



Opalesque Roundtable Series '15

UK

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Editor's Note

How Basel III and CRD IV are killing the hedge fund model

Basel III and CRD IV are impacting banks' leverage ratios, capital requirements and consequently all market participants with smaller balance sheets. Tier 2 and 3 buy-side entities like small pension funds will find that banks are now offering them much less services. The banks have started to cherry pick their clients as they no longer have the capacity in their balance sheets to service all clients they were once able to. Therefore, small buy-side entities, sell-side entities and small banks are all going to have to find a way to hedge their tail risk in order to have the same exposure without using OTC products but listed instruments instead. The bigger you are, the more choice you will have, whereas in the case of a smaller entity, the impact will be far greater on their business model and strategy going forward.

In hedge fund land that means prime brokers are now also starting with cherry-picking their clients. They will generally be careful with the type of managers they want to keep. The brokers are already increasing the financing rates and they could put further pressure on their least profitable clients like the ones with a low portfolio turnover. Funds are forced into discussions with the sell-side around the question of how much revenue the manager can guarantee them. As a result, one could expect a hedge fund manager to reduce the number of prime brokers in an effort to rationalise their models with less appointed prime broker relationships. Hedge fund managers will also beef up their treasury solutions to optimise their cash exposures among their selected custodians.

On the other side, the banks point to the fact that they are very constrained and suffer from a lack of manoeuvre because their balance sheets no longer allow them to extend credit lines as they previously could. These issues even trickle through into the domain of hedge fund administrators. Once you look into this a little deeper it becomes apparent how changes in market structures have come about as both a direct and indirect consequence of regulation.

Despite smart beta craze, two-thirds of stock returns still not explainable

The smart beta or factor driven investment sector is growing massively at this point. More and more smart beta factors find their way into systematic strategies. Just in the ETF space alone, their growth rate is twice that of the other vehicles. Smart beta has also helped weeding out fake active managers. Fifteen years ago investors were charged active management fees just for buying low P/E stocks. That's beta, quite frankly and it shouldn't be paid as active management. But we now have tools to analyze that and to potentially invest in all those forms of beta.

However, it is probably not the next style index or the next style ETF that the industry needs, but actually good asset allocation methodologies and algorithms. That is the missing part. Investors are increasingly becoming aware that they have all these great new "bricks" to play with, active and passive, but the question remains what should they do with them?

Still, smart beta or factors isn't all there is. Academic research suggests that about two-thirds of stock returns are still not explainable or not explained, even if you put all the smart beta and factors in there. So two-thirds of stock returns are still potentially alpha for which you should, by all means, be paying. But at least for one third you should be paying 50 basis points or less.

The Opalesque 2015 U.K. Roundtable, sponsored by Eurex and Maples Fund Services, took place in April 2015 in London with:

1. Renaud Huck, [Senior Vice President, Eurex Group](#)
2. Stephen Lewis, [Director of European Business Development, Maples Fund Services](#)
3. Eric Lonergan, [Portfolio Manager, M&G Investments](#)
4. Benjamin Day, [Head of Sales, Stratton Street Capital](#)
5. Peter Coates, [CEO, Omni Partners](#)
6. Tommaso (Tom) Cotroneo, [Ph.D., CFA, UniCredit](#)
7. Pierre Crama, [Deputy Head of Operational Due Diligence, Tages Capital](#)

The group also discussed:

- Creditors versus debtors: Earn more by lending to the most creditworthy nations
- Why traditional benchmarks can ruin a fixed income portfolio
- Tages Capital & Omni Partners: New seeders emerge
- What are second generation smart beta products?

- Opportunities in UK property lending, event, M&A and energy
- Is it possible to set up a frontier market fund of hedge funds?
- Eurex' new products to help players who are mandated by regulation to exit OTC
- How to survive the oligopoly of hedge fund administration firms
- Assessing the odds in Global Macro: Why M&G's hedge fund outperforms
- Why P/E rule of thumbs will break down in equities as markets enter "super moderation"
- Why Mario Draghi really stands out as extraordinary politician
- How negative interest rates create havoc in asset valuation models
- Solvency II: Investors focus on "return on regulatory capital"
- Finally! Some real innovation in hedge fund fees

Enjoy!

Matthias Knab
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Participant Profiles



(LEFT TO RIGHT)

Matthias Knab, Peter Coates, Tommaso Cotroneo, Renaud Huck, Stephen Lewis, Eric Lonergan, Pierre Crama, Benjamin Day.

Introduction

Stephen Lewis
the Maples group

I am Stephen Lewis, I work for Maples Fund Services, which is a part of the Maples group, where I head up Sales and Relationship Management in Europe. The Maples Group, comprised of legal services offered by Maples and Calder and specialized fiduciary, accounting, regulatory compliance and administration services from MaplesFS, through its operating divisions Maples Fund Services and Maples Fiduciary, offers a full-service solution to financial, institutional, business and private clients around the world.

Maples Fund Services is a leading independent global fund services provider operating in key onshore and offshore financial centers including Boston, the Cayman Islands, Dubai, Dublin, Hong Kong, Luxembourg, Montreal, New York and Singapore. Working within these key locations, we provide customized multi-asset class, multi-jurisdictional fund services to meet the diverse and sophisticated needs of our clients and their investors.

Prior to Maples Fund Services, I worked in a variety of sales, operational and product roles in custody, fund administration and related services at a number of banks, including: State Street, Deutsche Bank and The Bank of New York.

Renaud Huck
Deutsche Börse Eurex Exchange

This is Renaud Huck I am responsible for Buy-Side relations at Deutsche Börse. I work mostly for Eurex, the derivatives exchange of Deutsche Börse. We are the largest European derivatives market, and we offer listed instruments in various asset class to the trading community.

My role within the company is to promote buy-side entities and to give buy-side entities a voice within the company – and whether they are a hedge fund asset managers, pension fund, sovereign wealth fund, central banks – and also to work with them to explore new avenues, whether in terms of services or in terms of products that the company listed.

Benjamin Day
Stratton Street Capital

I am Ben Day, Head of Sales at Stratton Street Capital. Stratton Street is a London-based partnership with \$1.2bn AuM – our primary focus on fixed income (credit) investing. We have a contrarian (yet easily understandable) approach to fixed income and strongly believe in unconstrained investing. We are benchmark agnostic (given the inefficiencies of benchmark construction) and our preference to focus on the 'wealthier nations' of the world (explained by our use of Net Foreign Assets). We run both Global and Asia Bond Funds (UCITs & Offshore PCC) as well as separately managed accounts for institutional clients here in Europe

Formerly I was with an emerging market specialist on the equity side. That was an affiliate of Legg Mason. Prior to that, I started my career at Citigroup.

I have spent the bulk of my time focused on equity, and now credit, but mainly in the emerging market space.

Tommaso Cotroneo
UniCredit

My name is Tom Cotroneo. I work at UniCredit in London where I head up the Equity Derivatives Strategy Team which covers anything which you would call a derivative, so from options and futures all the way to alternative strategies.

Before UniCredit, I worked at Merrill Lynch and ANZ Bank. I have worked in London, Tokyo, and Hong Kong, always either in a strategy or structuring role focusing on Equity Derivatives.

Peter Coates
Omni Partners

I am Peter Coates. I am the CEO of Omni Partners, which is a London-based alternative investment management firm. We are currently managing around US\$950 million across various strategies. The largest strategy is a macro hedge fund, followed by a direct lending fund secured on UK property. The third fund is an event-driven fund, which is a re-launch of a strategy which Omni was founded upon.

I joined Omni in 2014 and before that I was with Lighthouse Partners, a US fund of hedge funds for which I ran their European investment business for a little over seven years and was previously with their Australia-based business for four years.

Pierre Crama
Tages Capital

My name is Pierre Crama. I am the Deputy Head of Operational Due Diligence at Tages Capital.

Tages is a London based asset manager with a branch in Italy which started managing assets in October 2011. The firm has been growing quite rapidly over the last three to four years via organic and external growth. More recently in June 2014, Tages entered into a strategic partnership with the fund of fund division of Paris based La Française.

According to the hedge fund publication InvestHedge, we were the fastest growing fund of hedge fund at the end of June 2014. We are currently in excess of EUR 2 billion of assets under management.

Tages Capital is primarily focused on tailor-made alternative multi-manager hedge fund and UCITS solutions. Among our recent initiatives, we have launched a frontier market fund of hedge funds and a vehicle to seed or provide acceleration capital to some emerging managers. So far we have seeded three managers over the last eight months.

Tages has a predominantly institutional client base across continental Europe, the Middle East and Japan.

Outside of our fund of hedge fund activities, our group also includes Credito Fondiario, an Italian bank specialising in the acquisition, intermediation, and structuring of distressed and illiquid credit in Italy currently servicing over USD 5.5 billion of distressed loans.

