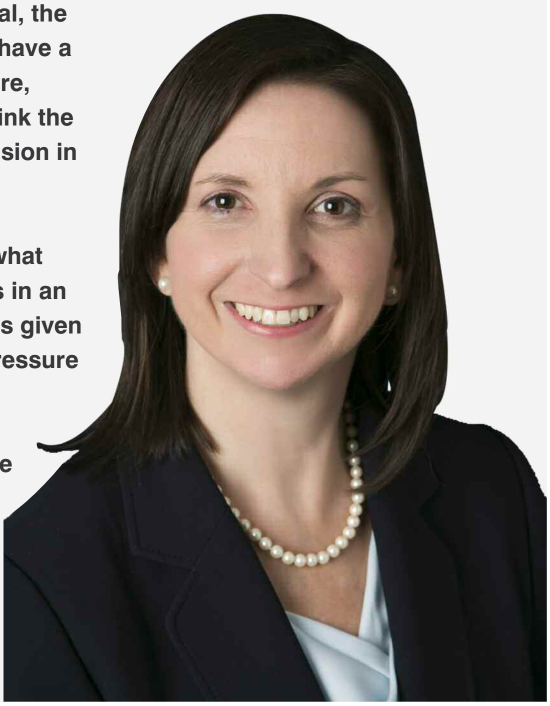
I think to me the real problem is really if the client is happy with the returns? It goes to this educational point of what are the expectations of the actual investor? Are those set properly, does the client truly understand what the product does? Even when looking at their returns, as John was referring to, and they trail this roaring bull market – well, they are supposed to...!

But, is that framed properly in the disclosure documents and in the way the fund is marketed? I think the answer to that is, at least in certain cases, not quite yet. I think that is where the disconnect happens and probably part of the reason why we have been seeing huge outflows from certain strategy buckets in the mutual fund alt space right now. Because people had unrealistic expectations that these things will offer them a full upside capture in an up market and yet still get downside protection, but this is just not possible.

To me, that is the main issue between fees and alpha capture or returns in general. It all comes down to understanding what the product is really designed to do.

On the flip side and as a positive that Christine also mentioned earlier is that now you are starting to see true alternative managers come into the mutual fund space as opposed to the mutual fund managers moving into the alts space. I personally view this as a very positive development in terms of what this corner of the investment industry will eventually look like.

Christine Johnson: Performance has been very divergent for alternatives and in fact, much greater than it is in traditional asset classes. Selecting a traditional fixed income manager, their dispersion is relatively low. When you look at dispersion for along/short equity, multi-alternative, or non-traditional, the dispersions are very large and so you could allocate to an alternative and have a different experience than you would have in a traditional category. Therefore, understanding manager selection quality and access is really key, and I think the investor is at the start of learning the impact of the manager selection decision in alternatives.



We think it's still an early conversation of fees and performance because what you're giving up for liquidity compared to typical 2% and performance fees in an illiquid strategy may not be as large over time. However, how much alpha is given up for liquidity? Overall, we think it's still early but we have seen the fee pressure to Jared's point.

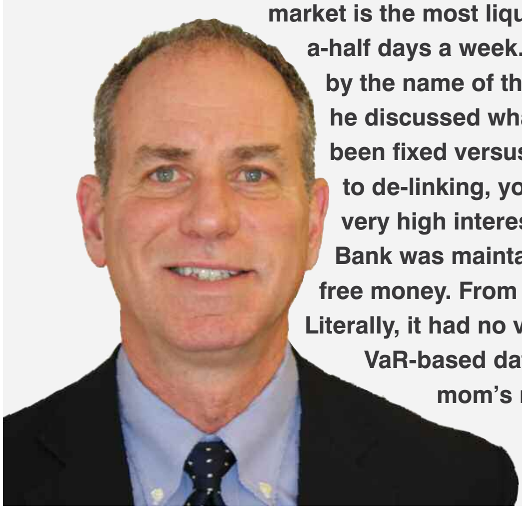
And then institutions, I think, have been quicker to express interest than we actually thought. This is across every different types of investors but certainly across fee conscious investors. If the next three to five years' performance will be interesting, we may see the institutional investor adopting liquid alts quicker than originally thought.

Barry Seeman: As we are talking about liquid alts, let me actually ask you a question about liquidity, which for me is a huge issue today.

As an end user of derivatives, I can watch how, in the dealer marketplace, liquidity is drying up in areas that frankly surprise the heck out of me. Whether it's around bank capital requirements, the potential movement of derivatives away from the bank's balance sheet into a non-bank subsidiary, or the use of collateral for both cleared and non-cleared derivatives, these environmental issues are putting tremendous amount of pressure on the markets. That means when you are talking about and selling liquid alternatives, do you think there are strategies that will have no issue in terms of liquidity and scalability, while you should rather stay away from others, even though today they may represent liquid strategies?

Nathanaël Benzaken: This is a topical question. You've probably read the press as I did. How many prop trading desks have shut down over the last few months due to the old and new regulations? I had some conversations with traders from banks and the conclusion of that conversation was like, "You know what? With a lower number of market makers in the market, it is likely that there will be a little bit more alpha available because banks now can't participate as easily as before in risk arbitrage, statistical arbitrage, and other liquidity dependent strategies." The opportunity in these strategies will be given back, I would like to say, to hedge funds. The question is: will that benefit liquid alts managers and investors?

For example, the environment for risk arbitrage seems favorable with larger numbers of announced merger deals and wider spreads (although it seems like spreads are volatile these days); statistical arbitrage, which I thought was a dead strategy, is likely to be back in favor because they extract value from providing liquidity to the equity market at a time when proprietary "stat arb" desks are shutting down.



Andy Weisman: The liquidity issue is, obviously, a very topical issue over the last week. If you think about which market is the most liquid in the world, it's the FX markets. It's open almost 24 hours a day, six-and-a-half days a week. However there's a well-known concept in the academic literature that goes by the name of the Peso Problem. Back in 1978, Milton Friedman delivered a speech where he discussed what happened to the Mexican Peso in 1976. At that point in time, the Peso had been fixed versus the US dollar for 19 years. Then one day in 1976, they delinked. Now, prior to de-linking, you could borrow money in the US, convert it into pesos, lend it out, earn a very high interest rate, convert it back into US dollars, knowing that the Mexican Central Bank was maintaining that parity, and then pay off your US dollar loan and walk away with free money. From a risk standpoint, if you measure the VaR of that trade, there was no risk. Literally, it had no volatility at all because the exchange rate was fixed. So if you were using a VaR-based data-dependent risk methodology, you would have taken your money, your mom's money and shipped it all to Mexico to lend out.

