



Opalesque Roundtable Series '15 BOSTON

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Editor's Note

Alternatives versus traditional investing in Boston

When coming to Boston, a lot of investors are intrigued by the depth of talent in the traditional mutual fund and increasingly the alternatives side as well. There have been transitions and migrations from Boston's long-only establishments to the long/short side for many years. Especially since the financial crisis, clients have wanted more protection of capital or less volatility or less correlation with the markets overall, and this has certainly picked up more recently.

But if you take a closer look at many of the most successful firms, the organizational size, as well as the dominance of long-only strategies, are creating challenges. There are often natural impediments to managing true best-ideas portfolios. Things like mandate constraints, capacity limitations, internal politics, conflicts of interest, incentive systems, and even career-risk fears can create slippage between great research and the actual client portfolios. On the positive side, the traditional long-only business is very well equipped for managing portfolios in a regulated, highly compliance-driven environment.

Shorting presents another challenge. There are shorts for hedging purposes and there are also shorts for alpha generation. Unconstrained managers not only come across great companies to own, but maybe as many companies with good reasons to short. Even the best short investors probably tend to benefit from it only 20-30% of the time; the other 70-80% of the time, it can be a costly drag on their portfolios. Figuring out how to short effectively and efficiently—to minimize the drag in bullish markets while still having the protection in place when the inevitable pullbacks happen—is a vital skill in this business. It is worth noting that a couple of the biggest owner-operated hedge funds in Boston don't really short. They hedge their portfolio in a number of different ways.

As the bull market is underway, investors globally are shifting assets towards strategies like long/short, market neutral, hedged or tail risk protection. As always, it is recommended to take a close look under the hood to understand how much protection you are buying.

Marketing opportunities in Europe as German regulator opens up alternatives for insurance companies

Meanwhile in Europe, the German insurance regulator introduced a new decree that insurance companies can invest **up to 7.5% of their portfolio into hedge funds without further regulatory restrictions**. Starting 2016, due to the implementation of Solvency II, the larger insurance companies may invest upon their own risk analysis into hedge funds, **even beyond the 7.5% ratio**. It will be very interesting to monitor the learning curve of these new investors in alternatives.

Risks: Why the real risk of investing today may be in areas that cannot be captured through numbers

Today, most investors rely on quantitative measures of risk. But, there are certain types of risk and behaviors that can be hard to measure just by looking at the numbers. For example, *how can allocators predict how a portfolio manager is equipped to deal with certain situations? How does his **behavior** demonstrate how he manages risk? Such questions are not as simple as a risk model and its numerical outputs. Can you measure how much conviction a manager has in his investments and how he has built that conviction? Is that conviction based on deep knowledge or stubbornness? Can you predict his most likely response to a downside move in a stock?*

The Opalesque 2015 Boston Roundtable, sponsored by Maples Fund Services and law firm WTS, took place at the Boston office of Maples Fund Services with:

1. Ben Deschaine, [Balter Capital Management](#)
2. Jason Brandt, [Maples Fund Services](#)
3. Kevin Maloney, [Gottex Fund Management](#)
4. Robert Welzel, [WTS](#)
5. Luis Cortez, [Essex Investment Management Company](#)
6. Ross DeMont, [Midwood Capital Management](#)
7. Scott Utzinger, [Crawford Fund Management](#)

The group also discussed:

- Why capital raising mechanism for small or mid-sized hedge funds is broken, and what opportunities does this open up?

- Investing: Strategies for efficient manager selection after the crisis
 - How investors can get better after-fee returns in liquid alternatives
 - Outperforming by focusing on owner-operated companies
 - Investing versus information arbitrage
 - Opportunities in life sciences, energy
- Fees: Aligning interests or fight for survival?
 - Are high water marks always good for investors?
 - Investors are willing to pay for alpha, but often they have no idea how to measure it
 - Are private equity fee structures the way to go?
- Risk (continued): How investors and managers get fooled by recency and frequency biases
 - How crowding and liquidity shortfalls will affect your portfolio
 - Why the current contract note redemption process of hedge funds is one of the biggest operational risks
 - What if you find out that you are the only human trading in a certain security?

Enjoy!

Matthias Knab
Knab@Opalesque.com

Participant Profiles



(LEFT TO RIGHT)

Greg de Spoelberch, Robert Welzel, Scott Utzinger, Jason Brandt, Kevin Maloney, Luis Cortez, Ross DeMont, Benjamin Deschaine.

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Introduction

Scott Utzinger

Crawford Fund Management.

Scott Utzinger from Crawford Fund Management. Crawford Fund Management follows an unusual approach to equity long/short. In the long book, we invest in an eclectic mix of typically under-followed stocks whose common characteristic is that they are what Crawford defines as owner-operated companies. Our hedging, on the other hand, is comprised primarily of hand-selected, single-name equity options and only secondarily of outright shorts.

This approach comes from a combination of the best practices our partners observed while working together for many years at some of Boston's world-class asset management companies including Wellington Management, Putnam Investments, Fidelity Investments, and Stark Investments. We managed large absolute and relative-return portfolios for these firms prior to founding Crawford six years ago.

Kevin Maloney

Gottex Fund Management.

Kevin Maloney from Gottex Fund Management. The firm's original foundation is as a fund of funds business, which we still operate today. We also offer products in alternative risk premium, multi-asset and real asset strategies. I am the Co-Chief Investment Officer of the firm. I have been with Gottex since 2003.

Luis Cortez

Essex Investment Management.

Luis Cortez from Essex Investment Management. Essex is a 40 year old firm concentrated in growth investments. We have long-only as well as long/short strategies. For 10 years, I have managed a long/short portfolio specific to the global life sciences sector. Overall, we look to provide our investors with a competitive return stream based upon the early identification of unique opportunities within the sector while simultaneously limiting any potential downside scenarios.

Benjamin Deschaine

Balter Capital Management.

Ben Deschaine from Balter Capital Management. Balter Capital Management is a hedge fund specialty research firm. We essentially help our clients get invested in hedge funds.

The bulk of our business is advisory work for family offices and high net worth individuals. We have recently launched a second business line, Balter Liquid Alternatives, which is focused on bringing high quality liquid alternative offerings to the mutual fund space.

Ross DeMont

Midwood Capital Management.

Ross DeMont with Midwood Capital Management. We're a small cap manager with more than ten years of experience in the space. We focus on finding idiosyncratic and uncorrelated situations where a stock's expected performance is a function of company specific factors rather than broader market forces.

We look for meaningful discounts to intrinsic value where we see a credible path for price to converge on intrinsic value over a reasonable period of time. We have been successful at generating alpha and defending capital in a variety of market conditions.

Robert Welzel

WTS.

Robert Welzel with WTS. WTS is delivering tax, legal and consulting services. It was founded in 2000 with six colleagues; now we are in Germany 500. WTS has offices in Asia and in the US in Boston and New York, too. I am a Frankfurt based German qualified lawyer and tax advisor. My team advises numerous hedge funds and other AIFs, also mutual funds with regard to German and European tax and regulatory structuring and compliance issues.

Jason Brandt
Maples Fund Services

My name is Jason Brandt and I am with Maples Fund Services which is an independent global fund services provider. We have been around for about ten years and work with a wide range of investment management firms and global financial institutions. We currently count over 200 clients who have entrusted us with more than \$50 billion in assets under administration.

I am responsible for managing our business across North America, as well as shaping our offering. Additionally, I'm currently focused on the growth and development of our recently opened Boston office and further expanding our footprint in the U.S.

70

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



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Eurex Exchange – the home to the euro yield curve.



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Greg de Spoelberch

When coming to Boston, a lot of investors in alternative investments are intrigued by the depth of talent in the region on the traditional mutual fund and increasingly on the alternatives side as well. How do those two let's call them industries get along, is there a lot of transition from the long-only into alternatives, what are some observations you would like to share?

Benjamin Deschaine: I am speaking from my seat, and having been investing in hedge funds for the last 15+ years, I would say that *very few investors from the long-only side have successfully made the jump into the alternative side.* This is probably because of a variety of different reasons. Most importantly, short selling is a difficult game that I think most people who have been trained to invest long-only aren't particularly equipped for.

That's not to say that they couldn't get there, but there's a certain mindset around holding short positions that in my experience hasn't translated well from the mutual fund world.