Lastly, we also have an advisory business focused on European cross-border transactions.

Eric Lonergan
M&G

My name is Eric Lonergan. I am a fund manager of the Episode Macro Fund at M&G. I have been at M&G for coming up to 10 years. Prior to that, I was responsible for macro research at J.P. Morgan Cazenove in the UK.

We run over one billion dollars in the macro strategy, and our team also has about \$4 billion in more conventional multi-asset funds which we also run. As of December 2014, M&G Investments has a total AUM of £264bln.

70

percent of the world's surface is covered by water.



Eurex Exchange turns figures into opportunities. About 70 percent of all listed and centrally cleared euro interest rate derivatives are traded on Eurex Exchange, making us the home to the euro yield curve.

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Eurex Exchange – the home to the euro yield curve.



Matthias Knab

All of you are working in very interesting sectors or niches. Could you please provide an update on opportunities you are seeing within your sector? Some of you have already mentioned that you have launched new products, please also share with us more details about those, and about the client interest you are facing.

Benjamin Day: As I mentioned, we are a specialist credit manager but we view the world slightly differently to your traditional credit and fixed income managers.

Rather than looking at the world as emerging markets versus developed markets, which is your traditional sense of how people invest, we look at it as creditors versus debtors. We believe fixed income benchmarks are inefficient in their construction - traditional benchmarks give a larger weighting to those countries and / or companies that issue more debt and so it typically leads benchmark driven investors to invest in the most heavily indebted nations of the world, which in our view is counterintuitive. This also leads to the anomaly that you end up being paid more to lend to the most creditworthy nations as demand is focused on the debtors. Quite simply put, we would rather lend money to those that have a greater propensity to pay us back.

Thanks to the endless QE around the world at present, we have all seen that Germany potentially is heading to 10-year negative yields and we are already seeing 5-year negative yields across the market. There is still a hunt for income. There's been a switch in the sense that people are now looking primarily at equity markets for income rather than the credit markets because there is a lack of income there.

There are however opportunities within creditor nations to find attractively valued credits offering positive real yields

Today on our traditional global and Asian investment grade portfolios, we are achieving a yield of somewhere between 4.5-5% without any use of leverage or hedging. I believe there is a clear opportunity within Europe, and I would take Germany as a good example, where institutional investors have a real problem with their credit portfolios

As an example, we met with an insurance company that are holding onto German Bunds yielding just under 3%, and as these bunds roll over what are they going to buy? They can't buy Spanish 5-year, because they can't buy low quality bonds. They can't buy newly issued Bunds as they are not allowed to buy negative yielding assets

So they are looking for other opportunities. Where can they look? They can look at the US and they can look further afield from Europe

So from our perspective, we believe that we can build portfolios that, again, given the proliferation of benchmarks, and also traditional mutual funds that just lead investors into those indebted countries, the credit inefficiencies across the market are providing us fantastic opportunities. And we are building investment grade portfolios with real yield, real return, and a decent spread cushion that going forward we think is going to be very attractive to the market. That's just one of the things we are looking at.



Tommaso Cotroneo: My focus is the development of systematic strategies. Systematic strategies are often developed by investment banks and then delivered via different vehicles, be it ETFs, funds or certificates, for example.

Over the last couple of years, people like myself and others were also very active developing and applying so-called smart beta factors into systematic strategies. I personally don't like the "smart beta" label that much.

My entry point in the space is thinking about style investing, thinking about value and growth, the way we used to do 15, 20 years ago. Back then, every single asset manager knew what these concepts were. The seminal book on Active Portfolio Management by Grinold and Kahn that lays out the theory behind using factors to build portfolios was published in 1999. Barra, the optimization and risk management software built using factor concepts, was already the industry standard. What was missing compared to today was a cool name for marketing purposes like “Smart Beta” and ETFs allowing ordinary people to buy factor-related strategies without needing to go to a specialized fund manager.

UniCredit as an institution has a long association with ETF business and has had what I would call “generation one” factor products for more than 15 years. By “generation one” I mean the easier to define and, still today, most popular strategies, such as high dividend yield or low volatility portfolios. These more bread and butter standard strategies have been around for at least 15 years and we have a very good presence there. Our oldest index in the space is the “Continental Star” which is a dividend based strategy launched more than 10 years ago and with peak assets under management above 1bn EUR.



Our challenge now is to define what we do next in the space of factor-based investing, or smart beta, if you prefer. The space remains of great interest in terms of being able to deliver more tools to a broader set of investors. We are an experienced player who has however not yet built a second generation product. We see this as a strength allowing us to go to the drawing board and come up with factor-based products that are truly about substance.

Matthias Knab

You mentioned first generation and second generation smart beta or factor driven products. Where do you see the distinction between the two? How do you define second generation smart beta?

Tommaso Cotroneo: To me, choosing between momentum or value is more natural than thinking: “do I buy consumer staples or oil”? I have grown up with factors being my natural way of reading the equity market. Of course, I am also a mathematician by background, so I need to think about the geekier stuff rather than the more straightforward one!

But seriously, for me and for a lot of people who have been educated as strategists in my generation, it is completely natural, you buy momentum; you don’t necessarily buy pharma or technology stocks.

What I called second generation factor products are more about broadening what’s being offered to investors, but the fundamental framework is very similar to the one previously used. So first generation was very much about providing exposure to a couple of very intuitive factors such as value, growth and dividends. You buy cheap stocks, you buy stocks that are going to grow forever and ever, or you buy stocks that pay you a big coupon every year.

In the last two or three years, the community of fund managers, banks and other market participants are delivering to customers far more sophisticated exposures to risk factors.

So, for example, let’s look at momentum factors. How many stocks have been appreciating in recent months? We look at quality through balance sheet indicators. Conceptually, we are doing exactly the same thing that we were doing fifteen years ago, just on a longer menu and often with more sophisticated techniques in terms of how that menu is put together.

But ultimately, we are still doing the same thing, which is offering investors access to characteristics of stocks, and increasingly of bonds as well, which go beyond the obvious ones such as how big it is, which country it’s registered in, and in which sector it makes most of its profit from.



Peter Coates: On the question of opportunities, I can break it down into strategy, business, and investors in terms of three categories.

In terms of strategy, Omni identified gaps in the lending space in Europe and particularly in the UK. These are loans backed by property in the UK and Europe, with very good yields, low LTV's, good security, and reasonable duration.

So in the UK space, for example, we have a fund which has an average duration for the underlying loans of nine months or less, but again, at very good yields. It's an opportunity which exists due to the fact that banks in the whole world have been reluctant to take on the resources and the infrastructure to do more difficult types of lending. It's not necessarily credit risk that the banks are shying away from, it's just not mainstream lending and doesn't fit into their computer model and requires old-fashioned underwriting. We have identified where there are some gaps in that field. and having the right business and resources in place, we continue to view that as one opportunity.

We are also seeing great opportunities in the event and M&A space, as deal activity is much healthier in the past few months, deal spreads are rewarding the risk involved, and there are fewer leveraged participants looking to invest in the activity. Unfortunately, many investors have been slow to invest in the event strategy as it is a cyclical strategy, despite having a low beta to equity markets.

The other opportunities at the strategy level are interesting. In a Quantitative-Easing, low rate environment, it's been difficult for a lot of hedge fund managers and strategies to make money, as we have seen over the last few years. But I think that we are due a shakeout with certain assets, certain strategies, certain managers. There will also be a shakeout in terms of the funding cost with Basel III coming into play and other regulations globally. There will be situations where certain strategies will struggle, but others will benefit from that. The goal for any allocator is to look for the good managers within the good strategies, and I am sure Pierre will cover that in more detail.

In terms of the business opportunities, the past few years since 2008 have highlighted a couple of things. For managers launching, it's tough. There's a lot of cost pressure, as regulations and increased transparency increase the cost pressure. The resources that a manager requires to establish a good institutional infrastructure costs a lot of money. And at the same time, allocators are putting pressure on the pricing that the managers can charge.

Where does that lead into the opportunity? Well, if you are a medium-sized manager with significant institutional infrastructure, you can join forces with some of those smaller managers, who have decent performance, and enable them to focus on doing what they are paid to do, which is manage portfolios and risk. You provide everything else around that. So that certainly is an opportunity for ourselves at Omni.



This will be an opportunity for at least the next three years. In our execution, we need to focus on two things: One, we need to make sure that everything, including with our existing strategies, is working for the benefit of the investors – as an industry, we are not managing capital for our ego; we are managing investors' capital for their benefit. Second, we need to make sure that any new strategy fits and that the managers are good at what they are being paid by investors to do. Our aim is that as a business we can take away the distractions that most managers have in setting up and running a business. Our portfolio managers don't need to worry about daily compliance reporting, HR, operations, etc. Again, all they need to worry about is managing the investment portfolio and managing the risk. That's essentially what investors pick those managers for.