Problem is that life is out of sample and when they delinked, the Peso instantly dropped in value by 46%, so you basically got the equilibrating event that showed you what the true expected value of that trade was; it just took a long time to occur. So that became known in finance as a peso problem where you have data-dependent risk methodologies that tend to be very pro-cyclical, in other words, they tend to estimate the lowest risk at the worst possible time, and these sorts of problems get people into trouble all the time.

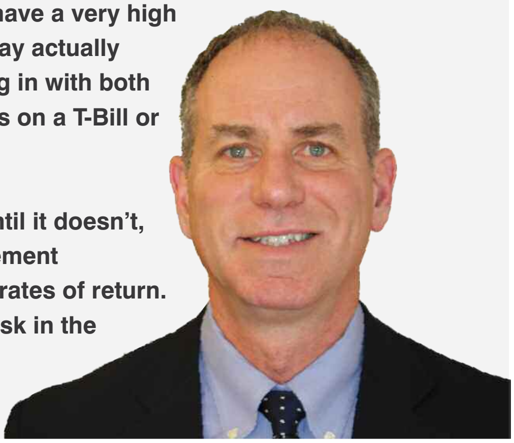
Just last week we saw that borrowing in Swiss Francs, which were linked to the Euro, was not a free-money trade. Even though the FX markets are the most liquid market in the world, you had a 21% gap move in the Euro versus the Swiss Franc. As near as I can tell, by looking at my Bloomberg screen, there was just no opportunity to trade, certainly not on any size, and it laid waste to a bunch of different organizations. Some of the major money-center banks immediately lost a couple of hundred million bucks each. So that's the problem; what is liquid and what isn't liquid is not an easy answer. It's a complex issue because things happen.

Matthias Knab I received an email from a friend and Opalesque client who is aware we are having this Roundtable today. She suggested that I should ask you how the recent decision of the Swiss National Bank to abandon the Euro peg has changed risk management? For most people and investment professionals today the Mexican peso crises is at most something they have heard about, but not experienced personally...

Andy Weisman Yes, candidly speaking Mexico is a distant memory but it was basically the same thing. The SNB unexpectedly de-linked and left the markets to deal with it.

Matthias Knab What's your recommendation regarding risk management going forward?

Andy Weisman: Well, I think that is why people have come to conclusion that risk management is a combination of science, art and experience, and that you should not be fooled when you make an investment by the mode of the distribution. What I mean by that is people tend to be attracted to things that have a very high probability of success in any given period. But in many cases, certin things may actually have a negative expected value. So a classic example of that might be jumping in with both boots on in 1997 into the Russian GKO market where you could get 30% yields on a T-Bill or rushing into CDO investments in 2007 with triple-A ratings.



Why? Because generally speaking, everyday looks like a good day right up until it doesn't, and that is probably the biggest problem that people have from a risk management standpoint. It's the biggest conflict of interest. The preference for high model rates of return. It's probably the biggest and most important incentive for creating systemic risk in the marketplace.

Nathanaël Benzaken: Actually, back in 1998 at a time when we decided to launch our hedge fund managed account platform, the starting point of that reflection at the time was, *"Okay, we like hedge funds, but we don't trust them."*

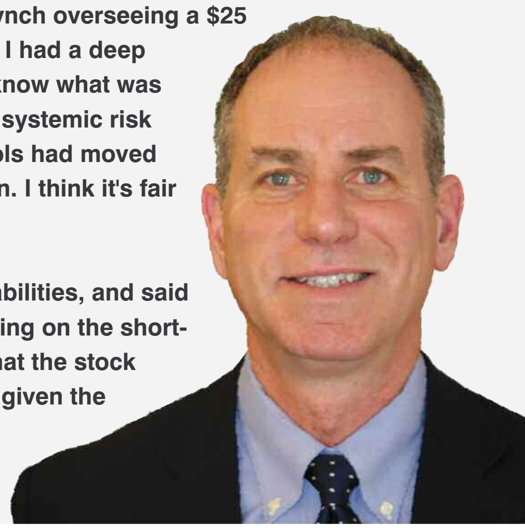
We wanted to invest billions with them, but we wanted, first, control over the assets, and second, daily transparency so that we understand what's going on and make sure they do not drift from their original strategy. This is the core of our risk management: we do position-based risk management, allowing to track key exposures (leverage, deltas, sectors, regions, liquidity etc.) and calculate stress tests.

This means that we don't necessarily have to wait until there is a dislocation in the market or a style drift to figure out if funds can go out of business. We stress test each of the portfolio and say, "Okay, what if there is a dislocation ?". We want to identify any situation where funds can be virtually out of business if such scenario happens.

In the U.S. we have built our business on that very same approach. For many years, we kept that position-level transparency for ourselves, and for our risk managers essentially through confidentiality agreement with managers. Following the crisis, we invested in a new technology to pass that transparency to clients in a way that is hopefully understandable, digestible and actionable. Additionally, we deliver information more frequently (weekly or daily depending on the situation), compared to the industry standards (monthly with several week lag generally).

So for instance, the recent Swiss Franc issue confirmed that our approach works. It happens that we follow some of the managers that were mentioned, and we would not tolerate a situation where a manager is leveraged five times or more on one single trade where the underlying position can possibly have a 20% or plus adverse move. Our stress-test mechanism would have identified a potential severe drawdown.

Andy Weisman: Going forward, separating investment management from risk management will be frowned upon. I'm going to give you a personal example. Back in 2007 when I was at Merrill Lynch overseeing a $25 billion hedge fund portfolio, so by the end of the first quarter of '07 actually I had a deep epiphany with respect to what was going on in the markets; in fact I didn't know what was going on! It was just a scary time because literally every major measure of systemic risk was ringing the alarm bell. Swap spreads had already blown out, implied vols had moved up, dogs and cats were living together in the street, if you know what I mean. I think it's fair to say that I was getting scared about the markets.



So, we went out and hired a small firm with solid financial engineering capabilities, and said to them: "Look, we need to build an interest rate momentum program focusing on the short-end of the U.S. and European yield curves." It wasn't like I was predicting that the stock market could take a beating, but rather that it was a possibility at that point given the massively elevated measures of objective systemic risk in the marketplace.

The theory was basically that if the stock market collapsed, the Fed would behave in a very predictable way; they will cut rates aggressively, and they will do it over and over again, and there would be a significant amount of autocorrelation at the short-end of the curve.