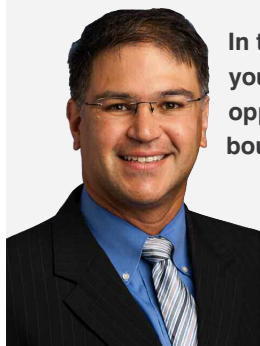
There have been some interesting studies around that phenomenon, in fact. I think there was a study from the London School of Economics, but don't quote me on that, which analyzed liquid funds that had come to the market. They looked at funds that were launched by long-only portfolio managers who came from traditional mutual fund jobs versus funds that were run by people who were traditionally running alternative strategies. The funds that were run by the long-only trained managers tended to materially underperform the funds that are run by hedge fund managers.

That's not to say that nobody makes the leap. There are examples of managers who have done it successfully. It seems like the hit rate based on my experience is relatively low, but I suppose that's fair to say about investment talent in general.



Luis Cortez: For us, it's a little different. There have been transitions and migrations from the long-only establishment here in Boston to the long/short side for many years. Especially after the financial crisis, you saw that clients wanted more protection of capital, or less volatility or less correlation with the markets overall and this has certainly picked up more recently.

I mentioned that Essex was founded about 40 years ago and we have been doing long/short investments for almost 30 years here alongside our traditional long-only portfolios. So we do both.



In the specific area I am in, namely Life Sciences, the dispersion of returns is very wide. In the sector, you can have a stock go up 100%, you can also have a stock go down 60%. So again, we saw it as an opportunity to take advantage of those two sides, also in order to differentiate ourselves as a boutique.

Our aim is to take advantage of both the long and short side to generate the best alpha that we can and also comply with our clients' desire to preserving capital given that we have seen significant three sigma events happen over the last 25 years.

Scott Utzinger: The partners at Crawford started our careers at some of Boston's top mutual fund firms. We consider ourselves very fortunate to have learned the business next to some of the world's greatest investors and analysts. There is simply no better training ground for the craft-skill of investment research—the talent, resources, and access are hard to match. Being given the opportunity to manage very meaningful client portfolios early in our careers at these firms was invaluable as well.

At the same time, the organizational size as well as the dominance of long-only strategies at many of the most successful firms create challenges, too. Shorting, for example, is a very different endeavor than investing long—the processes are not mere opposites. *Shorting is incredibly tough. Even the best short investors tend to benefit from it only, say, 20-30% of the time; the other 70-80% of the time, it can be a costly drag on their portfolios.* Figuring out how to short effectively and efficiently—to minimize the drag in bullish markets while still having the protection in place when the inevitable pullbacks happen— isn't necessarily a skill one learns at the biggest, long-dominated managers, yet it is a vital skill in this business.

We were also frustrated by the natural impediments to managing true best-ideas portfolios in some of the larger organizations. Things like mandate constraints, capacity limitations, internal politics, conflicts-of-interest, incentive systems, and even career-risk fears tended to create slippage between great research and the actual client portfolios. It wasn't uncommon that the most compelling investment ideas were the ones discussed in the hallways rather than in the investment committee meetings.

Ultimately, we decided to start a business where we could put our very best long ideas to work without constraint and where we could marry that long approach with what we felt was a thoughtful and efficient approach to hedging. In Crawford's case, we invest primarily in single-name put options on companies where we have a negative thesis, thus capping downside while still providing offensive and defensive short exposure. To say that such an unusual/hybrid approach would be impossible in mutual-fund organization may be a stretch, but it would be a long, uphill battle to maneuver it through product and marketing committees and finally commercialize it in the marketplace.



Kevin Maloney: In terms of our evaluation of managers, *I always found it a lot easier for people from the quantitative side to transition from long-only to long/short than people from the fundamental side.* It's not to say in any way that quant is better than fundamental, because I don't believe that, even though I am more quantitative in nature. I just find that when you go and you talk to fundamental investors, they want to talk about the long ideas first. It's the nature of the way they think about companies - taking market share from people, the launch of innovative new products, etc.



The areas in which I have seen people really be able to do better with shorts is in the growth-related sectors Luis has already mentioned. Areas like technology, healthcare, etc., where you have a natural innovation cycle, and there are always going to be winners and losers. It's much more natural for people to think in a long/short sense in those sectors than in consumer or industrial, for example. Those higher growth areas of the capital markets just lend themselves to large spreads between winners and losers, and that can translate into long/short alpha. You can at times even notice this in the way certain managers talk about things.

Ross DeMont: My partner and I did not come from the traditional long-only side of the business; we actually came out of mergers and acquisitions advisory and then private equity. There is not necessarily a right or wrong pathway to enter the business. However, we think our somewhat unique backgrounds allow for a differentiated approach to investing.

We meet with 300 to 400 companies every year. In doing so we encounter some very high quality yet undiscovered companies. On the flip side, we also meet a lot of companies with suspect business models, highly promoted stocks, and/or valuations that don't make sense.

One can respond to such meetings in one of two ways. Long-only investors effectively vote with their feet and don't invest in companies with less attractive attributes. But, if you have the flexibility to also short those companies, I think there's a way to monetize these interactions.

I would agree with the earlier point that there are a number of environments, like the one we've experienced over last five years, when it's been pretty difficult to make money shorting. As a consequence some investors may forget about the benefits of alternatives. However, at some point in the future the markets will remind investors why having defensiveness from a short book is important.

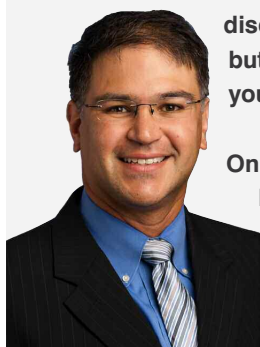


Luis Cortez: I do agree with you. Healthcare, for us, is a growth sector. It's driven by innovation and the sector is made up of winners and losers. Given the opportunities we are seeing in this sector, long/short is definitely the better strategy to generate more alpha for our clients and portfolios.

However, I want to make the distinction that for use there are shorts for hedging purposes and there are also shorts for alpha generation. We try to make that distinction.

Our quantitative risk management metrics leads us to have some shorts, either using derivatives or individual names, that serve as hedges. When there is an event that is surprising or unanticipated, those are the ones that always kill you.

But if you try to have a somewhat quantitative approach to risk management, that allows you to have that discipline and understand that the cost of those shorts come at the expense obviously of the upside, but for the purpose of capital preservation and in keeping within the risk management philosophy that you have.



On the other side, there are those taking advantage of the diversion between winners or losers, also leveraging the information that you are gathering on the long side in management meetings, industry meetings, where the industry is going, regulatory or macro-type of meetings that you have. You gather that information and understand that you can also generate alpha investing in this stock going down.

Benjamin Deschaine: We shared some good insights about the short side and I agree that it is a very valuable skill set, and frankly, it needs to be value-additive in the hedge fund structure, because that is where the manager is supposed to be getting the extra 20% incentive fee from. But, we also have to be clear that historically for most managers, the short book has not been the return driver.

As all of you know, a couple of the biggest owner-operated hedge funds in Boston don't really short, and that's fine. You can make money in a number of different ways. They hedge their portfolio in a number of different ways.

The last thing I would like to point out is that, while I haven't seen a lot of success from the long-only managers going to the hedge fund side, there's one firm here in town that has done a great job at it, and that's Wellington.



They identify their best portfolio managers in-house, give them the opportunity to run a long/short portfolio, and most of the time that has worked out pretty well for them.

Greg de Spoelberch

When I prepared this Roundtable, I found it interesting that a lot of the hedge funds or alternative investment managers here in a way seem to be in the weeds. They are just not visible. They are not marketing. They are not out there.

At an Opalesque Roundtable here a couple of years ago one of the participants said *Boston is more of an investment focused town and not a marketing-driven town.* That seems to be the case. What is your take on this issue and why is that? How do you market?

Benjamin Deschaine: Boston is a funny town in that regard. There are some very large hedge fund firms here that most people forget about. I think one of the most common ones is Bracebridge. If you ask people where they are located, they would scratch their head. There are several billion dollar plus firms scattered around Back Bay and the financial district, that I think people forget about.

I think that's the case because for whatever reason, some of the hedge funds in Boston have really raised a lot of capital relatively quickly, and they have the luxury of being closed and keeping themselves off the radar.

The hedge fund managers that I know and have met in Boston, the ones that are actively raising capital, tend to be a lot less promotional, frankly, than the managers in New York.