Matthias Knab

How many managers are you planning to take on?

Peter Coates: There isn't a defined plan as such to take on any specific number of managers, but if I look at the business and infrastructure that we have at Omni, we could quite easily add an additional two to four. We really have the infrastructure for a \$2-3 billion organization without any significant changes, so we have scope to grow into that, but it will come through a combination of performance, managing investors' capital with integrity and trying to grow business organically, and working with new partners to join the business. Because of my allocator background, I have been approached by a number of managers who like what we are doing, they like the rationale behind why I joined Omni, and are interested in having those discussions.



Matthias Knab

Can you tell us also how far do you help your managers to raise money and build their own asset base?



Peter Coates: Well, it's a partnership. We are closely aligned to make sure that we have the right managers on board and that we have good performance and integrity, while helping the broader partnership to raise assets. Since inception in 2004, Omni has relied on performance and integrity in raising assets from suitable investors, however things have changed since 2009, and managers now recognize that they have to go to prospective investors with a broader package or offering.

Matthias Knab

There are different models for such partnerships, how exactly is yours working?

Peter Coates: Omni Partners is not a hedge fund hotel or a platform; it is an alternatives investment partnership where we have traditionally built the funds from within, so they are developed internally. That is to say that there have been previous relationships with portfolio managers who have grown up within the firm, and then a fund is launched.

The next stage really is to join forces with some good managers, who have a similar culture, similar perspective on managing investors capital, and similar perspective on managing risk, but they probably spent the last two to three years running at a loss in terms of their business because it's an extremely tough environment.



Stephen Lewis

Peter, maybe you also would like to mention that you have already set up such partnerships before, so in a way you are expert at this, and it's not a new thing for you guys, is it?



Peter Coates: That is correct to a certain extent. When we set up the UK lending strategy, we invested in a business which was already doing lending and had a brokerage-led business. Omni also has a stake in a commercial real-estate debt business. Previously, portfolio managers have been recruited and raised internally before launching a strategy to external investors. Going forward we will continue to use that strategy, but we will also look to bring in existing fund managers.

Pierre, you talked about the phenomenal growth of Tages, and congratulations for that. I was wondering if the growth came mostly from institutional or from retail clients? What's your mix of those two investor groups?

Pierre Crama: As mentioned previously, our expansion is the result of acquisitions through strategic partnerships and organic growth. Our institutional client base is predominantly across Continental Europe. We have also been successful in the Middle East and more recently in Japan. We see a lot of interest for bespoke solutions coming from those regions. At Tages, we tend to run a more concentrated portfolio than some of our peers. Across a typical product, we will have about 10 managers.

We have launched a frontier market fund of hedge funds, which is quite a unique solution in the marketplace as not many competitors are navigating into that space, especially when you consider the challenges of doing a proper due diligence in those markets.

In the frontier markets space, you can expect the operational quality of the manager does differ from those located in New York or in London where the regulatory environment is more robust and the operational staff are typically more seasoned. At Tages, we have a seasoned operational due diligence team to operate in all jurisdictions.

We are fully aware that one solution doesn't fit all type of clients so you need to offer different structures (offshore like Cayman versus more regulated onshore products like UCITS) to respond to different markets and attract different type of investors (retail versus institutional).

Coming back to the point made earlier on Basel III, I think shadow banking is going to continue to grow, with asset managers trying to find avenues for peer-to-peer lending, taking advantage of the strict capital requirements at the bank level and the constrained balance sheet usage. We are seeing a number of participants in the market such as hedge funds and PE willing to offer direct lending to SMEs, who tend to get restricted financing from the traditional banking model.

As part of the Basel III implementation, we are already seeing that some prime brokers are starting to cherry-picking their clients. Prime brokers are going to be careful with the type of managers they want to keep. Our ODD team focuses on counterparty risk and we are monitoring the implications of Basel III.

Prime brokers have already started increasing the financing rates and they could put further pressure on their least-profitable clients like the ones with a low portfolio turnover. As a result, one could expect a hedge fund manager to reduce the number of prime brokers in an effort to rationalise their models with less appointed prime broker relationships. We also expect a hedge fund manager to beef up their treasury solutions to optimise their cash exposures among their selected custodians. Everything will be scrutinised very carefully. For emerging managers, it's going to be even more difficult if they are running a strategy requiring a low turnover and low use of leverage.

Going back to the question of where do we see opportunities in the industry, UCITS is one. The seeding opportunity is another one with a considerable flow of talent with whom we are in dialogue to assess their business propositions. A unique differentiating factor at Tages is the ability to offer a seed ticket to launch a new product or a replication of an existing funds in a different structure.

We are active in seeding UCITS across a number of platforms. We observe a number of independent innovative UCITS platforms competing with banking platforms. We are also in the middle of raising further capital for our offshore seeding vehicle as we are seeing a lot of interesting opportunities.

Another thing we have recently done was seeding a discretionary macro manager located in New York.



We also try to play European equity while neutralising US equity for the time being.

We want to capitalise on the M&A boom where opportunities still exist. If you look at Italy for example, the deal volume is at all-time high and therefore some of our equity and event-driven managers are participating to some of those Italian M&A deals.

We also see a lot of dislocation into the energy space so we really want to take advantage of this.

In emerging markets, we favour Chinese managers. We haven't been overly active until now so we are looking more into that space. We also play more idiosyncratic catalysts like Argentina with the upcoming election towards the end of the year; we are considering picking one specific manager to play this theme until the opportunity set fully manifests itself.

In the UCITS space, we are aware that not all strategies are eligible. If one of our offshore managers wants to replicate their strategy in a UCITS format, we want to verify whether it is possible to replicate their flagship fund by understanding the instruments traded, the level of leverage and the liquidity profile.

Most platforms struggle to raise the first dollars. We have therefore identified a gap in the market where we act as a strategic partner by offering a seed ticket to a UCITS manager on a platform in exchange of a fee rebate for the benefit of our clients.

It is not uncommon to meet a US manager willing to launch a UCITS fund to have a dedicated product to market in Europe. Most don't want to go through the AIFMD regulated route. We have actually come across a number of UCITS launched by US managers to tap into the European market. Most managers will assess whether to do it themselves or via a platform.

Stephen Lewis: I would agree that the UCITS platform provides attractive opportunity for non-EU managers. Maples Fund Services has seen tremendous progress servicing UCITS funds in 2014. Our servicing mantra applies equally well to UCITS funds as it does to other structures. If anything the tightness of timescales highlights the zero error approach we apply to the UCITS process.



We also pride ourselves on our reporting capabilities as our service package includes a specific set of UCITS based performance and analytic tools. This has been particularly helpful to our fund manager clients and their investors as it's another expense that can be removed.

Renaud Huck: Similar to Pierre's firm, Eurex has also identified customer demand and opportunity from the same vantage point, which is the massively changing regulatory landscape. In Europe, EMIR is going to change the rules of engagement. At the same time, for other market players like banks, the changing regulatory landscape through Basel III, CRD IV is panning out the way Pierre just described, impacting leverage ratios, capital requirements and consequently smaller balance sheets.

So what does this mean for the whole industry? Well, it means that there is a very large elephant in the room, which is regulation. This trend has already come into play over in the United States with Dodd Frank.



On our side of the pond, EMIR is going to have a similar impact and continues down the path initiated by regulators, which you could call the futurization of the industry, whereby OTC trades are moving on exchange into a listed environment.

The regulators have decided that standardized OTC derivatives should be traded on exchanges and cleared by CCPs. As an exchange and as the largest clearinghouse in Europe we naturally were impacted. As a result, we had to go through an entire reauthorization in order to be EMIR-compliant but at the same time we realized that the whole new regulatory framework also brought opportunities for us.

It allowed us to think forward to which listed derivatives would be part of the next generation since a consequential segment of the market was going to have to exit the OTC space, and so we had to offer some proxy instruments. This is the exact reason why we decided to go down the avenue of launching interest rate swap (IRS) futures and repo secured funding futures on the fixed income side.

On the equity index side, we established a relationship with MSCI, one of the largest index providers in the world, and we now have over 40 MSCI benchmark equity indices in our product suite that have been launched over the past couple of years.

We have already seen traction in these products. We saw these as opportunities for us as an exchange to pursue - if you are a top tier buy-side entity, you have the possibility to choose whether you trade OTC, or whether you do a similar contract but listed on exchange. However, if you are a tier 2, tier 3 buy-side entity or a small pension fund in the home counties of the UK, you will not have the luxury of such possibilities, purely because the banks will not service you. The banks are now cherry picking their clients as they no longer have the capacity in their balance sheets to service all clients they were once able to.