That was our working premise. So we built the model and allocated about half a billion dollars to a relatively small firm. It's sometimes better to be lucky than good. When 2008 happened, that investment, net of fees, paid off 41% and provided a real buffer for investors.

But the reason why I bring that up is that potentially, as the U.S. has effectively emerged from QE, there is a real possibility of significantly higher volatility in financial markets, specifically in bonds, currency and commodity markets. With the return of volatility, probably one of the most useful things that you can do in terms of adding a productive risk factor is the inclusion of strategies which effectively replicate a straddle-like pay out on price movements across asset classes.

Effectively a multi-asset momentum-based strategy, and that's what I have been jumping on a soap box about for the last year basically saying, "Look, this is something if you don't get it from us, we'd like to think we do a good job, but even if you don't get it from us, this is something that people really, really need in their portfolios going forward because we're in a very uncertain world and there's a potential for very significant, highly-autocorrelated price movement that just wasn't occurring during the period where rates were on hold."

Coming back to my initial point, our 2007 investment was done from a risk management standpoint. I think we're now at a point in history where we should really start thinking about doing this again. We actually just started a joint venture with Wilshire to provide a basic core multi-asset momentum program.

Richard Lindsey: The question about whether or not risk management has changed since the Swiss Franc move is very easy to answer. There have been no changes in risk management since the SNB decision a week ago because everybody is still doing the same thing that they did before the change. Of course, there are lots of people scratching their heads and saying, "Well, what should we have done or could we have done something different?" There may even be some people looking for jobs.

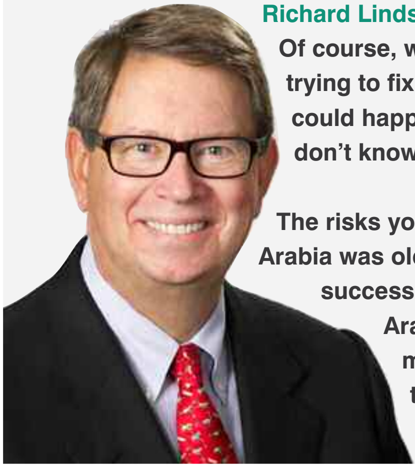
When it comes to risk management, typically there is a tension between risk management in a bank or in a large institutional firm and the trading side. That is because the trading side is, of course, revenue producing and risk management isn't. Risk management is almost always considered to be a cost center. If a risk manager comes and says, "There's a lot of risk in this position." The trader sits there and says, "What do you mean? Show me where there's risk. Are you saying that something that's never happened before is going to happen" And when the two sit and have that argument in front of senior management, you might be able to guess which side tends to win.

Andy Weisman The alpha abatement team always loses.

Richard Lindsey: Yes, the alpha abatement team always loses. That is one of the problems associated with being a risk manager. There are good ways to do risk management, and I agree with Nathanaël that scenario-based stress testing is probably a better one.

Of course, the regulators have focused on something else, so they like a nice computational approach, VaR, and then you multiply it by three to make it a really good number, and of course it isn't.

Andy Weisman Which would not have been very helpful with the Swiss Franc the other week. Not at all.



Richard Lindsey: Not at all, because was not something most people included in their risk analysis. Of course, what generally happens in risk management is everybody spends all their time now trying to fix the risk that happened last week and not worrying very much about the risk that could happen next week. To borrow that old phrase, "There are risks you know and risks you don't know...."

The risks you don't know are the tougher ones to find. I mean, we all knew that the king of Saudi Arabia was old. Did we know he was going to die last night and did we know exactly what the succession plan was going to be and that there wouldn't be an armed take over in Saudi Arabia? I don't think so. But those things would have had significant impact in the oil markets if there had been a different outcome today. So, risk management is a game of trying to look and see the future in a very murky crystal ball.

Barry Seeman: I think Andy brought up an excellent point about the correlations across markets. We also view all markets as highly connected and highly correlated, with liquidity being one of the driving forces behind that.

Insurance companies love if interest rates were a lot higher. That would just make our day, but that's not going to be the case. And on top, we have to worry about those geopolitical risks, about market structure risks, and again, about liquidity in the marketplace, not only within the actual market structure itself but also within our service providers, the banks we are dealing with, the exchanges and the clearing operations. As you work on liquid alternatives, how much of those issues are considered when you put together products?

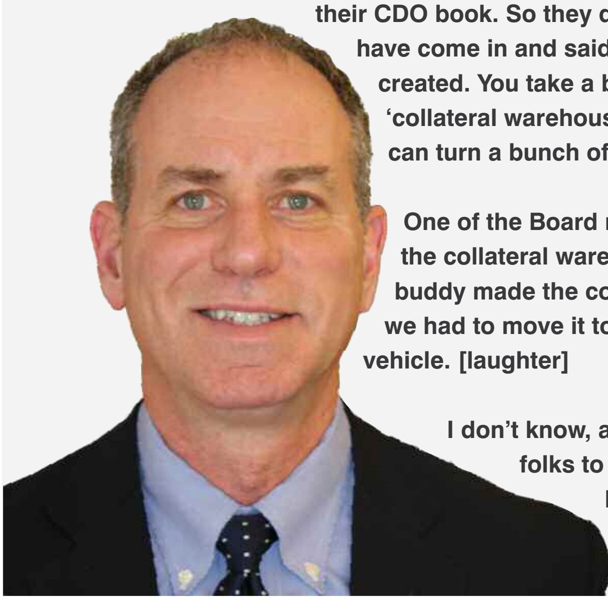
Also Nathanaël brought up an excellent point before, you want custody of assets. There were many firms that had exposure to Lehman. How do you manage those risks, how are you looking at those issues in a world which is extremely different but at the same time extremely similar to where we were before, during and after the credit crisis?

The regulatory environment today has done so much to slow money movement but it hasn't really fixed the problems.

Andy Weisman: I agree with you. To a certain extent, those problems may have been exacerbated simply for some of the reasons mentioned already, which is the dealer communities are smaller and have fewer resources available to them.

In fact, it wasn't so much the proprietary trading desks of those firms that were creating systemic risks. It was structured credit that was creating the problems. When you are manufacturing CDOs, you end up with equity tranches as a by-product of the structuring process. Those are a little harder to get rid of; it's like running a nuclear reactor. A lot of toxic waste that gets spun off that the banks ended up holding and couldn't trade out of.