I spent two years at Sabretooth, which was a fund seeded by Tiger Management, and there's a lot of flashy, very loud people down there. In New York, given the number of hedge funds, you have to be that way. You really have to make a bit of a fuss to get noticed. There's a lot more people looking to get money.



Whereas in Boston we have a fairly robust hedge fund community, but when the hedge fund analysts from the bigger firms come to town, they will already have their short list of funds that they typically go see, so as a manager you may not have to be that much out there, as you called it.

Boston strikes me as that community where if you are a hedge fund manager, you kind of want to keep quiet a little bit, keep things to yourself. That has always been my impression of the managers in this town.

Kevin Maloney: We at Gottex are looking at the global industry, so we see a lot of things across a lot of different regions. It is often much easier to market outside the US than it is to market inside the US, so that can be a significant constraint on hedge funds. If people have the luxury of having started their funds a while ago, they may now have a loyal base of investors who like their process, they may have enough assets to keep their focused team, so in essence they may not feel that they have to do too much marketing, because the compliance and regulatory burdens in the US are just enormous.

I know even for our firm, the vast majority of our products are not distributed in the US. We have one US distributed product today. The compliance constraints on writing commentary, preparing a fact sheet or producing other marketing material are enormous.



That is probably one of the reasons why people don't actively market because regulatory compliance people can fine you for a lack of disclosure or disclaimers "on page 37" of your presentation.

Jason Brandt: Boston being more of an investment town and not a marketing-driven town was a major reason for our decision to launch our U.S. operations here. Boston is one of those cities where you really need to have boots on the ground in order to do business here. I agree with Ben that New York, and arguably Chicago, are much more gregarious in nature.



Boston fits nicely with our corporate personality as well, in the sense that we're not a big marketing organization. We've grown very organically, in large part, through relationship building, and one of the easiest cities to do that is here in Boston. It's a very tight knit community and we felt like in order to be successful in the Northeast, this is where we needed to be.

Greg de Spoelberch

Do you think that will help you differentiate your fund service practice?

Jason Brandt

I think in some ways our location can be very attractive. People that value greater access and transparency in their relationships with their service providers can have that. For many of these firms, if they want to see us, we're just down the street, our doors are open, and they can come in anytime. This can be a key point of differentiation for us. You can't offer that level of access and in-person interaction without being nearby.

Robert Welzel: Kevin mentioned that in the US it can be very difficult to market an investment product. Europe is getting more-and-more difficult too, especially with the introduction of the AIFM and abandoning private placement regimes. UK and Switzerland are still quite relaxed, but, for example, marketing to Germany and other jurisdictions is getting tougher.

On the other side, just a few weeks ago, the German insurance regulator introduced a new decree that insurance companies can invest up to 7.5% of their portfolio into hedge funds without further regulatory restrictions. Starting next year the larger insurance companies due to the implementation of Solvency may invest upon their own risk analysis into hedge funds, even beyond the 7.5% ratio.

The current regulatory landscape is bifurcated, alternative investment managers can enjoy better investment opportunities with big-scale regulated institutional investors, but on the other side they have to comply with a more stringent marketing regime. In fact, we hear concerns from the investor sides that they may be de facto limited to get access to the small and mid-sized hedge funds. On the other side, hedge funds, especially new managers, may struggle how to approach these potential new investors and how to bridge the regulatory gap. I think there are smart and tailored solutions required.



Ross DeMont: We have talked about how Boston firms may be marketing differently than other firms, but I would just add that it's important to *note how marketing has changed over the last 10 to 15 years*. Going back to the formation of our fund, at that time marketing was more about how talented the team was and the strength of the returns. Those things were really paramount back then, and each investor was trying to find the next great team.

Today, the conversation starts with compliance and organizational depth and returns are often secondary.

The most important aspect for allocators is making sure that the organization they are investing with has built a solid infrastructure.

I might also add that earlier in our conversation we were a little tough on some of the long-only guys coming over to the hedge fund side, but I would say that *the traditional long-only business is very well equipped for managing portfolios in a regulated, highly compliance-driven environment*. So from that perspective those firms should actually adapt pretty well to this new environment.



Greg de Spoeelberch

So one of the major takeaways is that for a number of reasons, marketing has become an even bigger challenge today. Would you like to talk a bit about your own investor base, and how you appeal to them with regard to the value-add of your firm and strategy?

Kevin Maloney: I would say that our investor base has changed dramatically because more-and-more investors basically decided that fund of funds are not the way they want to go at the end of the day.

When I first started in the industry, hedge funds were mystical things, and allocators, including the investment consulting firms, felt very ill-equipped to research and invest in them professionally. As a result, they wanted to hire specialists who could speak the language, who could help them navigate their way through all the strategy nuances and the structural issues associated with hedge funds, and fund of funds had a very natural way to do that for them.

Within the general area of marketing and distribution, another thing that has also become very clear is that large end-investors like public plans and private pension funds are amazingly fee-sensitive these days. *It used to be that you could just say, net-of-fee returns matter, and if you delivered solid net of fee returns, everything was fine*. Today, investors have to report so many things about fees. That is literally one of the first questions that gets asked before they even want to know what your strategy is or what you do. This is a dramatic change.

The investment consulting firms have also gotten smarter, although I think they work on a timeframe that may not necessarily fit with what some of their end clients want. I think they've professionalized basic due diligence. I know that sounds really important, and it is. But they don't spend as much time doing what I think our job really is, which is to ask, "Not only is this a good manager, but is this the right time for that kind of strategy or how does that kind of strategy fit within an overall portfolio." I think a classic due diligence process doesn't really capture that. It's more about how many people do you have in your compliance department? What's the investor concentration? How qualified are your compliance people? We have to do that too. We obviously do this as part of our evaluation of a manager.

One thing that we always try to determine is if a fund has the right strategy for the market environment, and if they are one of the best managers in that space. This is more important than determining that "this is a good manager because they have 50 people in their back office and there's not going to be any risks associated with checking that box." Excessive focus on those issues is why you see a huge concentration of assets to this business these days.



Benjamin Deschaine: The asset flow to hedge funds these days continues to go to the largest managers, and that has created a very interesting and unique opportunity for our business.

We have always been focused on smaller managers since we have been in the business. We really think that this is the area of the market where you can add the most value. It is in this segment of the market where you are likely find managers who truly take an active approach, in inefficient strategies, in different asset classes, and we think that's really what drives alpha and performance over time.

But, as more institutions move into the space, they are also changing the hedge fund landscape. It's not the same business it used to be 10 years ago, because, as we already pointed out, they are looking and therefore demanding all of these other things, like: "How is your compliance? What's your risk management?" I'm not saying that those things are *not* important, but as the industry's focus has shifted so significantly, certain other, special traits and strengths of the hedge fund community have been negatively affected or weakened in a way.

At Balter, we have recently made a commitment to the mutual fund business because we see a big opportunity for small and mid-sized managers. This is largely due to the fact that the capital raising mechanism for small or mid-sized hedge funds is broken. In the past, a manager was able to start with say \$25 million in the form of a seed investment or via friends and family capital. Then they would access high net-worth individuals which got them to a \$100 million or more. From there the small and mid-sized fund of funds would get them to \$500 million or higher. Today, funds are still launching with \$25 million but the high net worth investors are tapped out and the small and mid-sized funds of funds no longer exist the way they used to. Pensions, via their consulting firms are looking to invest in funds with large capacity so you end up with this phenomenon where the big funds keep getting bigger.

In our business, we have relationships with a lot of managers in the \$25 to \$100 million asset range and we're reaching out to some of them to run mutual fund money. The tradeoff is that we are offering a fixed fee which naturally some people are open to and others aren't. For those forward thinking managers it's really a way for them to diversify their businesses, have a foot in the growth of liquid alternatives.

The reality is that *a lot of investment advisors are moving their assets this way*. As the options get better, they are building portfolios of alternative mutual funds instead allocating to traditional hedge fund of funds. The liquidity is a nice option but it's not really the driving factor we find, investors like the lower fees, and the fact that they get a 1099 instead of a K-1. Sophisticated advisors also like having the ability to build a portfolio around their specific client needs, rather than buy into a one-size fits all solution. Liquid alternatives give them the flexibility to do this. We've seen this shift and it's something that we're definitely changing our business around.