The situation will be the same for small entities in the UK and continental Europe. Small buy-side entities, sell-side entities and small banks are all going to have to find a way to hedge that tail risk in order to have the same exposure without using OTC products but listed instruments instead.

This is exactly where we see an opportunity but unfortunately it is not that straightforward, as you cannot entirely replace a tailor-made universe by a very standardized universe, which are futures. For the switchover to happen there will have to be a point where the standardized products are at a level which works just as well for the portfolio manager as when they were using OTC.

Benjamin Day

What would you say is a critical mass for a hedge fund to still be considered viable for say a top prime broker so that they actually say to a hedge fund, "we still want you in our books. You can still trade your tail risk hedging through your traditional products if you give us enough flow...?"

Renaud Huck: This is a very good question and I do not think that this has necessarily to do with the level of AUM; I think it's more a question of trading style. For example, whether a fund has a high rotation of its positions, so a high turnover, which from the bank's perspective guarantees certain yearly revenue.



Moreover, I have heard a lot of portfolio managers saying that the discussions that they have with the sell-side revolves around the question of how much revenue the manager can guarantee them. Basically, from the managers' perspective they are forced to re-discuss or re-establish the conditions and terms of their business relationship. On the other side, I hear from the banks that they are very constrained and suffer from a lack of maneuver because their balance sheets no longer allow them to extend credit lines as they previously could.

Once you look into this a little deeper it becomes apparent how market structures have come about as both a direct and indirect consequence of regulation.

Previously, from the PM and asset managers' perspective, cash was more the display of securities that your investors had invested in – tomorrow cash will represent how flexible you can be as an entity.

It is apparent that the world is changing, the rules of engagement are changing. The bigger you are, the more choice you will have, whereas in the case of a smaller entity, the impact will be far greater on their business model and strategy going forward.

Stephen Lewis: The rules of engagement are also changing in the fund servicing industry. I sat on a recent panel where the debate was focused on the evolution of the fund administration market where the term 'Oligopoly' was used to describe a market dominated by a few large players. Clearly a great deal of uncertainty has been created by the Citi Hedge Fund Services exit and the recent activities of a number of the larger players. There has been a wholesale evaluation of client profitability within the fund administration business largely driven by the additional costs associated with the provision of regulatory reporting and the continued expense of providing high levels of client service.

Until recently fund administration used to be viewed as a job for life, or of the fund life at least. The hedge fund manager would complete the beauty parade, select a fund administrator and there would be zero expectation that the decision would have to be revisited at some point in the future.

How times have changed! The only reason for changing an administrator was their performance and that was nearly always avoided because it was expensive and potentially reputational damaging as it meant explaining to investors that a key service provider was changing. The fund manager would give the administrator a great deal of leeway, maybe invoke penalty clauses if they had been written into the contract and eventually bring the servicing back into line through regular meetings and the scrutiny of key performance indicators. Even when one administrator acquired another the same leeway would be given. Senior management would arrive, lunches would be had, hands would be shaken, and assurances would be made. 99 times out of 100 the new administrator would retain the client and continue the relationship.

The early indications that something was wrong were ignored. The servicing issues were seen as isolated incidents and not even the consultants took a helicopter view and saw that the cottage industry was evolving, functionalising, becoming controlled by industrial scale behemoths who were forced to increase their spending on technology, process and people. The spate of acquisitions in the last 18 months was also positioned as normal, the sale of a non-strategic asset, the wealth realisation of a group of individuals who had built their business and were personally going to benefit from an IPO or trade sale, the way of things.

Possibly the last straw has been the additional cost of providing global regulatory and tax reporting. It's a burden that quite naturally the 'bottom of the food chain' administrators are prepared to take on in one last desperate attempt to make a profit. Like a drowning man, head just above water, exhausted taking a couple more strokes before giving up. Many of the large players used the same scale economies they had always applied and managed to build large businesses with unprofitable components. In the same way that custody acted as the backbone to profitable foreign exchange and securities lending businesses, fund administration as an extension to the custody component has achieved the same low margins. The recognition that the lack of profitability meant that the business wasn't sustainable came slowly.



Many have recognised that their business wasn't sustainable and their first reaction was to cut internal costs, the servicing teams year on year have to do more with less, the service immediately suffers. The next phase is to revisit the overall relationship and explore opportunities for the client to buy more services - can the service provider increase their 'share of wallet'? If that approach is not successful, then prices are increased considerably. It's becoming evident that many customers are not prepared to put up with increased prices for the same levels of service and are moving their business.

There have also been a number of new entrants, banks that haven't learnt the lessons of the past and are prepared to build low client value servicing businesses based on production line scale economics. They may well benefit in the short term as business moves from the larger players to the middle ground. But it's not sustainable in the high-touch, high-value, hedge fund administration environment. Pricing has also been re-set in recent times by the smaller administrators as they scramble for market share in an attempt to achieve their ambitions of a trade sale or IPO.

Matthias Knab

I agree with you, Stephen, there is a lot of commotion in the fund administration sector, it will be interesting to watch how things eventually develop there.

Eric, I have come to know a bit about your strategy, which is quite fascinating and different as well. Can you share with us how you and your team approach global macro investing, and what opportunities you are seeing?

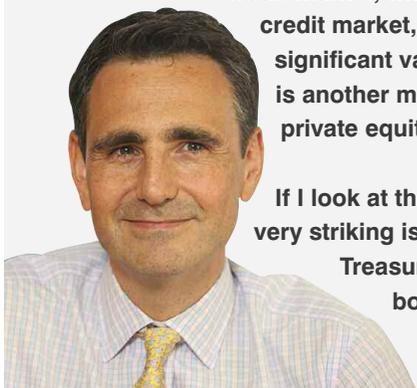
Eric Lonergan: Thanks Matthias. There are two ways to approach macro, which is you can either try and take a full forecasting view and predict when for example the Fed is going to raise rates, if they do, or whether China is going to have a recession. That is a mug's game, to put it politely.

The alternative is to take an objective assessment of the odds. As a sensible starting point you can look at where valuations are, and in particular, what's implied by real yields.

Now, if I look across the world at the universe of investable assets, I think it's no coincidence that a lot of the opportunity set that I have already heard discussed today are what I would view as being illiquid, at least in the context of the broad universe of assets. Therefore, I think there may be value in illiquidity, which should be no coincidence, because the last event that most people referred to, including regulators, was actually a huge liquidity event.

Therefore, it's no coincidence that post-2008, if you are going to find value, there are certain things or risks you are able to take on today, and I think illiquidity is one of them. That could be in different sectors, whether in areas of the credit market, which I think is legitimate that there are opportunities in certain illiquid portions of the credit market, or even in stocks. For example in micro and small cap there appear to be very significant valuation opportunities; whether they are actually exploitable by asset managers or not is another matter. They may ultimately end up being gifts to the private equity universe, because private equity is certainly still willing to really take illiquidity on.

If I look at the major asset classes, highly liquid government bonds, credit and equities, what's very striking is the odds don't look great anywhere. In other words, if you look at where 10 Year Treasuries are, and they are the most reasonably priced of developed market government bonds, you are getting a zero real return, 2% nominal on a yield-to-maturity basis.



Now, the easy thing about bonds is they do actually tell you what your return is going to be, at least in nominal space, right? You can bring some of that forward, so you can get more in year one, but you are not going to get more cumulatively to year 10.

Now, even when you take more risks within credit, if you go out to high yield, if you go highly liquid and look at the CDS market, you are barely getting compensated for normal levels of the default risk you are taking. Therefore, it seems to me that in the liquid areas of bonds and credits your odds are very poor.

I think equities valuations and expected returns are more normal, but they have also deteriorated significantly. European equities, for example, have delivered in excess of 20% return, which would be a very good annual return, but that rise has actually happened in a very short period of time.

That means your forward P/E multiples are now looking much more normal in the context of history; if not outright elevated. This has been well-rehearsed if you think of things like cyclically adjusted P/E multiples of the United States, Shiller P/Es, where a lot of the standard rules of thumb that equity investors use are now saying that equities are overvalued or above their long-term real returns.

So it's not obvious when you look at the world where the great odds are.

What you can then try to do is say, are there biases in investors' beliefs? So rather than trying to predict things myself, can I identify any biases that people have and then try and draw some investment conclusions from that. When it comes to investor biases, I think there are two things that are very striking to me. So if you limit yourself to the universe of sensible people, so everyone around this table, all sensible people have given up on mean-reversion in the bond market. But they still believe in mean reversion in equity valuations. That's inconsistent.