I remember a really telling episode when I was at Merrill. A buddy of mine was up on the 42nd floor of the World Financial Center the day that their Board discovered that the firm had lost somewhere between $50 and $100 billion on their CDO book. So they decided that they wanted to learn what CDOs were. Someone must have come in and said something to the effect, "Okay. This is basically how they are created. You take a bunch of crappy loans, you stick them in this legal vehicle, called a 'collateral warehouse' and then you prioritize the cash flows from these things and you can turn a bunch of pigs ears into silk purses."

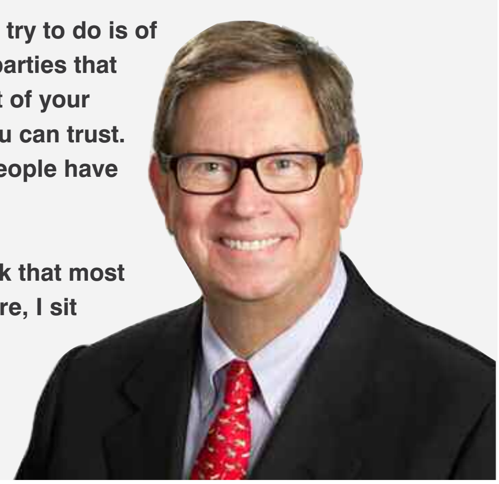


One of the Board members stormed out of the room, furious, demanding to be taken to the collateral warehouse. Now, we are talking about a legal structure, right? So my buddy made the comment, "Well you know, with rents being what they are in Manhattan, we had to move it to Jersey City." I suggested we take him there in a special purpose vehicle. [laughter]

I don't know, at this stage of my career, you can almost lose faith in the ability of folks to really deal with these issues in a serious and professional way, because that sometimes involves a lot of work.

Matthias Knab That's a great anecdote, Andy, and certain you are right with your concerns. Coming back to Barry's question, how do you deal with all these different dimensions of risks in the business?

Richard Lindsey: Well I think you deal with them the best you can. So what you try to do is of course when you set up your counter-parties, you want the strongest counter-parties that you can identify. You want to have more than one counter-party, and to the best of your ability, you want to hold your collateral or have it at a custodial location that you can trust. So the idea of just turning all your assets over to somebody else, I hope that people have learned some of that lesson, given the failure of Lehman.



When it comes to larger macro risks like clearing houses and such, I don't think that most people are spending a lot of time thinking about macro risks. As a full disclosure, I sit on the board of a clearing house and run the risk committee, so I pay a lot of attention to those risks, but the idea that most people are focused on what happens to a clearing house is unlikely, I don't think most product developers are thinking of those issues.

Barry Seeman I believe if something were to happen at the clearing exchanges, the LCH, the ICE or the CME, the Fed would have another thing to deal with.

Andy Weisman: At our firm, we have $185 billion or so that we manage. Every security in every portfolio has to be valued accurately enough by 4:30 in the afternoon. Any client who tells us, "I want my money back at that price you just quoted", we have got to give it to them. So my point here is that the infrastructure our firm built is very different than you'd get out of a hedge fund.

Barry Seeman But you wouldn't be able to give them that price?

Andy Weisman Well, effectively, if they put in the order the day before and it got executed, then yes.

Christine Johnson: Some of the liquid alternatives that are offered by hedge funds are now being done in a sub-account form. That means you have custody and transparency into the underlying holdings. That is a major benefit certainly from a risk standpoint, having daily transparency into the holdings.

Jared Cornell: Just in general, I'm not so sure that you can effectively manage the risk out of some of these situations. You have to take on risk in order to get return in certain environments and that is part of what an asset manager is doing. Take distressed credit and intermediary lending as a current example. Investors need yield. Small companies need capital. The market is finding ways to put them together – the trick is making sure the investor understands the potential for downside.

At the same time, we should be flexible and deal with those risks we have to, and from that perspective, we also want transparency as the first step. But then you have to do your work and, for example, also identify certain strategies that may be forced into liquid structures that ultimately don't really belong there.

The concern is that you end up with liquidity mismatches between the underlying investments and the liquidity structure of the vehicle, be it daily or even monthly or quarterly, depending on what they are actually doing.

In the aftermath of the financial crisis, everybody was shouting, "We need liquidity. We need daily liquidity!" Everything has to be liquid, but guess what, a lot of things aren't, and if the investor is willing to confine himself to certain investment strategies, then so be it, but those decisions have their own consequences.

So, there are many strategies that can be done in a liquid format, but also a lot of them that can't. That is one of the underlying issues as this liquid alts space develops.

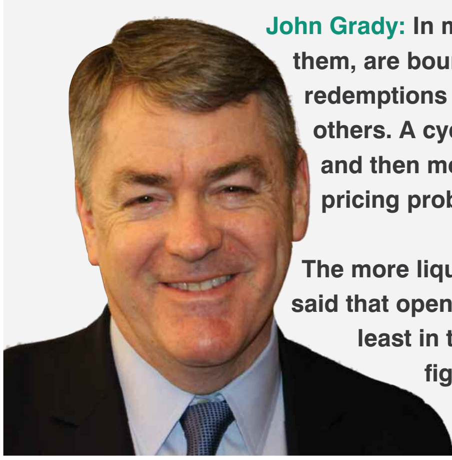
Again, I think the shake out at the end of this bull market will probably tell us a lot about the fact that maybe it's not so much about the risk management that wasn't up to par, but maybe more that you can't effectively mitigate away some of those liquidity mismatches. **That is also why Barry and many of you come back on this liquidity aspect and the correlations of assets. It is likely, at certain points, that some managers will not be able to liquidate distressed debt strategies fast enough to meet redemptions. It's just not going to happen. Educating and disclosing these risks to our clients from that standpoint is really vital.**

Matthias Knab One thing that is discussed a lot when we deal with UCITS funds and the UCITS regulations in other Roundtables is that investors and even product providers are really hammering out this warning that people shouldn't assume a UCITS is risk free just because it's a regulated vehicle.

I think it's the same with the 40 Act Funds. Everybody still has to do, ideally, a full due diligence, which includes, like Jared said, to check on potential liquidity mismatches. Even if it's regulated, you still need to figure out who's the manager and what type of company and set up is behind the offering, what are the risks involved, and so on.

Jared Cornell: You are probably right, and one last point on that. Regulators in the United States are struggling with this right now and every once in a while, they sort of allude to, "We might come at you with all of this complex product regulation and force you to actually start to live by it," as opposed to just debating from a standpoint of what we're willing to put in front of people and what we're not.