On the traditional hedge fund side, we are still very active there but we're really changing our requirements. If you want to charge 2 & 20 or 1.5 & 20, you really need to be able to justify being in a limited partnership structure. We tend to lean towards more esoteric, less liquid strategies where the manager requires an LP structure. This allows us to build a bar-belled portfolio of liquid and less liquid strategies. *Frankly, on the long-short equity side and a number of other different strategies, we're getting better results from the liquid alternative side, and that's largely due to the fee arbitrage, if you will.*

Scott Utzinger: The long side of our book focuses on owner-operated companies. We define that as a company where senior operating executives get a heavily disproportionate share of the value they extract from the company from their personal equity ownership rather than from the cash compensation they pay themselves every year. We've created a unique metric to gauge how "owner-operated" a company is; it requires thorough analysis of proxies and understanding who runs the company, what they pay themselves, and how much stock they truly own.

This characteristic of our long book really resonates with our investor base, undoubtedly in part because of the intrinsic logic of wanting incentives aligned with your portfolio companies but also, unquestionably,

because so many of our current investors are high net worth individuals and family offices who can relate to running their own businesses that way. We also tend to operate the Fund in a tax-efficient manner. Taxes are not the primary driver of our investment decisions, but we always try to be tax-aware. As partners, the majority of our own liquid net worth is invested in the fund, and most of our clients seem to share our desire for tax-efficiency if done smartly.

Regarding fees, we spent a lot of time before launch—possibly even too much time—thinking about the right fee structure. We did not want to slap on a 2-and-20, take-it-or-leave-it price tag; rather, we wanted to be more thoughtful and make sure we were attracting like-minded investors. We also didn't want investors to feel like they were paying us to just sit on capital. We ended up choosing a 1-and-20 standard fee structure, but we added a hurdle rate and also an incentive step-down for investors willing to commit capital for longer than a 1-year lock.

We get lots of compliments on our thoughtful fee structure, but in the end, I must admit that it doesn't seem to be top-of-mind for most of our investor base today. If anything, our current investor base seems more focused on making sure they're getting Crawford's best deal than they are on what that deal is per se, i.e., they want to be treated fairly, but *they are choosing Crawford for our product and performance, not for our bargain fees*. Maybe this will change as we grow and interface more with the largest institutions, but so far, bargain-hunting and intense fee negotiations have not been Crawford's experience.



Luis Cortez: I have to say, I can't give you the right answer about what the "right" fees are. But the entire industry is changing, not just how we manage, but also how we market and how we differentiate ourselves, and also how much we charge for our services. We're in an appearance transition – I don't know what the right answer is.

The tag that we have taken is that we have to listen to our customer base, our client base and reach some type of medium. We do have to justify why we charge 20% of gains, is just the way it is. We view it as our incentive given our own moneys in the fund and we work for our clients. There is an incentive for us to perform much better than hurdle rates, than benchmarks, than what they can do alternative in the marketplace.



But, again, I think we are in a period of transition. I don't know what the answer is, or if the answer is two and twenty or one and ten. I don't know if the answer is fixed fees. But we do believe in what we do. We want to make a long term business out of it. We're going to go through the transition period just as much as everybody else and we will continue trying to figure out what works best for some clients. Generally, want to charge what is fair for our services and also embrace transparency around the fee question.

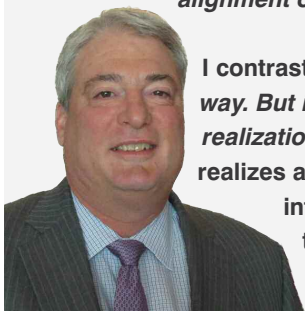
Benjamin Deschaine: Scott has a very enviable client base. We have spent a lot of time talking with potential investors, and fees are probably the number one topic on their list across the board. We believe the long-short equity fund that we manage in the mutual fund space offers extremely high quality hedge fund managers at a deep discount to their LPs, and it's still considered too expensive for some advisors out there. This is a flat 2.19% expense cap, so it's a relative bargain given that the money is managed by an active hedge fund manager. That's not to say that there aren't a lot of people who really find it very attractive, but there is a large portion of the market that still finds it too expensive, although that seems limited to traditional mutual fund investors. So we're seeing tremendous push back across the board on fees and our client base is predominantly high net worth individuals and family offices.



Kevin Maloney: One of the things that I always found intellectually interesting about the fee structure is that investors are willing to pay for alpha, but they have no idea how to measure it. As a result, they end up evaluating total return. The easiest thing for hedge fund managers to do with their incentive fees is to put it on total return, while for the investors the better deal would be to have a structure that rewards alpha as opposed to total return. But that's a very hard thing to do.

Another issue is that everybody thinks that high watermarks are good things for investors, but in reality they are options for fund managers, unless they have claw back mechanisms when you are below the high water mark. It's very hard to structure something that is simple, explainable, and that creates the right incentives. *The industry has always struggled with balancing the correct incentives versus simplicity of the calculation.*

We have negotiated fees as you might imagine with investors and with funds in exchange for chunks of capital. They often have complex fee structures in them, but we can only do that in a separate account. Funds cannot easily do this in a commingled vehicle, because it is very difficult to apply with money coming into and out of the fund. But I do think *the standard fee structure in the hedge fund space has always been something that has not delivered the right alignment of interests.*



I contrast it with what private equity firms do. *Private equity firms do pass on lots of expenses along the way. But if you look at their incentive fees, they have a hurdle rate and they only apply incentive fees on realizations. They don't accrue the incentive fee and pay it every year or every six months.* If an investor realizes a gain above the hurdle rate, they pay an incentive fee on that. There's a natural alignment of interest in that case and it leads to a long-term partnership between the private equity firm and the investor.

Jason Brandt: We have seen similar situations from a service provider perspective. Everyone is fee-sensitive and it's very difficult to find the optimal combination of low cost and quality service. One or the other must be prioritized.

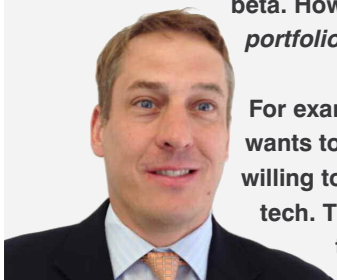
The hedge fund lifecycle is much different now. Whereas in the early 2000s, a manager could hit their personal economic benchmarks in 5 years, now it may take 10-15 years. Managers are becoming less willing to live with the pain being caused by a service provider for a long period of time. Now, the focus is on re-addressing it. A sizeable portion of our business is conversions from other fund administrators. Again, everyone is still very fee-sensitive but now there is a greater understanding of the quality and long-term growth benefits that come with a potentially higher cost option.



Greg de Spoelberch

Let's look at some of the opportunities you are seeing within your specific strategies over the next 6 to 12 months or beyond.

Ross DeMont: We are in a six-year bull market, so it's getting harder to find value in the market. For us, that means we need to seek out highly idiosyncratic situations and find stocks where there are just fewer eyeballs and ideally less beta. However, *our previous experience has taught us not to compromise or reach just to fill our portfolio.* We have continued to maintain our price discipline and our deep fundamental research.



For example, we have come across some discarded names in spaces like energy services. Nobody wants to touch energy services except maybe those investors who are swimming against the tide or willing to own "the best house in a bad neighborhood". We also continue to find investments in small tech. There are lots of dislocations in small technology with some winners and many losers, and therefor plenty of stocks to go long and short.

Currently, we're seeing larger companies with somewhat inflated valuations get very aggressive on the M&A front. This can really work for investors in small companies given that often the best end game for many of these companies is to someday be acquired by a mid-cap or large-cap. So hopefully, if we can play those themes, we can be successful this year regardless of the market environment.

Scott Utzinger: We have a very similar feeling. We like to say that now we have to turn over a lot more rocks to find the gems than we did a few years ago or even just a few quarters ago. But we are fine with that; after all, it's what we do—dig through rock piles to find the gems!

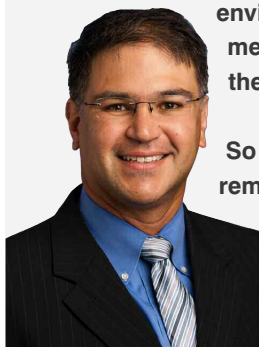
Similar to how Ross expressed it, we are also trying to find more uncorrelated ideas, more special situations. Good companies at good prices are still the bulk of our portfolio, but the market has also handed us new themes recently. One such theme is names that have sold off too much on foreign-exchange exposure. The effects of a strengthening dollar are real, but like many real phenomenon, the market is prone to overreaction. There are quality companies that have really gotten hammered for a currency-driven earnings miss despite still being great business, i.e., babies getting thrown out with the bathwater, and we've added a couple of those to our portfolio.