I don't know anybody sensible who believes that real yields are going to go back to threes and fours. Everybody has subconsciously shifted what they believe the mean is gradually down. It's very instructive if you go back to the start of last year when you had just come through tapering. In January 2014 the US 30-year treasury had a yield in excess of 4%. Both Gavyn Davies and Jim O'Neill came out and said they expected the 10 year to go 4%. Actually at the time, that was a very easy thing to say. Nobody thought you were a fool because it looked at that point in time that yields were moving quite aggressively.

Now, I think people have completely abandoned that view. We can debate where the average Fed funds rate or the yield is going to be, if the center of gravity for the 10 year yield is going to be two, or three, or is it going to be one. But actually that's already a big shift in beliefs. That's not the debate that prevailed over the last 15 years. So everybody in the sensible universe believes that real yields are permanently lower.

But the interesting thing about equities is that you've got much more normal levels of earning yields in the context of history. What's striking is that sensible people believe that equity yields should mean revert, despite the fact that the real interest rate structure is lower in equilibrium. And lower real interest rates do not appear to mean lower levels of profitability. Even very experienced equity investors are still using rules of thumb that say there should be a static P/E multiple for the S&P 500. So they have a sense that this is the mean and this is what you fluctuate around.

My perspective would be that actually we are probably close to an equilibrium, ironically, in bond markets. I just think the equilibrium is a lousy investment.

Now, the equilibrium return in the equity market is not what you're used to historically. But it's still priced to deliver you very, very significantly better returns than competing assets. So even if you take a Shiller P/E, which is the most conservative way of valuing the S&P 500, it gets around 25 times reported earnings if you do a trend line. That's a 4% implied real return. Now, over 15 years, that's an 80% real return. So that means actually equities are priced to beat bonds by 80% real over the next 15 years.

Sure, it's not going to be a straight 4% real. You are going to have to deal with very, very lively fluctuations. So, in a sense, my kind of operating thesis is that I suspect that *the rule-of-thumb is going to break down in the equity market*. Because when you actually look at the history of the P/E multiple, there's no such thing as a static mean. If you're on a higher P/E multiple, your prospective returns will be lower. If you're on a low P/E multiple, your prospective returns will be higher. You cannot fight mathematics. But where you're going to sit on a decade's view it becomes absolutely unstable. The S&P trade can trade around a mean of 20 times or a mean of 7 times. It depends on the world that you live in.

I think if I was sitting in America, actually in the context of history, I would say the world is a pretty good place for the corporate sector. Corporate profits are doing very well, wages are low. There's very little economic volatility. *My own bias is that we are getting super moderation now*. So we have the great moderation which was actually about low volatility in inflation, which was actually right. But what the policy-makers ignored was creating volatility in the financial system ultimately, structural fundamental volatility.

I think everything that the regulator is doing is reducing volatility and risk in the financial system, *which now means you should expect more, the greatest moderation you've ever had* because you don't get any risk in the financial sector and you still have stable prices, which is pretty much America. America is actually getting reasonable growth. I mean 2.5% is absolutely fine, and the unemployment rate is low.

So why shouldn't the S&P as an equilibrium be trading on a very high rating? That would be my kind of structural backdrop for where people might be wrong. But this is uncomfortable because what you're really saying is that equities are going to do something similar to what bonds have done, and that's an uncomfortable set of dynamics.

The other point, just as a final observation, is my belief is that one has to be very tactical and open-minded now precisely because of the environment that we are in. It's less about risk premium compressing, and going forward it will be more about investor behavior. Perceptions of risk can flip. For example, if in the equity market suddenly people are going to shift from thinking equities are risky to thinking it's risky not to own equities, and I think we are already starting to see that. In fact, I believe the industry is way behind the curve as you'd expect on this.

So I still find it fascinating that everyone is obsessed with being negatively correlated with equities, kind of the anti-beta strategies. *You want to be positively correlated with the best performing assets*. The truth is people have loved diversification because actually there should be a cost associated with diversification, whereas the reality is if you've had diversified portfolio, you've been paid.

Bonds have delivered you fantastic diversification and fantastic returns, but you're not going to get that prospectively. Prospectively, you're going to have to live with volatility to generate decent returns. So I think you have to be very tactical and open-minded.

The other thing I would say is I actually think the return to shorting is going to materialize again, because essentially what I'm describing now is a world that is upon a journey to *everything* being overvalued. The irony is that the revaluation of the equity market may well be the catalyst for sustained economic recovery in parts of the developed world.

And the next irony is that the corporate sector is already starting to see it. The longer you get away from your last shock, the greater the probability that people are going to get optimistic about life. So, again, the irony will be that when we extrapolate forever these low real rates, we extrapolate for a long time these very low-credit spreads. And then we re-rate the equity market, CAPEX kicks in, and you get a normalization in rates, and then you have a major problem on your hands, at least as an investor.

So in summary, I think there are some biases out there. It's very difficult to find valuation opportunities, with the exception I think of liquidity in particular areas where one is going to have to have courage and withstand volatility and be willing to commit capital for longer time horizons. I think there is a very material probability that we see P/E multiples that we haven't seen for a long time.

There is some diversification within the equity market – but it's premised on earnings delivery. I mean, European equities could still be very cheap if the earnings do anything like normalize. So if you cyclically adjust the earnings in places like Italy and Spain, those markets are still very, very cheap. That means there is still a kind of potential for positive economics to deliver very, very significant returns.

Therefore, let me reinforce once more the need to be very tactical and open-minded about what these markets could do, and also consider opportunities on the short side, whether it's through specific areas of the bond market currently, which I think do look vulnerable, or whether eventually in areas of the equity market. Because the equity markets, if you take the S&P 500, there are cheap sectors, for example banks. Banks now get de-rated on a price-to-book basis, so you get paid a 3% to 4% dividend yield. I consider banks now to be very safe. The regulator doesn't let them take any risk.

There are big barriers to entry as we have heard. Because the cost to regulation goes up, it suits the economies of scale. If you read the annual report of JPMorgan and the shareholder letter from Jamie Dimon, I find him actually very interesting because he tackles an awful lot of these issues. A lot of these banks are cash machines in America, and they are beneficiaries if anything, if there's any change in interest rates. So I can see areas where on an absolute basis I can get some pretty good value.

Benjamin Day

I worry about QE in Europe - you had mentioned reduced volatility, but do you think credit risk has been suppressed and there may be a massive risk for an implosion there, given what's happening across Europe?

Eric Lonergan: There are a couple of things I'd say about QE.

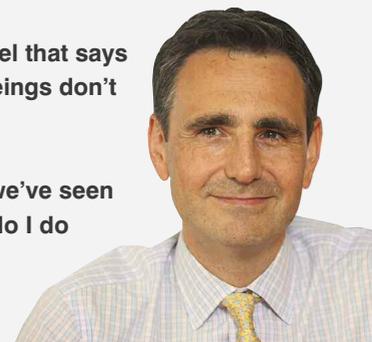
In a way Mario Draghi has been extraordinary. Nothing less than extraordinary, *as a politician*. People have forgotten, but you will remember this, how the German tabloids celebrated Mario Draghi's appointment to the ECB because he managed to convince the German media that he was *the most German, non-German* member of the ECB Governing Council, and the complete reverse is true. He is a genius as a politician.

When we think about the implications of QE for the economy, we have to ask why we had a sovereign crisis in Europe? Because they didn't do QE. And it was obvious to market participants at that time. JGBs were rallying after Fukushima despite the fact Japan was increasing its budget deficits and had the most debt. At the same time Italian and Spanish spreads were widening. *So why on earth were Japanese assets safe and European assets risky?* Well, because the BoJ could buy all the Japanese bonds and the ECB was saying "we won't buy any".

So what Draghi did, by crossing that Rubicon, was profoundly important. We have also seen the absence of contagion – that has been road-tested with Greece. It's conceivable something might happen again, but I think that was a profound shift, because now, anything goes wrong in Europe, he will do more QE. So you have *removed credit risk from the sovereign*, which is incredibly important. And you have had a boost through spreads compressing and from the euro; he talked down the euro very masterfully as well.

Therefore, all of that is sensible; my only concern with QE is that economists have a model that says ever-lower interest rates are punishing savers and forcing you to consume, but human beings don't work like that. I think savers are now operating with rule of thumb.

When you go from 10% interest rates to 5% interest rates, you do get consumer booms, we've seen that in emerging markets. But when you go from 2% interest rates to minus 15bps, what do I do as a saver? I don't give up on saving and just consume.



No, you save more because you are using a rule of thumb like: “How much saving do I need to fund my retirement?” And of course you see this in corporate pension funds as well.