There's a real problem with investors not being presented with enough understanding or enough knowledge on the front end to really understand what they are getting into and I think there's going to be a fair amount of smacking down of the industry overall from the regulators at some point around. Again, when the shakeout happens, the regulators are likely going to say something like, "We told you not to do this. You went ahead and did it anyway. So now you're basically just going to make everybody whole."



John Grady: In my view, those liquidity issues, as well as the pricing and valuation issues around them, are bound up in the core nature of mutual funds: redeemability. If you start to see redemptions going the wrong way, you have pressure in one area that impacts you in all the others. A cycle may start with redemption pressure from performance or even external factors, and then move to liquidity. Or it may start with liquidity issues that in turn create redemption or pricing problems. They are all very interrelated.

The more liquidity you offer, the greater the challenge. That is why the SEC staff has effectively said that open-end funds have to act as if 85% of their shareholders will leave the next day (or at least in the next seven days) and have to be paid cash for the value of their shares. The figure had previously actually 90% and it was taken down to 85%.

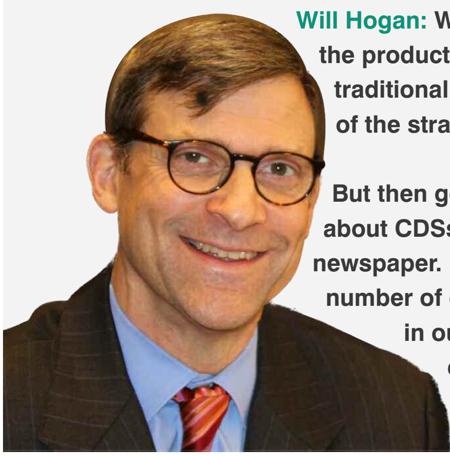
So when we are looking at the risks, particularly for retail investors, you can argue that risks may be magnified for retail investors if they buy just one alternative fund for their alternative exposure. The investor in that instance has all the risks associated with that fund, whether it is manager risk or liquidity risk. In my view, adding an "alternative fund" is not enough – investors should be diversifying across managers and strategies, as they do now in the long only equity fund space.

My point here is that investors need to diversify their alternatives exposures. If we don't get them to diversify across alternatives the way that they diversify in other portions of their portfolios, that is another kind of risk. People who buy just one fund are, in my view, setting themselves up for disappointment.

Nathanaël Benzaken: As you can imagine, we have been working with many managers over the years and over a wide range of strategies. Some of them are quantitative managers. After 17 years of research, we understand their strategies and their technical languages, systems and models. Hopefully, we know how to differentiate between a good and a less so CTA manager, or a good and a less so long-short equity manager.

Now, my question is, especially for those of you who are involved in distribution, how do you explain to a distributor, a high-net worth individual, or even to a retail investor what a CTA is, what Trend Following is, what Risk Arbitrage is? I mean, those are complex matters, generally fairly technical.

Can you share your thoughts about this? How do you turn a highly complex product into something understandable?



Will Hogan: When we talk to our clients about structured credit, which as I mentioned is one of the products we're launching first, one of the ideas we share is that when you add it to a traditional portfolio it dampens risk and improves their efficient frontier. Those are the effects of the strategy itself, and we have some data that illustrates that point.

But then getting into the underlying strategy can be trickier because then you start to talk about CDSs and CDOs, basically all this toxic stuff that everybody has heard about in the newspaper. But those assets still exist and in many instances offer good value that a limited number of qualified managers can recognize and capitalize on. We believe that the manager in our vehicle is one of those who has that capability, and we have some history and experience to support that notion.

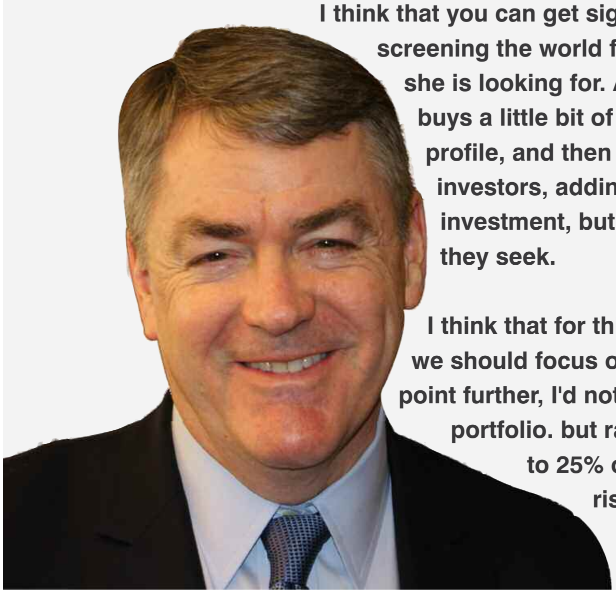
Matthias Knab A good part of this discussion includes aspects around distribution of liquid alternatives. How have you, as providers of liquid alternatives, set up your distribution channels? And how much of that is push, so you soliciting, and how much is pull, in the sense is there already a kind of idiosyncratic demand for the product?

Will Hogan In our case, for alternatives we have to follow a push or more pro-active approach, also because we are not yet known as an alternative provider, so we are not necessarily the first call that our clients or our consultants would think of with respect to alternatives. But that is sort of specific to our organization, at least up to now.

Christine Johnson: AllianceBernstein offers single strategies and also multi-manager alternatives in a liquid format. From a broader perspective, intermediaries are overwhelmed right now given the significant product launches. From our perspective building alternative multi-manager we see some interest from high quality managers due to our long-term track record in the fund of hedge funds strategy as well as our distribution capabilities.

John Grady: Regarding the push or pull question, I think that depends on the distribution mechanism that you're using. We are using two.

One is the model portfolio distribution mechanism, wherein the advisor uses internal or external models that employ building blocks to deliver a complete portfolio. You also have the broker-dealer rep selling products to clients. For purpose of this discussion, I am just dividing the world into those two general approaches.



I think that you can get significant pull behavior from the first model, where someone is screening the world for investments for funds, and your fund has the attributes that he or she is looking for. As I mentioned before, the biggest fear I have is that somebody just buys a little bit of alternatives, not enough to make a difference in their return or risk profile, and then thinks they have sufficiently invested in alternatives. As for many investors, adding alternatives is still a new approach - they may think well of their investment, but they may still not be getting the risk mitigation or other attributes they seek.