On the short side, we're actually finding an increasing flow of attractive ideas—some new and some recycled. In the “new” bucket, there have been hundreds of IPOs during this protracted bull market. A few have already become leaders in important new industries, but others are also-rans, products of a zealous venture and banking machine that capitalizes on hot themes to bring occasionally questionable companies to market. Many of these me-too IPOs won't survive as public companies and will be de-listed within a few years. Crawford has developed a systematic approach for identifying the qualitative and quantitative characteristics of those young companies that are most likely to fail. That hunting ground has become very fertile of late.

In the latter bucket, recycled ideas, we were very negative on energy for a long time, bleeding modest put premium for more than a year before our hand-picked basket of put options on the worst E&P energy companies really lit up in Q4 2014, contributing meaningfully to Crawford's 2014 performance. But the oil and energy-sector bounce-back since its October 2014 lows has created another wave of opportunity. We've seen some really sketchy companies—companies which were hemorrhaging cash even when oil was at \$100—whose stocks have now bounced back dramatically even though their odds of bankruptcy over the next year or two remain high. In some cases, we have re-initiated negative positions on the same companies where we harvested gains in Q4 2014; in other cases, the opportunities have come in new names within the same theme.



Luis Cortez: Life sciences has enjoyed a good long side of the trade for the past couple of years, and I think that has been well-deserved. There was a reason for that, and I believe there's still a reason for that. However, the expectations that we have today in a lot of the names to realize their promise is a lot higher than it was three years ago. But the tailwinds that I could have articulated three years ago are still there. We still have a regulatory and micro-environment that is benign. We still have innovation that had been funded through private or public means for many years, and now we are at that cusp. We also have significant product cycles towards the beginning or the middle end.



So all of these positive factors are still in place; however, we do expect that regulatory environment to remain benign regardless of what the product is. We now do expect the continual funding of those ideas and innovations to continue to be benign and behind those factors. We also continue to see or we expect the productivity of the whole industry to remain at the pace that has been in the past 18 months – and that's where the risks are.

There are just as many good ideas as there are risky ideas, and that's how we see it. I think we are at a point where we need to discriminate a little more, where we need to understand the risks that we're taking and understand the things that we don't know. Those are the things that when we're wrong, the capital at risk is much higher today than it was before.

So I still see the life science sector as a good sector to be in or to invest and to look for ideas, I just think that the risks now are much higher and you need to understand it and you need to have a strategy that deals with the risks. In a very research-intensive specialized area like ours, when expectations are very high or where the probability of the expectations now being made is pretty high, you can also differentiate yourself by better understanding them, and take advantage of those.

Given the risk of just repeating, what we all know from our lives is that we'll continue to spend money on healthcare and we'll continue to innovate. We've all heard about all this great new areas of gene mapping, gene editing and harnessing the immune system to fight cancer. Probably a lot of us saw the PBS documentary by Ken Burns on cancer. We know all the reports that we see in the news every day, and we live here in Boston where we know that a lot of our businesses come from the life sciences, so a lot of that is right in front of us. We have great academic hospitals here and great services, innovation and academic institutions. Healthcare is part of our lives and will continue to be part of our lives, it's a sector that represents or has a lot of good opportunities for investment. While it's true that where we are today is not where we were three years ago, but I still think that it's a good investable area.

Greg de Spoelberch

Luis, do you change portfolio concentrations and weightings in an environment like this?

Luis Cortez: I do, yes. It's following the risk parameters that we see more than anything else. There are studies that suggest that *when you're in a bull market, you concentrate*, and we follow the Janus model. When we're not in a bull market and in a bear market, we don't concentrate. That said, it's within a pretty narrow band and in sticking to our overall process that's been in place for many years.



Greg de Spoelberch

Let's continue to focus on this theme, and look at the various processes in your portfolio construction and research.

Ross DeMont: Having come out of the mergers & acquisitions and private equity disciplines, our process is highly focused and rather protracted, maybe sometimes too protracted because the equity markets can move pretty quickly. It takes us anywhere from a month to three or four months from the moment we start underwriting to ultimately buy the first share of stock. We only have 15 to 20 core longs and 20 to 25 core shorts, so we don't have room to dabble or to make mistakes. Therefore, we have a very long process in advance of buying that first share.



Our personal capital invests side-by-side with the money of our limited partners. We want to be able to say to them and ourselves that if we put dollar one into an idea, it will be very, very thoroughly researched.

There are about 2,000 public companies in our cap-size range of roughly \$100mm-\$2.0bn. The reason our strategy works well in this environment is that we only have to find one, two or three great investments per quarter, so we don't feel like we have to own the broader market. A team with our experience that works hard, travels a lot, and meets a lot of management teams should be able to find a few attractive investments each quarter.

Another interesting dynamic is that now that Midwood has been in business for more than a decade, we are able to recycle previous ideas. For example, one of our largest longs at present was originally a short that we made money in years ago. Conversely, one of our current shorts was previously a long where we did very well.

This is a wonderful facet of public equity versus private equity: public equity constantly recycles, re-prices, and provides repeat opportunities.

Luis Cortez: We are fundamental investors, so we do exhaustive and somewhat unique research. Our process is geared to identifying companies in the early part of their growth cycles and to take advantage of either high skepticism or other confidence in the market. Because that's what we say we do, our process is geared towards identifying those lead indicators in those growth cycles and such we are very fundamentally oriented.

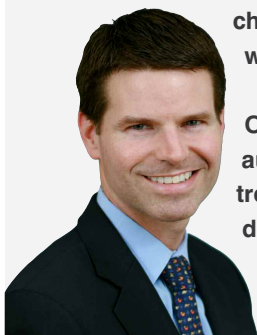
We also know that there are things that we can look for in those areas. We can look at balance sheet measures. We can look at income statements and cash flow measures that usually point to, for example, a flex point in the cycle, either on the way up or on the way down. So we look for those ideas or themes that are early in their life-cycle. We look for those inflection points and fundamental change and then, after generating those ideas, we do our exhaustive and intensive fundamental research on the companies, generate our own internal projections, and that's how we know how we differentiate ourselves from the street, what is our edge. Specially in the life sciences I believe that there are a lot of inefficiencies that we can take advantage of by doing good fundamental research. By having a good understanding of the science and using our expertise in the sector from our many years of being involved in healthcare, that's how we can generate the best returns and put together a portfolio of our best ideas.

Our highest convictions are ideas based on how we differentiate ourselves from the street; the gap between our expectations and the street expectations and the sustainability of that inflection or that growth cycle. That's how we put our portfolio together, and we also understand that we need to have a risk management policy in place because of the sector that we play in and our style.

We know that we can pick the stocks. We are very confident that we can generate the ideas. We just also need to understand that we can be wrong, because when we're wrong, we pay dearly in capital and performance. Therefore risk management, for us, is extremely important.



Scott Utzinger: Crawford takes a multi-stage approach to idea-generation, research, and portfolio construction. We are hunters, not farmers, but we'll go anywhere and look at any industry when we see company characteristics we like. We need to be very efficient at quickly weeding out unappealing ideas so that we



Our next stage is to take the most attractive prospects from those high-level screens—importantly augmented by other ideas that come from our team's voracious reading and study of business, trends, and markets—and determine which of this combined list qualify under Crawford's unique definition of an "owner-operated" company. I've already mentioned this owner-operated concept, but to reprise, it entails making sure that the key operating executives are incentivized far more by their outright stock ownership than by their cash and/or options-related compensation.

It is a relatively time-consuming process because it can't be downloaded from a database; nonetheless, it's vital to our work, it's differentiated, and we've been doing it so long that we already have at least some knowledge of most of the roughly 1000 companies that qualify as Crawford owner-operators.

From here, the resulting ideas are subject to a series of fundamental research exercises, each of which weeds out low-probability prospects and leaves us with a smaller group of top ideas on which to carry out deeper work. We read annual reports and 10-Ks, we meet with managements and listen to their calls, we talk to clients and competitors and study customer feedback.