So there’s an equation that all these central bankers have in their model. It says: lower real interest rates boost consumption. *I think actually lower real interest rates may be boosting savings.* I think that’s a much more valid hypothesis than it used to be. So I do worry -- what happens if all this stimulus in Europe doesn’t translate into economic recovery? That is not a pretty picture.

The odds, I still think the odds are kind of 60%, 70% that it will translate to economic recovery. We have just got to be very patient. It’s going to take a long time, but there are some encouraging signs.

Benjamin Day: I think the policy makers in the US managed to get economic recovery, a real economic recovery, started, when the country was running a current account deficit. And they implemented QE early enough so that the stimulus did get into the real economy in some way. At least they recapitalized the banks, which is incredibly important in any economy. Did it inflate US equities? Probably yes, but the problem in Europe was that they in fact raised rates, which was wrong. Then they had to backtrack.

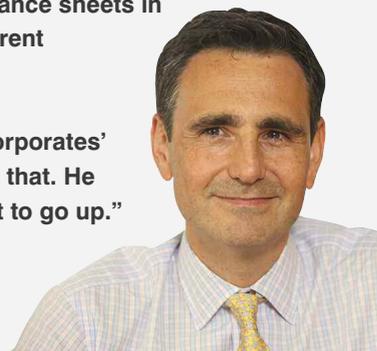


But they have also implemented QE when the Euro zone is running a current account surplus. Now, granted, it’s only two or three countries that are actually driving that, i.e. Germany, Netherlands, so the question could be if it is actually too late for QE? And besides, looking at the scale and implementation, the challenge is to actually implement the whole procedure correctly - we struggle to believe they can do that.

Eric Lonergan: I think the difference you draw between QE in America and QE in Europe is very important because also demographically the US is very different.

The other aspect is that the Americans cleared an awful lot of household debt through default, right? That is one way to get rid of it. You can either inflate your way out of it or you default on it. Household balance sheets in America have improved very significantly. The point here is that because of the very different demographics, I think that also the sensitivity of interest rates in America is different.

The other thing we have to keep in mind is that the stock market is pivotal in American corporates’ and households’ sense of well-being. If you go back a bit, Bernanke was very clear about that. He said, “If you get any weak data, I’m going to do more QE because I want the stock market to go up.” I suspect that ultimately that has worked in the States. Whether you can rely on the same factors in Europe, I’m not at all convinced.



Benjamin Day: Well, I think European equities could, in the next six months, benefit because yields are so low and credit opportunities are unattractive. So where might this money go? Well, personally, I think European equities could fly, not based on any real economic improvement but just based on where people will finally end up putting all that money. In other words, I think that is a beta call.



Renaud Huck

Do you think that the Footsie can go up and up over the course of the next six months without any tangible fundamentals? The UK has a high level of national debt, which has not improved considerably over the last five years.

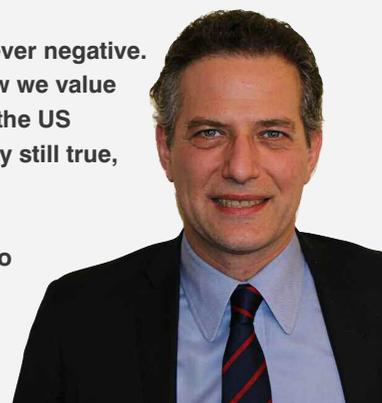
Benjamin Day

Well, I think the FTSE will do okay, but I would actually make a separation in the sense that I believe European ex-UK equities could on a relative basis have a wider scope to rally than the FTSE. We have all seen what the US equity market has done over the last four or five years. So I believe continental Europe will be a nice place to park your money, but, again, don't base it on any fundamentals and its more of a short term trade

Tommaso Cotroneo: I agree with the previous comments about the opportunity set in less liquid investments and I also concur with Eric that we are going to zero or negative bond yields. Equities will eventually follow and end up with stretched valuations. However, despite all the efforts the regulators are making to move everything towards listed and liquid structures, I wonder if we as an industry will actually be forced structurally to move back to illiquid investments? Because there are pension fund liabilities and insurance ALM challenges.

As a mathematician, I've been taught to price options assuming that interest rates are never negative. Well, that is not the case. We even have theoretical problems at this point in terms of how we value assets, because all financial theory until two years ago was based on two assumptions: the US Government will never default and will always pay a positive yield. The former is probably still true, but the latter definitely isn't.

So forgetting theory now, and looking at practice, will the industry not be compelled to do exactly the opposite of the regulators' best interest? I guess it's more for you guys in terms of what you're seeing from your client and investor base.



Peter Coates: I agree, that illiquidity and spreads present a potentially serious issue. Omni operates in a very liquid space with our macro fund, event-driven and equity funds, which focus on liquid equities. To your point, Tommaso, about the illiquidity aspect and in relation to our lending strategy, in the UK you can go to a high street bank and get a 25-year mortgage and pay about 10 years fixed for 2.8% or 3% per annum. In our lending fund, we are lending on a much shorter term, 12 months in duration typically, and generating much higher return for a similar if not lower LTV of about 70%. My point here is that the reason why this strategy works and why it's so attractive is not necessarily because of any illiquidity aspect, but because it's a very resource-intensive process and paper-intensive to do it, which is why we have a separate business doing that.



These are loans not on primary residences, but mainly investment properties. This is a less liquid strategy versus our hedge funds, but it's not long duration - there is a mismatch in terms of yield for liquidity.

Eric Lonergan

This is interesting also in terms of what technology is doing to the banking sector. I mean it's a common theme that goes back to the point that inefficiencies are also created as a consequence of regulation.

This is one of the ways or mechanisms how opportunities are created in financial markets. But the kind of challenge here is about scale, isn't it? It's difficult to deploy very, very large amounts of capital into those type of investments.

Peter Coates

Correct, you're completely right about scale. The big banks can't put enough capital to work in this type of area of lending to justify the business model. The market for this type of lending in the UK is probably around GBP2-3 billion at these yields, and therefore it is not worthwhile for the big banks, nor large private equity funds to come in and do it. Firstly, they haven't got the background and the expertise. Secondly, they would need to buy a business or set up a business similar to one that we currently have. Thirdly, they probably just can't get the scale and volume to make it work. That's why I think this form of direct, secured lending is one of the typical niche areas that boutique firms like Omni are best suited to exploit.

Renaud Huck: I have a question for the portfolio managers at this roundtable: What is the investor appetite for those strategies that are less liquid, illiquid or in a narrow market.

It is one thing to engage in education and show examples and explain how there are opportunities but the mass majority of investors are driven by a long-term investment style, whether it is in equity or bonds. How do you change the mindset of the investors going forward and show them that there are opportunities that are different, which they should look at and evaluate? In this low yield environment it is really in the investors' interest to make sure that they explore all possibilities in order to find attractive yields.



Peter Coates: It really depends on the investor and what their specific requirement and constraints are. If you look at a typical continental European pension fund, under pressure to invest in European assets, into more liquid, less leveraged assets, and move away from offshore funds, however UCITS alternatives are acceptable because they are regulated in Europe. I don't necessarily disagree with that - it's just the reality of the situation and the reality of the way regulations have gone since 2009.

But at the same time some investors do clearly have interest for less liquid type of strategies which better match their liability duration. We tend to see more demand coming from the US which may be the result of a more economical thought-process from their perspective - they are looking at the capital allocation, return on capital and duration, and have less rule-based regulation in comparison with Europe.

What's interesting is that we have worked with teams within pension funds who invest into the more liquid hedge funds, and they wouldn't consider the lending strategy. But then they have a separate team that deals with private investments, some private debt, private equity investments. Typically somewhere within most institutions there is a cross-over or an access point, which depends on how the investor is organized internally.



Back to the earlier point on where we all see potential opportunities, my third category was investors. The industry needs to better understand what investor requirements are and why they have those requirements. For example, go back pre-2008 and most hedge funds refused to provide transparency on their portfolio. Now, it is widely accepted and understood that investors require transparency for regulatory and fiduciary purposes, and can actually use that transparency better. Similarly, regulations have raised potential opportunities in themselves, whether looking at gaining lead-advantage in UCITS, AIFMD, or Solvency-2 and Basel-3 compliant structures. Investors will not invest unless a manager has performance and integrity, but if we also make it easier for investors to have the right investment structure and be comfortable with risk management, transparency, and other areas, it makes it all the more easier for the investment decision.

Pierre Crama: I totally agree. The interest for UCITS in Continental Europe is very high. We don't see lots of interest for co-investment opportunities in Europe. Those one-off deals are much more driven by the US. I agree with Peter. US-based managers can serve two types of allocators by offering different products. One is offshore for their local market and one being UCITS to tap into the European market. We don't see many European hedge fund managers moving into a more private equity type or hybrid illiquid solution because they don't have any demand from their local investor base.