I think that for this client group, instead of focusing on selling individual strategies, we should focus on creating and offering access to allocation products. Taking that point further, I'd not sell that person one alternative fund that represents 30% of their portfolio. but rather a package of funds or differentiated strategies that gets them to 25% or 30% of their portfolio. That may actually have an impact on their risk levels and returns that is material and worth the effort.

Matthias Knab I like your point John, it makes total sense. I'd also like to add that what you have described is also typically the rationale for a funds of funds. However, if you take one fund of funds as your sole alts investment and ramp it up to the percentages you mentioned, the investor will also end up with some of non-investment risks we talked about earlier, like concentration or counter-party risks...

Christine Johnson: If you look at how, years ago, institutions first invested into hedge funds, it was through a diversified fund of hedge funds. To a large extent, U.S. retail investors have entered liquid alts through investing in single strategies rather than a diversified approach. We believe investors should use a diversified approach to alternatives as their entry point, and then, if they think that there are certain tactical opportunities, they can make additional and more specific allocations. That will also allow them to build their understanding and experience of alternatives over time while allowing an institutional quality investor to guide their experience at the beginning.

Barry Seeman: Christine, you mentioned the institutional investor, and actually like probably all of you I found it very interesting that CalPERS has decided to exit the hedge fund space. Maybe a bit like the Swiss Franc move by the SNB, it was in a way surprising and not so surprising. I think in hindsight, you could argue that CalPERS found that the hedge fund allocation within their portfolio was there for a probably a good reason, but didn't really perform or had the effects they expected, or that they had to spend a tremendous amount of time on due diligence, monitoring or discussing fees and asking why they were paying so much. All of that for a mere 4% of their assets just didn't seem to be worth the time and the effort.

But as I think about liquid alternatives, I have to say that as much as the marketplace is trying to develop products for the retail space, I wonder if this is really much more of an institutional product as evidenced by some of the work done by Lyxor, or when you look at how that other California pension plan, CalSTRS, is taking on a different approach, no?

I would argue that in many cases the institutional investor doesn't necessarily understand hedge funds either, because you need a high skill level to do that. So maybe the liquid alternative product becomes a mechanism for institutions to get the transparency and the liquidity they require. They would invest in a more regulated environment, and as Christine just said, can take a step by step approach. That process may give them more comfort. They may still beat up on fees, but they may be a little bit more comfortable about of making that allocation for the right purposes, for whether as a risk mitigator or whether it's about adding a different type of strategy. What are you seeing from your side looking at institutions?

Richard Lindsey: I think you are right, Barry, we do see that happening on the institutional side. So while we do have a retail product, we also have institutional liquid alts products and have lots of conversations with institutions.

You mentioned the fee aspect, which is certainly important. Let me add here that none of our products has a fee greater than 2%, and we don't charge performance fees either, so all of that makes a difference.

We had a meeting with the pension group of a very large West Coast technology company about a year ago, and we explained to them the concept of and risk associated with netting fees or hedge fund netting.

If you own a portfolio of hedge funds and let's say half of them are up a 100% half of them are down a 100%, you have made no money for the year, but you owe 20% incentive fees to the half that were up a 100%, so you actually have lost money. We explained this to the pension plan and they looked at each other and then said, "Right, last year we paid $15 million in fees and earned nothing on our hedge fund portfolio."

That is part of the story of CalPERS, and, of course, also that they only had about 3% or 4% of their portfolio in hedge funds, which is not really enough to make a difference. Plus, when you add the netting risk associated with fees, it makes the difference.

So, in our experience institutions are interested in liquid alts. As I said earlier, I think institutions abroad are probably as step ahead of institutions in the United States in terms of their thinking about how to apply them, but indeed liquid alternatives can serve as a substitute for hedge fund investments for some institutional investors.

Andy Weisman: I just want to follow up with one point on netting risk because I don't think it's an issue that's well understood; in the presence of netting risk where you have incentive fees that you are paying to managers, what constitutes optimal is very different than what constitutes optimal in the absence of incentive fees. There is, in effect, an extra term in your objective function which is a penalty for diversifying the portfolio.

It is analytically provable that the netting risk, the cost associated with creating a diversified portfolio, actually increases as the average correlation of your managers declines. So there's literally a penalty for diversifying the book, which is why a lot of fund-of-funds end up having a Pavlovian response to not making any money and say, "Okay. We have to have more of a concentrated portfolio that's making a single global macroeconomic bet on the direction of the stock market because if we don't do that, we're going to get eaten alive by incentive fee netting costs."

Just to put a little more meat on those bones, in a typical boring year where nothing particularly interesting is going on in a typical hedge fund of funds, netting risk represents close to a hundred basis points of additional fees. In a more interesting year where it is more volatile, it can be several hundred basis points. You also have that netting risk at the portfolio level within a multi-strat hedge fund.

Like I said, what ends up happening is that you literally have an incentive structure to effectively dial down the diversification on your portfolio. That for me is a big problem and to a large extent explains to me why, for example, the HFRI Index has had a correlation over the past several years of over 0.9 to the S&P.

Nathanaël Benzaken: I believe that not only in the U.S. but pretty much everywhere institutions have this need to increase their alternative investment portfolio, or more generally their absolute return portfolio, which in some cases is the new generally-accepted terminology for "hedge funds".

Alternative investments can be used to provide diversification and lower correlations when scenarios involving equity all of a sudden goes down, interest rates goes up, volatility goes up, or credit spreads widens.

Financial markets can get so stretched in all directions sometimes that institutional investors may need to have some investable solutions that are able, at least on paper, to navigate into these waters. Therefore, we are strong believers that it's not 2%, 3%, or even 4% that an institution should macro-allocate to such strategies, but closer to 10%, if not more.

The other very sophisticated investor group here in the U.S. are endowments and foundations, and indeed you can find some with a much higher allocation, up to 25% or more, and this is probably where they should be.

The problem those investors may be facing is that they can't or won't pay exorbitant hedge fund fees. Fees have become sort of a headline risk. I am sure you have done the math, it's a very simple exercise: take a hedge fund manager who charges 2% of management fee and 20% incentive fee, which supposedly is the old-standard fee structure, and assume they deliver a 20% gross performance. 30% of this performance goes to the manager and 70% to the investor. You could argue that this is kind of a fair deal, if you believe in the ability of the manager to monetize alpha.

Now, assume a gross performance of 5% – which is what has been observed on average in the industry – that wealth allocation unfortunately gets reversed. 60% of is goes to the manager while only 40% goes to the investor.