The result of each individual analysis among the approximately 25 favorable characteristics we care about is a score (1-10). If it's a qualitative attribute (e.g., management quality, communication/transparency, product quality), the score obviously entails subjectivity, but that doesn't stop us from assigning a number. With both engineering and business backgrounds, we believe in the value of systematizing what tends to be a very emotional process. This is very different than saying we are quantitative investors; rather, it allows us to be consistent in our evaluation of all factors—quantitative and qualitative—across disparate types of companies, and it reduces the tendency to be overly influenced by *recency and frequency biases*, both dangerously prevalent across the investment industry.

All of these scores go into a framework, culminating in an aggregate score for every company in the portfolio and every company under consideration for the portfolio. The valuation score, the largest weighting in the framework, is constantly changing, while other scores change much less often. The goal is to find ways to upgrade the portfolio by swapping the lowest-rated names we do own for the highest-rated names we don't own when those swaps can also upgrade the expectancy of the portfolio and/or decrease the overall risk. It's a constant tournament of sorts, but the framework and scores ensure that we are only trading for something truly better, not simply on noise or emotion.

The last thing we do before actually sizing a new position and putting it into the portfolio is that our *Chief Compliance Officer* runs what we call the *Failure Flags*. Most of our team's work up to this point has focused on characteristics we like in an investment, but there are also characteristics we want to avoid. Every investment has some hair; if it didn't, it would be priced to perfection. But too much hair can signal a likely torpedo. We evaluate each final-stage idea on 20 characteristics which experience has taught us are bad in an investment. Once again, it's a mix of qualitative and quantitative items. If a company checks more than 5 of those boxes, our CCO tells the PM not to make the trade. Extensive experience with these Failure Flags indicates that we can avoid many multiples as many losers as we miss winners by sticking to this discipline.

Kevin Maloney: I agree that risk has to be at the center of investing. Just to add to my background, I used to be a professor, so I came at things from a quantitative perspective. I worked at Putnam, where I ran a quantitative research group for a while. So it's very natural for me to think about risk in a traditional sense of the factors that drive returns, etc. That is really important, so we try to pay attention to that and try to collect that information from the underlying funds and bring it together so we really know from an aggregated perspective where we stand.

However, it's the things that you can't capture that way that really matter in this business these days. One of the things, I am going to ask the others to discuss is "crowdedness of trades."

A couple of you have mentioned M&A. For the last few years, it has been a great environment for generating returns from events, broadly speaking, whether it's M&A, restructurings, et cetera. I think everybody would generally agree, financing is cheap, and it has become more accepted in many countries – for example Japan comes to mind as going through a sea change in terms of corporate governance these days.



It's becoming increasingly clear that shareholder friendly activities are being rewarded in the marketplace. Combined with cheap credit and lots of liquidity around, that's a good environment for an event.

What you have seen however is that *event-driven strategies haven't done great on a risk-adjusted basis*. They perform really well for a while, and then all of a sudden you get these air pockets, which come from a natural consequence of this investing style – individual names get very crowded. When people start to exit, these air pockets are the result.

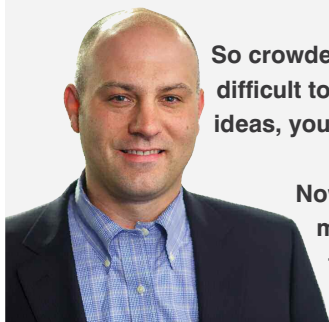
We are in a marketplace today where the depth of liquidity, I think, is challenged by a lack of capital backing trading desks. That is the certainly the case in credit markets, but maybe not as much in equity markets.

Hedge funds investing in event themes and quantitative funds investing in momentum names lead to crowded trades. You saw this in technology, for example, in the second quarter of last year, when serial winners that everybody liked fundamentally got really crowded, and then all of a sudden, they all sold off violently. People hit their stop losses, and more selling ensued.

This crowdedness phenomenon, which is almost impossible to quantitatively measure, has become an increasingly large risk factor in the hedge fund market space. I would love to hear from the others your thoughts about this. How do you think about that risk in your business, how do you measure it? Do you worry about it, or maybe you just say, that's a mark-to-market event. If I have the right companies, I will just last through these periods, which is perfectly acceptable, if that's the way you think.

Benjamin Deschaine: This risk that you identify here is a risk that has been at the forefront of my manager selection process for as long as I can remember. Part of the reason why we focus on smaller managers frankly is to avoid the risk of crowded hedge fund trades. *I find that the crowded name risk tends to be more prevalent with funds that have of a lot of analysts.* This is most likely the case because they are looking for an idea that moves the needle and they idea shop with their analyst friends, that work at other hedge funds and all of a sudden there's this one thesis on this name that everybody owns for all the same reasons.

Whereas, at smaller firms, like the people around the table today, the portfolio managers are effectively the analysts making the investment decisions. They have built a process, and for us, that is crucially important. But there are many hedge funds today where the investment process, as far as I can tell, is to go to as many idea dinners as they possibly can and build their idea pipeline that way.



So crowded hedge fund risk, for me, is the number one concern when investing with a manager. It's very difficult to quantify that, but when you speak with enough managers, you have enough calls about ideas, you get a pretty good sense of who is in the crowded trades and who is not.

Now, there's always some left tail risk that you are not thinking about, but this idea of hedge fund managers all owning certain events or certain names is just right there at the top of the things that we are concerned about.

Luis Cortez: Ben, actually I was going to make the same comment on that, and this is especially true for the life science sector. What I like to say, and I can't take credit for this phrase but I like it, is that *I am not in the business of information arbitrage. I am an investor.*

In the life science sector, everything is probability oriented and scenario analysis. A lot of the events, even if you really feel good about them and the probability is 90%, there is still 10% that can go against you.

We make it a point in *making an investment for that product cycle or that inflection point in a fundamental change, not because I know what's going to happen to a trial, a clinical trial, or because I talk to one doctor that identified one product to be better than the other.* That happens in my sector a lot and it gets to be crowded. They all go to the same dinners. We all go to the medical conferences. We all listen to the same doctors. We all are in the same presentation. There is that risk of all arriving at the same conclusion.

But a big reason why I can't do the information arbitrage game is because I understand that if I am in the group, or if I am invited, or if I have access to that information before everybody else, then I will be the incremental winner. And the day that I am not, then I will be the loser.

When I cannot attend a medical conference, then I would be a loser. When I am not invited to a dinner, then I will be the loser. *That's not, in our opinion, what investment is about.* It's not getting the information before somebody else or it's not getting the same information as somebody else. It's making the investment and understanding where you get your returns, what are you good at, what can you repeat year in and year out, what is the process that got you there three years ago, two years ago and five years from now. That's what we do, and the reason why we say, we are not in the business of information arbitrage, we are in the business of investment.

This is the way we manage, what we do. We have price targets on the upside and on the downside, depending on different scenarios. We do have different probabilities of success for our assumptions, for our expectations. We also understand when our projections are now consensus projections. If consensus is wrong and then we are wrong, as a result we take more risk in that position.

So we manage it by understanding what the expectations are for the event or for the process or the particular product cycle. We understand our valuation parameters and we are disciplined in understanding that if our thesis played out and the gap between our expectations and the market's expectations has closed and we have achieved our price target.

There are still 3,000 life science public companies out there. We only need to own about 50 in our portfolio, we believe we can find one good name out of 3,000 to put in our fund on the long or the short side.



Robert Welzel: This is a very interesting conversation about the important issue of risk. I just like to add here that AIFMD and other global regulatory initiatives include a lot of transparency rules so that ultimately the investor and probably also the regulator itself can establish sufficient risk models.



It will be very interesting to monitor the learning curve of new investors in alternatives, especially after the new German investment ordinance has opened up 7.5% of insurance companies' assets for alternative investments and will further reduce regulatory restraints with Solvency II.

Kevin Maloney

Isn't it true under Solvency II that the capital charge or risk charge is radically different whether the underlying investment gives position level detail or not?

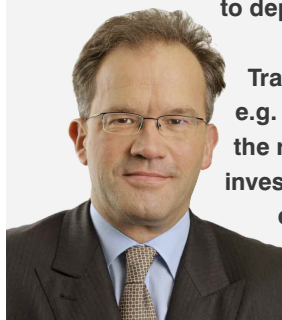
Robert Welzel

Yes.