We define the appetite for co-investment as a way to potentially get access to the best ideas or longer terms plays from a given manager. Some allocators will super-size a trade from an existing manager, others will participate in co-investment opportunities provided by their hedge fund managers. Relationships play a key role as hedge fund managers tend to talk about special opportunities with allocators with whom they have a long lasting relationship.

It largely comes down to the number of years you have known the manager to access those special trades which are usually capacity constrained and time sensitive. Assuming your SPV is ready, you will be in a better position to participate in those deals as you will be able to move fast.

I mentioned earlier that our investor base is fairly concentrated. When you sit down with your client to understand their individual risk return profile and their regulatory constraints, you are better prepared to offer customised solutions and niche products tailored their needs. At Tages, we value considerably the transparency offered by our managers and the transparency offered to our investors.

With the impact of Solvency II on insurance companies, almost all our funds report to an external risk aggregation provider which facilitates the reading of our overall exposure per geography, sector and asset class. In addition, some European regulators require specific exposure numbers which could not be possible to aggregate without the full collaboration of our underlying hedge fund managers.

When you get to the level of granularity at the position level, you can potentially become an eligible solution to an investor who was reluctant to allocate to hedge fund strategies.

We are working on finding solutions to allow insurance companies to keep their hedge funds exposure. Does anyone have a comment on Solvency II?



Stephen Lewis: I won't comment specifically on Solvency II, but, from a reporting perspective, administrators are developing ever more sophisticated regulatory and tax reporting solutions for their clients. The volume of data and at times the complexity of the regulatory requirement have caused a serious headache for fund managers who have turned to their administrators for help. As the repository for that information, regulatory support for a fund manager has become an obvious extension for an administrator with the right technology and the necessary data management skills. This has been coupled with a continued increase in complexity of financial product, available legal structure, markets globally and reporting deadlines, frankly an area where the fund administrator is taken for granted.

The role of the fund administrator continues to evolve and certainly in our business it has been recognized that the same reporting capabilities are of significant benefit to investors. The extent of that benefit has become clearer over the last few years where we have moved from providing additional investor analytical reporting to acting as a data/reporting hub for large pension funds.

Many of our clients were struggling with the quantity and complexity of data being provided by their fund managers and associated service providers. That legion of data has to be aggregated, quantified and made available in a variety of different reports dependent on who was required to read them.



I don't want to make too many distinctions between the reporting needs of an asset allocator and a pension trustee, but, they exist and it takes experience, a flexible consultative approach and the right technology to produce the right reports for the right people.

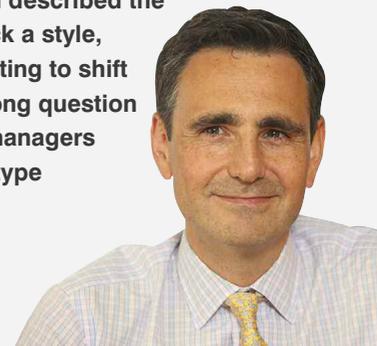
It's my considered view that the level of understanding of the impact of regulation on funds will be greatly enhanced by the quality of reporting that is available to both the fund manager and the investor.

Eric Lonergan: To our earlier point, I am very loath to make a distinction between US and European investors, but I think there is truth that the US investor base is less homogenous than the European. So in Europe you may be able to refer more to common trends whereas America is sufficiently deep and diversified that you can find people with an appetite for very different approaches.

There are investors in America who will take a totally different approach to risk than the conventional volatility/equity correlation/daily NAV-world that has become very much the convention in Europe. I think that is fair and in a way an undeniable characteristic.

Where we see a lot of demand I think is still in asset allocation. I think a lot of the trends or almost the fad that Tom earlier alluded to is a genuine challenge for active managers within the equity world. Tom described the landscape very well I thought, which was sort of 20 years ago where if you wanted to back a style, you chose an active manager to provide that style for you, although that was already starting to shift in America. But now, those styles are available to you off-the-shelf. So there is a very strong question as to what exactly do you choose. Do you just go to the lowest cost, or you have active managers effectively offering a style type, or do you try to get even more sophisticated in the style type product?

I don't think those questions have been resolved in asset allocation.



Tommaso Cotroneo: I totally agree. In fact, if I think of one thing that would make sense to develop in that particular space of factor style investing, it's probably not the next style index or the next style ETF, but actually good asset allocation methodologies and algorithms. I think that's what is missing right now. If I'm a pension fund trustee, or an insurance company executive or a private client investor and I have these great new bricks to play with, what do I do with them? I think that's not being explained properly enough or is not being offered properly by the industry.



Eric Lonergan

I think it's intrinsically harder.

Tommaso Cotroneo

Of course it is.

Eric Lonergan: In part because of the sample size and also because if you look a bit under the lid in asset allocation, what you will find is that there is a lot of fake diversification.

What we really care about – true diversification - is what happens in a recession. I mean diversification, when everything is going well, doesn't really matter, but in a recession, you kind of have two assets left, which are bonds and equities. Everything converges to one of those. So I think it will be very interesting to see how the systematic space evolves in that respect, but I think there's quite a lot of work to be done.



Peter Coates: Pierre made some good comments on the investor-type European regulation like Solvency II and Basel III, etc. Firstly I should say I have spent far too much time over the last four years looking at Basel III and Solvency II. What I realized after a while of looking at it was that, as we didn't actually have any European insurance or financial investors, there wasn't any immediate threat to us. Similarly, I did not believe there is any threat to markets and asset spreads.

As a firm, and as a team, we have a lot of managed account experience, so we already provide significant transparency, control and insight to our clients. What the regulations are actually demanding from those investors is reporting and transparency with control and risk management overlaid. So in a way, with such regulatory threats you can also often find some kind of opportunity to provide investors with the right structure and information. We now have investors, typically coming through fund-to-funds, who are looking for a solution for Solvency II and Basel III requirements.



One frustration that I found four years ago when initially assessing Solvency II, while talking with some of the consultants and to some of the insurance companies, was that at that point they were less concerned with the treatment of their minor allocations to hedge funds. They were too concerned about the fixed income and property allocation which was a significant part of their non-equity book. Given expected returns on fixed income, the volatility in equities, and where credit spreads are, things are now changing.

Matthias Knab

Timber is typically also somewhere in that mix....

Peter Coates: But now things will change on a greater scale simply because the investors can't get the same kind of return for their liabilities in fixed income. So maybe they will be looking more and more at alternatives and hedge funds, to get that what I would call the optimal "return on regulatory capital" (or RoRC) as opposed to the return on volatility or return on capital.

From that perspective, asset allocation is going to become more complex for the allocators themselves. But I think it has also taken time for the industry to actually catch up with the new complexity and be able to have that discussion with investors and really understand what they need. Now we understand why you need transparency, that you need the element of control and risk management, and that we can actually work with you by making slight adjustments to our business model and facilitate investor requirements. I think the industry is getting there, but it has also been an evolution on our side.



Pierre Crama: Just a quick observation about risk premia which has also become an interesting concept for fund of hedge funds allocators. We see a specialist capable of identifying risk exposures across diversified investment styles and asset classes with low fees structure as a complement to our hedge funds in our portfolios. This cost effective solution could be identified as a solution for lower fees.

Our clients are very sensitive to the fees we are paying at the underlying manager level. Fee compression is a common trend for some time. Management fees are coming under pressure and to a less so degree performance fees. Fee customisation is increasingly adopted by hedge fund managers. Managers might offer fee breaks for a large ticket and/or longer lock up.



We have also noticed that some managers are more innovative with fees structure. An example which comes to mind is a manager offering a reduction of the management fees as AUM grows. We like it as it supports the business in its early stages, and when the manager hits the break-even point, the fees are reduced to better incentivise the manager to perform without focusing on asset gathering.

We have noticed some complacency towards established managers who are less incentivised to produce returns as they have a large AUM base generating good fees. In some cases we see managers targeting lower volatility as their investor base becomes more institutional.

Fees remain a hot topic in my opinion.

Peter Coates: Having come from a similar background in the fund of funds space, I appreciate your comments. What I actually think is the best solution for all is that capacity constraints should be adhered to. If a manager can only manage so much capacity in a certain strategy before they start to see degradation of performance, and therefore performance fees, investors and managers should abide by that capacity constraint.

As an allocator in my previous role, back in 2009 I did allocate with some big managers because they were safer from a business perspective. There was a higher likelihood that those managers were going to continue to be in business within the next three years. I couldn't say this about the smaller managers back in 2009. However, my over-riding preference is for funds that are able to follow more niche, nimble strategies. I believe that the fund of funds industry needs to focus on its edge over other allocators by doing what you have exactly said: focus on the niche managers and the niche strategies, and be more constructive with managers about how they can actually align their interests.