This explains why some institutions are bashing hedge fund fees. They have realized that they are paying large amount of fees and may be getting a smaller portion of the created wealth. Even worse, if the managers lose money, the clients still have to contribute. That is a huge asymmetry. The managers usually do not pay back for the losses, at least not yet. That might be the next move, in the near term.

We are left with this interesting equation to resolve: a) the need for the managers to be able to run a business, invest in infrastructure and technology, attract and retain talents, and b) for the investors to get competitive absolute and diversified returns and a fair deal on fees for their investments for the risk they take. We sense that some institutions need to materially scale up their absolute return portfolio. Again, you are facing the need for scalability and the headline risk associated to high fees. I think the liquid alternatives, and the '40 Act wrapper in the U.S., can be of some help.

Why? Because they are essentially not a hedge fund anymore. They are onshore and fully regulated funds. They usually are charged lower fees too. Investors may not feel as obligated to conduct the same intense operational due diligence process. Definitely on the contemplated strategy of course, but definitely less on infrastructure and associated matters.

Barry Seeman: That is also why I keep wondering if the liquid alternative space isn't really the realm of product development in the institutional asset management space. If you look at traditional asset management today, I think over the next several years we will have a true need to generate alpha on top of what could be a very painful or very restrictive beta.

Actually, the term "portable alpha" had been used a number of years ago, but never really broadly utilized. From that side, many of the liquid alternative strategies could be potentially created into overlays, total return swap type products that could be added to portfolios in a much more efficient fashion.

One of the biggest issues for pensions in the U.S. and most other places is the current low rate environment. Funds that were adequately funded several years ago are today playing catch up again. More and more funds will probably be forced into a liability-driven investment (LDI) framework because of the way they have been managed.

And in this rate environment, in this day and age, a LDI mandate is extremely difficult to manage. You not only have to think about how to get duration for your clients to match off their liabilities, but actually where to get the types of returns you need to meet those obligations?

Andy Weisman Five year yields in Japan are now negative.

Barry Seeman Exactly! So whether you look at the U.S., Europe, or Japan, we are in essence talking about a zero rate environment. So these liquid alts strategies can now essentially be used on a larger scale as true overlay products for highly scalable mandates. I think they are probably very much in need.

Richard Lindsey I have a question. We can understand what problems large life insurance companies face. Like all institutions they would love to have a much higher yield curve that would mitigate quite a bit of risk off the balance sheets and would allow them to immunize their exposures. How do you actually deal with that?

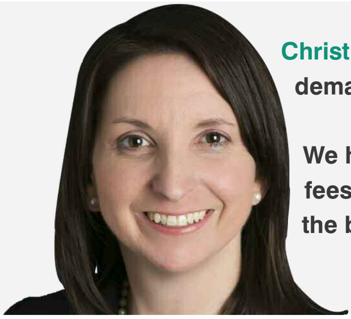
Barry Seeman: I would tell you that the prudent course of action would be to probably look to trade quite a bit of forward-starting yields, to buy the belly of the curve here in the United States. I say that because I personally, and I can't speak for the rest of my firm, but I personally believe that we remain in this rate environment, for the foreseeable future.

My reasoning for that is as follows. The one thing we haven't really spent a lot of time talking about is geopolitical risk. We did bring up Saudi Arabia and oil, which are excellent points. We live in a world where $50 oil means Venezuela is bankrupt, Russia may come close to bankruptcy, and Iran begins to have some real fiscal issues. Any sanctions that our U.S. Government thought of are meaningless compared to the price of oil, right?

The ECB announcement on quantitative easing also means that there are only a couple of markets that you really want to invest in from a fixed income standpoint or from a yield standpoint, and naturally the U.S. is going to be one of them. We live in a world today where it's conceivable that countries like Italy and Spain may trade at yield with a one handle, and four years ago nobody would have thought of that and yet here we are. So we are collapsing an incredible amount of capital into markets and therefore really depressing the overall yield environment today.

So getting back to the question at hand, I would agree that probably every LDI program out there should be using alternatives as a big part of their allocation, because I don't know where else you would get the yields from. Of course, you could layer on a lot of credit exposure, but I would imagine that we will begin to see substantial defaults this year in the high yield space as it relates to the energy-related issuers. Whether or not that impacts the rest of the high yield market remains to be seen, but I would imagine that we'll see some repercussions and those will start eating their way into other spread products.

So I believe you need risk mitigators that have the potential for alpha as well on top of almost every portfolio out there. And, by the way, I've invested in CTAs, as well, in my personal account for those reasons.



Christine Johnson: That is a good point, Richard. Another question we didn't address is the demand for liquid alternatives for defined contribution plans?

We have received this question frequently. However, we find resistance to alternatives due to fees. Another obstacle is participant education and acceptance. Even if plan sponsors see the benefits of including alternative strategies these are important challenges to overcome.

Will Hogan: I could see inclusion of alternatives in target date funds because allocation to alternatives in this context is done as part of a total portfolio, so the participant is not electing a specific alternative investments allocation. As most people are probably aware, education is a huge issue for most plan participants, for even the traditional investment option set in a defined contribution plan. For more sophisticated employers, maybe there is a place for single strategies or funds of hedge funds, but I have a hard time seeing alternatives being used appropriately in 401(k) plans, and lots of potential for litigation.

Matthias Knab I am curious to learn how the individuals of this Roundtable invest on a personal level? Richard already mentioned he also invests in CTAs. This question is what they call in economics the "real preference". So, if anyone cares to share or not where their money is, I would just be really intrigued.

John Grady: I don't know if it will contribute to your research, but a lot of what we as professionals can do also relates to the regulatory regime. I own funds that we either manage or distribute,. That actually works well in a lot of different ways, including disclosure of those investments in our disclosure documents. When I get cold calls trying to sell me securities, I say, "I can't buy it unless you are selling me my own fund!" That really works well to keep the calls short.

Matthias Knab Andy, what about you?

Andy Weisman: Well, I can't be held to my own standard. [laughter] Of course, part of my asset allocation is a very large holding of a single stock, but I have no choice about that, and that's Janus' stock. I don't know if you have looked at that chart recently, but the day Bill Gross joined was a wonderful day.

I was actually getting surgery done at the moment that the announcement came out. I was just about to be wheeled into the operating room and I said, "look, I don't need anesthetic. I am happy, just go for it!" [laughter]

But aside from that, like John I basically put the bulk of what I have into what we do. There are a few things you learn in finance, and we all know that the only free lunch you get is diversification. I like something that's really diversified, and I also like to know what stuff is worth on any given day.