Kevin Maloney: It's as simple as that, right? If you give up all your positions, then the insurers will be able to invest in you and not have a big capital charge. If you don't, they will be much more restricted. This is the weirdest thing in the world, because most of the best people around the industry won't give position transparency because that is the intellectual edge.



Robert Welzel: Based upon Solvency II, insurance companies have to provide for risk capital, and the question is how to deploy such economically expansive risk capital to their various investments.



Transparency is an essential feature to reduce the required risk capital. If an in-transparent entity, e.g. hedge fund, does not provide for sufficient information, this will trigger such a negative impact on the required risk capital on the level of the investing insurance company, so that most likely no investment will take place. Whereas, if the investor get e.g. access to the underlying names, it can employ its own risk analysis and modeling and this approach will most likely reduce the specific usage of risk capital substantially.

Kevin Maloney: It used to be the case that if a hedge fund gave up their positions to a third party risk aggregator, and then the risk aggregator could specify to the end client like say a pension fund the fund's factor sensitivities and other risk parameters. The end investor would not get the individual position names. That satisfied lots of people and firms like ours at the end of the day.

But this Solvency II regulation is the first one where in fact they say, there are two levels, just purely getting to the risk factors is fine. But you will go from exorbitant capital charge to a modest, much smaller one if you give up the positions. That is in fact very challenging to the hedge fund business in general because the managers don't like to give up their decisions, particularly on the short side.



Robert Welzel

This might be the case, however we recognize that insurance companies with significant investments sometimes already get access to enhanced transparency - even on position level - from some hedge funds to populate their own risk models.

Kevin Maloney

I know this is the case in Switzerland. I am pretty sure, because a member of our Board is a senior executive at Swiss Life, and this was one of the things he said. Fund managers have to be ready to give full transparency if they want to have insurance clients.

Ross DeMont: I might just add that as a firm we certainly try to use quantitative measures of risk. Given we have north of ten years of history and there is a lot that potential investors can learn by analyzing our data. But, there are certain types of risk and behaviors that can be hard to measure just by looking at the numbers. For example, how can allocators predict how I, as a portfolio manager am equipped to deal with certain situations? What do my behaviors demonstrate to you about how I manage risk?



It's not as simple as a risk model and its numerical outputs. *Can you measure how much conviction we have in our investments and how we have built that conviction? And is that conviction based on deep knowledge or stubbornness?*

Can you predict my most likely response to a downside move in a stock? Some managers just sell and say, “I don’t know this situation.” That’s not necessarily a wrong response. I think for us, we are more likely to be a buyer, given our depth of research.

Another question might be, if there are 50 investors in a stock and the stock is down 20% on a given day, with which investors will the CFO be willing to engage? Which investors have spent the time to build a relationship with management? That’s a form of risk management; the ability to re-underwrite a situation quickly in the face of stock dislocation.

And yet another form of risk management is paying the right price for your investments. I know that’s sort of a circular argument, but if you don’t overpay for things, over a long period of time you will outperform because you are taking less risk. If you have \$3 of upside or more for \$1 of downside, if you can find that asymmetry, that is a form of risk management.

So again, *risk comes in many dimensions*, and not all are numerical. Some people look at it through a different lens, but for us, buying asymmetry, being able to get the CFO on the line, having high conviction of what we own, those are all elements of risk management. These elements have proven beneficial over time and demonstrated themselves in our returns, but can be difficult for outsiders to observe.

Jason Brandt: One of our key deliverables to our clients is helping them to mitigate their operational risk, whether it’s dealing with valuation, dealing with their investors, or with the audit, for instance. We also spend a lot of time helping to manage operational risk.

The little things can really make a big difference. Something as simple as having the proper notifications and alerts in place, whether it’s alerting investor services about a pending redemption or contacting the managers to let them know they might be getting overly concentrated or have breached a certain exposure limit, can offer a huge layer of protection for them.



Kevin Maloney

Do you think we will ever have an exchange to get out of this whole contract note business to an electronic fund settlement? How far off do you think that is?

Jason Brandt

Technology wise, it’s probably still another five years out at least, but there will likely be an electronic application that will allow investors to communicate subscription and redemption requests.

Kevin Maloney: I think that in the hedge fund world, one of the biggest sources of operational risk is the whole delayed contract note redemption process. Every other part of the capital markets, maybe with the exception of private equity, has worked towards shorter settlement periods with capital behind the settlement process to make it less risky. In the hedge fund space you put in a redemption, then you have to wait X number of days until it gets processed and then wait another Y days until you get payment. There’s actually a lot of risk over that whole time period. It’s very infrequent, but costly if something happens.



Jason Brandt

I agree, if it happens it can be very costly. I don’t think it’s that far off again, because you have so many different service providers that are playing in both the alternatives and the 40 Act space with respect to the U.S.

Jason Brandt: They are used to it. It's continuing to evolve. I think as a smaller administrator, we have been able to focus on areas where we gain greater efficiencies and mitigate further operational risk, especially as the regulatory environment has cooled off. A big one is the investor services aspect of it. For example, how can we have an online subscription process or redemption process to eliminate the manual processes? This is still a few years out but we're certainly on the cusp of more advances in this area and hopefully that will start to trickle down to other service providers.



Kevin Maloney: Can I ask another question? I made this point before of capital market liquidity when we talked about risk. I am really interested to hear more about how you feel about liquidity. *Every central bank in the world has poured liquidity into markets, which is inflating prices, etc. But when you really go to trade something in size, are you feeling you are capable of doing that, or are you finding that liquidity can also seem kind of challenging?*



The thesis that I have is because of regulation like Dodd-Frank, the banks can't put capital behind their trading desks for fear of being classified as a proprietary trader. As a result, they have gone back to being pure agents without taking real positions, which means that the market impact and cost of trading seems to be going up. I know it's happening in credit, you can absolutely see it there. I don't know how you guys feel in the equity markets. What's your view based on your experience?

Ross DeMont: Midwood has operated in the lower end of the liquidity spectrum for our whole careers. To us, there is an art form to transacting at this end of the market, and that's actually a strategic advantage. So while sometimes I'd prefer more liquidity, other days I recognize that the ability to go source half a million shares of stock with limited market impact means we're good at operating at this end of the market. If everyone could avail themselves of all of these stocks at lower valuations, they might do it.

So liquidity is a double-edged sword and I believe it requires some specialization to participate in lower-liquidity small cap names.



Scott Utzinger: Crawford would describe it much the same way as Ross from Midwood. Chris Crawford, our PM, prefers to do most of his own trading and also sees our patience and experience as a competitive advantage. We operate across the market cap spectrum—from the occasional nano-cap up to the occasional mega-cap—but the sweet spot for our long book is in the \$1-3B cap range, where we have typically found sufficient liquidity.

The hedge side of our book can present interesting trading experiences, but the term really is "interesting" more than "problematic." We do always have some outright shorts in the book. They tend to be our larger, more liquid hedges. Most of our hedging, however, is via single-name put options. Even though we can typically find the liquidity necessary in the options markets, it's fair to say that *we are often the only humans trading in some of the more esoteric contracts*. When we place a trade, it is fascinating to watch the programs often "learn" from our order, rippling that new "knowledge" through the options-chain automatically. Usually we are able to source the volume we seek; on the occasions when we can't – or not at attractive prices – we simply back off, maybe returning later and maybe moving on. Happily, this is pretty rare.



Kevin Maloney: I think the market has become, maybe not in the last six months or so, but certainly in the two years before that, more macro-driven, so things like for example ETF trading and ETF rebalancing dominates liquidity. There seems to be far less trading based on individual insights and far more from those macro or technical factors. I agree that in some market segments, when somebody actually comes in with individual trades, it can be like a shockwave through the market. They go, "Where is that now coming from?" We know that's happening in credit and it feels like it's happening in equities as well.



Luis Cortez: I don't have a way to prove it, but I think that you are right. This also happens in the life science sector where in the mid to small cap range we also feel that at times that lack of liquidity, but then we also say that volatility is actually our friend.

While in the overall fund we aim at having a low volatility and it's true that my portfolio has that low volatility characteristic, but I actually take advantage of high volatility in my sector - I want it, and I like it. So I actually welcome if there is a lack of liquidity in some names where I feel I have the edge and I have a differentiation, because I then can take advantage of that when I apply patience.