Because you have a diversified fund of funds, which effectively diversifies away the manager risk, to a certain extent operational risk, market beta, and volatility in the current environment, fund of funds can take on more of those risks at the individual manager level.



Pierre Crama: You are right! It is important to be careful about how you deal with capacity. When a manager prides himself to manage up to a certain level of AUM, you really need to challenge him when, for any reason, he decides to go beyond his initial limit. You need to look at the strategy level which is not always reflected into one product, but could include multiple managed accounts.

Without over-generalising, by experience, young and emerging managers tend to be more transparent and more receptive to recommendations than established managers. We tend to have much more control with managers which are much smaller.



It is important to have regular contact with the manager and receive a detailed risk report. We don't like surprises, and style drift is a big flag. During our investment committee meetings, we review outliers, monitor large performance movements up or down or that are not in line with expectations. Style drift does take place in the industry and unless investors are very attentive, they might have different underlying risks than the one targeted.

Benjamin Day: I guess this is kind of music to a smaller manager's ears, to be honest, because while we see ourselves as fairly traditional in the sense of how we run our money. With limited leverage or limited hedging, we follow a contrarian approach.

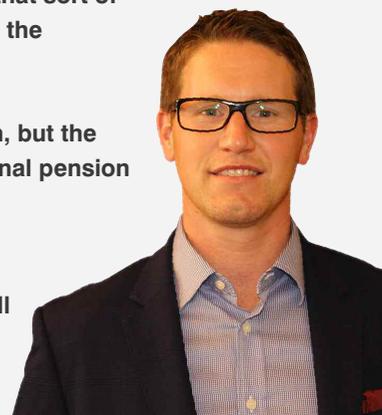
We compete with the Templeton's / PIMCO of this world in terms of performance. Now, maybe contrary to Eric's point earlier, we are not delving into an illiquid space – our average issue size within our portfolios is US\$1bln, and we don't look at anything under \$500mn. It's investment grade, but the difference is we look at different markets compared to what other typical managers will look at, and again it goes back to the benchmarking effect I mentioned in my introduction.

So where do we have the challenge? Well, with increased rules and regulations and risk aversion of your traditional allocators, you don't get fired for buying PIMCO, let's just say that for example. But you might get fired for buying Stratton Street if it goes wrong... So you've got that risk aversion which leads allocators towards the bigger managers.

Certainly my challenge as Head of Sales is to find those allocators that have the understanding of the diversification benefits of our products in terms of low correlation to traditional fixed income and equity managers as well (coupled with very strong performance). But it's a smaller target market and it can potentially be more time-consuming, and finding those traditional managers, like yourself, Peter, that could potentially allocate to that sort of space. But you're always coming up against the headwinds of the big guys, especially in the consultant driven space.

So what can we do with the larger consultants? Now, we will get lucky with some of them, but the reality is our business model is not going to come through that way. It will be the traditional pension funds and institutional investors in the UK / Europe that again, think outside the box.

I completely agree, the whole "death of fund-of-funds" didn't really happen. But yes, the financial crises sorted out the winners and losers; the winners that are still innovative will continue to grow and blossom.



Stephen Lewis: Our fund of hedge fund business actually grew significantly last year. Since the financial crisis, many of our competitors have shifted their focus away from the fund of fund market as that part of the industry went through a renewal and reinvention phase. Their demise has been inaccurately reported as many have worked their way through the issues largely attributable to the hedge funds and emerged stronger and more creative.



The fund of hedge funds dependency on banks has also waned as the need for funding has been removed, and as a result the link to the bank administrator has also become largely redundant, allowing Maples Fund Services to pick up those willing to make the transition. We have been largely agnostic when it comes to the phase of the funds life that we on-board and have managed to find economic solutions for funds that are in run-off.

Tommaso Cotroneo: The sector is growing massively at this point. Just in ETF type of vehicles, it's growing twice as quickly, if not more, than the rest of the space. I think Eurex has already listed, or is thinking about listing, some of the MSCI type futures on some of the MSCI style indexes. So they are actually available in cleared form, which just gives you a feeling for the institutional interest that there is in all of this.

Is it the answer when it comes to the asset allocation challenges? No, it's not. It's one of the tools that we need to use to deal with the negative interest rate world we're living in. Even in liquid equities, we just need to be able to provide smarter allocation tools to other clients.

One also needs to bear in mind, and not just because Eric and other active managers are here at this Roundtable, that smart beta or factor-driven investments will exist in addition to active management, making asset allocation even more relevant.

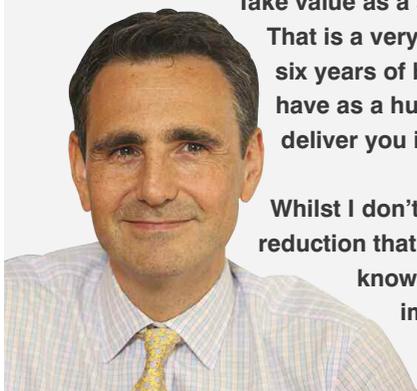


Eric Lonergan: I am seeing an awful lot of people at the moment who are telling me, "I can get a superior return through low-beta stocks." Now what they are telling you is they are going to satisfy all of your behavioral biases, which is myopic volatility, all the things you don't like. I'm going to get rid of all of those and deliver you better returns.

If Eugene Fama was a stock, he's right at the bottom now - and he is not a total fool. What he says is that when you can prove that something works - that's really what he means by the efficient market hypothesis - it's actually when it's statistically proven, you then have to scratch your head and go, "Well, if everybody knows about it, it's statistically proven; I can show you all of the data," then that is starting to sound very much like a free lunch.

Take value as a style, for example. Why does value as a style work? Because it's very uncomfortable. That is a very good behavioral rationale as to why value might work as a style because it can have six years of being out of favor. In its sixth year, if it's 1999, it gets annihilated. So the challenge you have as a human being is the probability you're going to give up on the style just as it's about to deliver you in spades.

Whilst I don't want to overstate the case because actually I have huge sympathy for the cost reduction that's implied and where style and factor approaches can be implemented intelligently. I know I'm not telling you anything, Tom, that you don't already know, but I think that's an important caveat that I would just throw out there, is beware of the Holy Grail.

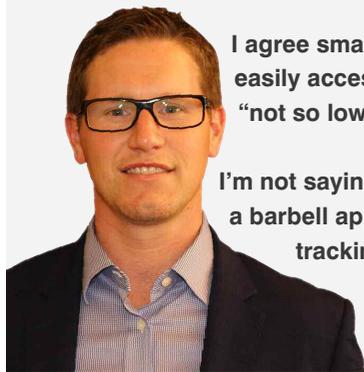


Tommaso Cotroneo: Completely agreed, Eric, and the most interesting thing in that respect is if you show anyone that you take a value index divided by the benchmark, you'll see it's 85% correlated to the ISM and negative to the VIX. That's the reality. That's why we're not reinventing the wheel through factors. Ultimately, we're just providing different or more efficient ways of essentially trading the market and the risk cycle, and doing so at a lower cost. As we mentioned, the challenge is not so much building the next fantastic factor but how can to call the cycle efficiently, and as a result of that, which factor to take. That's the real question, to me at least.



Benjamin Day: Smart Beta has been around a long time, it's just being repackaged with clever use of marketing, but I think a few more challenges remain for the industry and for investors.

For example, Eric also made such a point earlier; we have been told by consultants that we have had great performance over the last seven years, but that we have been, in certain stages of the economic cycle, highly correlated to certain asset classes. For example, we were highly correlated to EM when it did well. In 2007, we were highly correlated to Triple A and government bonds when they did well. But surely, that is actually what you want as we move our credit positioning as to where we believe we should be in a credit cycle.



I agree smart beta is the right approach. For beta, it should be low-cost, transparent, very liquid, and easily accessible. Of course being an active manager, I still wholeheartedly believe there is space for “not so low-cost” active management with true alpha generation potential.

I'm not saying this is an easy game by any means, but I think that should be the way the world thinks – a barbell approach. You choose the way that you want to construct your beta portfolio and your index tracking, then you keep it as low cost as possible. On the other side you find those niche alpha managers / strategies and you pay according for them.

Tommaso Cotroneo: There is maybe one main reason why smart beta factors are now popular, which is definitely a positive one: it has weeded out fake active managers. Fifteen years ago investors were charged active management fees just for buying low P/E stocks. That's beta, quite frankly and it shouldn't be paid as active management. But we now have tools to analyze that and to potentially invest in all those forms of beta.

Academic research suggests that about two-thirds of stock returns are still not explainable or not explained, even once you put all the smart beta and factors in there. So two-thirds of stock returns are still potentially alpha for which you should, by all means, be paying. But at least for one third you should be paying 50 basis points or less.



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