If you have a large collection of relatively orthogonal risk factors in your portfolio, and this is not to denigrate what we do for a living, but you don't have to be that good to achieve a meaningful outcome. Again, my point here is that diversification is really, really helpful.

The other thing that is core to the way we think about investing; we are just not very good at forecasting which markets are going to do well. And just factually, speaking no one else is either.

Just to put some meat on those bones, if you think about it, equity volatility typically runs on an annualized basis on the order of 15-20%.

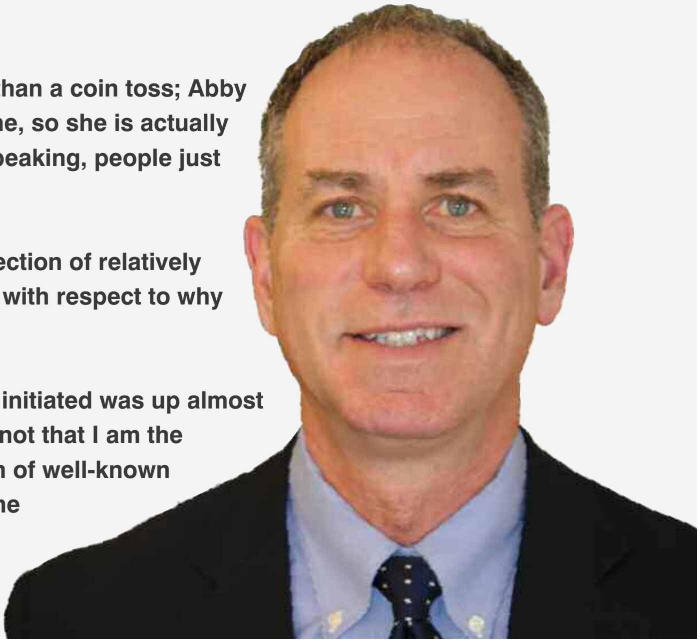
So factually speaking, 95% confidence bounds around any point estimate you give are literally plus or minus 25%. So from a statistical standpoint, any one-year forecast of stock market's return is, from a statistical standpoint, essentially the same number within a 50% range.

Beyond that, you should consider for a moment the smart guys you hear from in the news. There's a really funny website out there, just Google the term "guru grades'" run by a company called CXO Advisory Group. They have compiled a list of famous market prognosticators along with their published forecasts and determine the percentage of the time that they are correct.

I think the best guy was in the low 60s, Jim Cramer is worse than a coin toss; Abby Joseph Cohen of Goldman Sachs fame is right 35% of the time, so she is actually pretty useful. You have just to change the sign. Empirically speaking, people just aren't good at it.

So the reality is if you build a portfolio where you have a collection of relatively orthogonal bets, where you have a reasonably good intuition with respect to why you deserve to be compensated, you do well over time.

Just as a small act of self-promotion. Last year, a product we initiated was up almost 10%, with 5.8% vol and zero correlation to the S&P. Why? It's not that I am the smartest guy in the world; we simply made use of a collection of well-known and well-documented risk factors. We put them together in one portfolio and made sure none of them was allowed to dominate.



Matthias Knab So Andy, can you give us some recommendations on how to properly diversify?

Andy Weisman: Here are some risk factors that are well-known and well-documented, Fama/French risk factor. Size: Being long a basket of small relative cap stocks and short a basket of large cap stocks. Over time, you tend to get paid for that. Value: Being long a basket of stocks that are cheap relative to their fundamentals and short a basket of stocks that are rich relative to their fundamentals. Now, these doesn't always work. That's why these things are called risk premia and not simply premia.

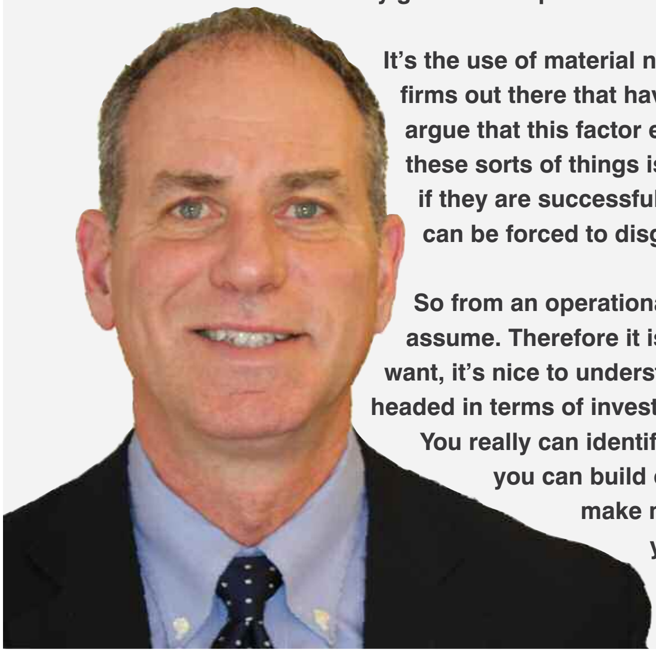
Then you have momentum across asset classes, an extraordinarily useful set of risk factor exposures.

Currency carry is another one that, once again, has a fairly high normal rate of return, big left tails, so it has to be engineered properly, but it's a reasonably useful risk factor.

Then you have roll yield in the commodity markets; or value strategies in the commodity markets.

So there's a bunch of these factors, and honestly, there are reams of information out there about how useful these things are. So if you can get a collection of these risk factors, ones that are reasonably well-understood and well documented, you can build a good portfolio.

The other really useful thing is that you can eliminate the risk factors that are generating returns that you don't want. So just to be a little bit tongue-in-cheek, what is the most useful risk factor that you can assume as a trader that will virtually guarantee a positive result on every trade?



It's the use of material nonpublic information. So, basically, it's insider trading. There are firms out there that have made a career out of it. It would be very easy to suggest and argue that this factor explains a lot of what SAC did for a living. The problem with these sorts of things is ultimately if there was a fraudulent conveyance occurring, and if they are successfully prosecuted, you can never close the book on that trade; you can be forced to disgorge profit.

So from an operational standpoint, I like to stay away from risks that I don't want to assume. Therefore it is very helpful if you are able to identify and know the ones you want, it's nice to understand the intuition, and this is actually where I believe the world is headed in terms of investing in alternatives, because you ultimately get better outcomes. You really can identify factors that are relatively statistically independent. That means you can build exposures that don't require the stock market to go up in order to make money, and don't necessarily require yields to be 12% in a ten year note in order to do okay.