Some people may have a misconception or a misperception of lack of patience in a biotechnology or a medical technology name, and, as I said, I take advantage of that. When I go in and I start buying a stock, I don't have a lot of people buying the same name. Just as Scott mentioned, that allows me to be patient and see my thesis play out. It's also often a confirmation that we are truthfully early in identifying those inflection points. I can take my time buying the name over the next few months and wait until the sentiment turns. That is how we use that volatility or lack of liquidity in some names to our advantage.

Jason Brandt: From a service provider standpoint we try to stay at the forefront of where the managers' pain points are and how we can better support our clients and support where the industry is moving, whether that's investor-driven, industry-driven or regulation-driven.

Regulation is still a key focus with things like Annex IV and FATCA but it has cooled off a little bit. But I'm curious to know some of the other things that you guys are still struggling with. Whether it's demands from investors for greater transparency or more frequency in transparency or greater risk demonstration, where are the pain points in your businesses today?



Ross DeMont: It probably depends a little bit on what type of clients you are looking to land. Maybe it differs for small clients, but it goes without saying that the regulatory burden is disproportionate on small firms. Therefore, to the extent that you can create efficient regulatory solutions that would be great. The easier you can make it on small firms and create plug and play options that will be of help.



Right now, often with a single regulatory change we have to reach out and touch every single limited partner to update their paperwork. That is really time consuming, and a lot of high net worth investors don't want to be disturbed. They don't want to have to take a document, notarize it and send it back to you. The regulations are asking a lot from them and they are not invested with you to have to deal with that kind of thing. If you can make it easy on us and non-disruptive to our limited partners that would be ideal.

Kevin Maloney: Let me expand on a comment I made earlier. When we started evaluating hedge funds twelve years, ago the most important things were team, pedigree and process. Those were the first things we tried to understand. Today we still have to do that, but my first look now is to check the regulatory jurisdiction of the fund and the liquidity. You have to match up all these characteristics between the characteristics of a fund offering and the constraints of our product. As you might imagine, it leads to growth in the number of funds on the approved list. A very good fund may only available in one format. And managers may not be interested in creating another fund offering in the format you may need.

That means you can end up dealing with multiple similar funds, because one may be in a UCITS form, another one in a 40 Act form, and another in Cayman form. If there was a solution for the industry it would be a synchronization of regulation with the ability for fund managers to manage portfolios without having to manage all these structures. I am sure a lot of the smaller firms spend way too much time thinking about this stuff relative to the investment side of things.



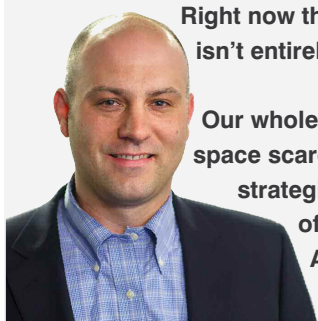
Ben Deschaine The liquid alternative solves a lot of these things.

Kevin Maloney It does at one level, but for US centric funds.

Benjamin Deschaine: 40 Act funds are only available for US investors, but they can relieve a lot of headaches investors have with LP structures. The industry is still gearing itself up and there were a lot of mistakes made with some of the initial funds that came to market. Well, mistakes might be a strong word, but some of the early products that came out maybe weren't constructed in a way that the investors wanted, but that's evolving and we feel we are at the forefront of that change.

I think once the product offerings reach a critical mass, you are going to see a lot more capital move toward 40 Act funds. With better choices coming onto the market, they are starting to put pressure across the entire traditional hedge fund structure. The biggest brand name guys may sort of ride out into the sunset collecting their 2 & 20, but it's really that next level of manager that will getting involved with a 40 Act fund where this is becoming increasingly relevant. If investors can get something in the 40 Act space that looks and feels a lot like your long/short equity fund, they are going to end up going in that direction eventually.

Right now there is still a perception that '40 Act alternatives are lower quality, and frankly that perception isn't entirely inaccurate, but every six months it's getting better and better.



Our whole goal is to bring strategies that are appropriate for the alternative space to market. The credit space scares us in that area. So we are not doing anything in there right now. But there are lots of other strategies that can fit into a mutual fund with no issues, and frankly, no offense to anyone here, 90% of the long/short equity funds that exist in the market today can run their strategy inside of a 40 Act without any issues.

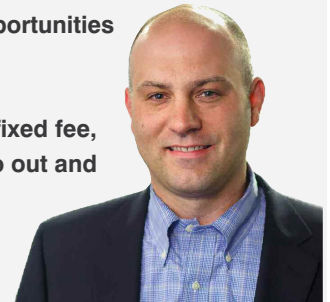
Greg de Spoelberch Are you afraid or concerned that some of the bigger players will be entering the 40 Act fund space and spin out a fund say every other month? What do you think are your advantages in a crowded market?

Benjamin Deschaine: I am not particularly worried about that. I think a lot of the bigger long only firms will give it a try, as they should. I mean, we are all capitalists here at the end of the day.

That study that we referred to earlier on took a look at long only firms trying to do just that, which historically hasn't worked out very well, largely because of the factor that Scott mentioned before about restrictions on what you can buy, restrictions on what you can short. You can't short something that you can be long in another part of the business – it gets pretty messy in that regard. So they will give it a shot and maybe there will be some successful ones but if history is any guide the majority will fall short.

I think our strategic advantage is that everybody at Balter has been in this business coming up on two decades. We have a lot of relationships with smaller managers. That has really been the bread and butter of our business, and we are not really going out there chasing down the biggest brand name funds. That is not really where we are putting our clients' capital to work, rather in that area of the market where there are firms that are run by business owners who are committed to running a smaller pool of capital, who are open to exploring opportunities in this area, where they also can continue to work for themselves.

If we can come to a manager and say, "You know what, here's \$300 million!" – maybe it's at a fixed fee, but the reality is that it adds a nice level of stability for their business. They can continue to go out and market their hedge fund or maybe launch a different strategy that's only available in a limited partnership format, one that you couldn't put into a 40 Act strategy.



Ross DeMont: We act as a sub-advisor on a multi-manager 40 Act product. We turned down a good number of proposals for similar relationships before we entered into our current relationship. It was critical that we felt we had intellectual alignment with a sponsor.

We have successfully managed LP Capital for a long period of time and will continue to do so, but we see that there's going to be a lot of growth in 40 Act. We wanted to find a sponsor who understands how we invest, who understands how we make money and outperform over time, and who will appreciate our potential alpha while being patient during the challenging periods.

I do think that some of the people who have launched 40 Act products are actually not aware of the need for this alignment. They're generally saying, "Hey, I can gather some money and cobble together some managers and we'll see what happens." To me that's not an enduring strategy. Without a deep relationship with the underlying managers and good alignment the chances of long term success seem limited.



Benjamin Deschaine: I fully agree with you. In our case, our fund is a long/short equity fund focused on small caps. We didn't believe that we should roll out with just a single manager so we could have some degree of scale. The problem is most of the 40 Act funds coming to market are trying to raise \$10, \$20 billion in order to move the needle. We say good luck to them but that is a difficult asset base to try to add value on.

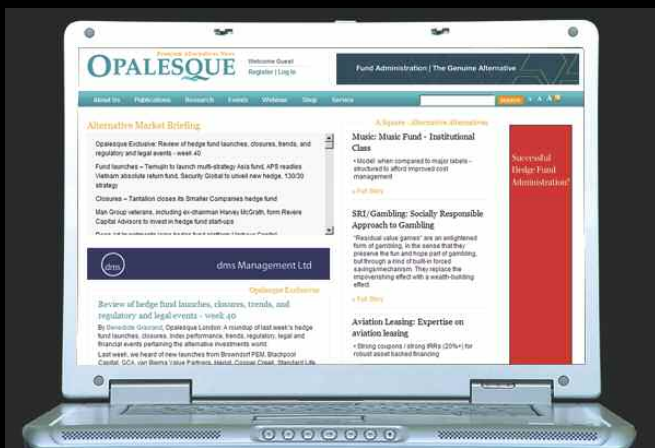
For us, if we raise a billion dollars with four, maybe five sub-advisors, that for us will be a very successful fund. We think that this vehicle frankly will outperform the vast majority of the peers in this space, because as we have talked about before, small caps are still a structurally inefficient asset class, where we believe fundamental research still adds a lot of value. So we are just taking a very different approach to many other managers coming into the space.



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