

# Opalesque Roundtable Series '15 GERMANY

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# Editor's Note

## Will the paradigm for certain institutions change to “now you HAVE to invest in alternatives”?

Many large, institutional investors have between 75% and 85% of their allocation in long-dated Triple-A or similar bonds. Whenever a bond matured, they could simply reinvest it in another 10-year Government Bond. No real investment skill was required for that, but this game has come to an end. Insurance companies in Germany, for example, have currently only 3-5% in equities. That means *the yield environment is putting these institutions with their back to the wall*. They must move sooner or later.

So it's probably a good thing a new administrative guidance on the investments of insurance companies now allows up to 7.5% of the committed assets in alternative investment funds. And by January 2016, with Solvency II, there will basically be no boundaries for insurers. As long as an insurer has the capability to measure risk, they can invest in almost anything.

**But we're running out of time.** When the current low interest rate environment continues for more than two or three years, nobody knows how many insurance companies will face significant issues. We will sooner or later read a headline in the newspaper that insurance X is bankrupt. It may therefore not be enough to allow say a 75% allocation to alternative investments. Maybe the next step needs to be to a mandate that the insurers or other investors who are in distress have to invest in those asset classes and strategies. Buying a zero yielding bond means you are just destroying assets — so maybe the paradigm has to change from “now you can invest in alternatives”, to, “now you have to.”

And those insurers are not alone. Many listed companies are now forced to contribute more cash into their corporate pension funds, which are all underfunded. As this means less cash for the corporates, shareholders may at some point revolt. And similar to the insurance companies, we may well see further acceleration of this problem.

Whatever may come, whether interest rates stay low for some more time to come or increase sooner, both scenarios need a conceptual amendment of the investment strategy of the past.

## Alternative investments are part of the solution, but still many still see them as “risky”

Most experts agree that alternative investments are part of the solution. But still, many German and other institutional investors will still have a certain fear or hesitation to use them, even if their regulations allow. For some, alternative investments are synonymous with “risk”, but of course, if you dig deeper, you will find alternative investments are not generally more risky. A lot of hedge fund strategies, for example, are even less risky than credit strategies right now, or investing into high-yield bonds.

The trend is irreversible: more and more investors invest into alternatives. Some treat them as an *alternative to fixed income*. Another approach to the alternative asset class is from a *real asset perspective*. Especially during the heights of the Euro crisis, many investors started to think about investing in real assets. A further way to approach alternative investments is to build a bucket in a portfolio that seeks *pure diversification*. Alternative strategies like Global Macro, Insurance Linked Securities, Equity Market Neutral and CTA strategies are usually the ones that are at the top of the agenda. Over time, as those institutional investors get more experienced with alternative strategies, this alternative bucket could grow over the next 10 to 15 years to reach quotas like 30% from the the 5% we see today.

## Why foreign asset managers will benefit most from coming flows

The number of successful boutiques that set up in Germany over the last decade is probably not more than five. This is more or less a nightmare for the biggest economy in Europe, as foreign asset managers should be able to capture the bulk of assets going forward. But that does not mean marketing in Germany and Europe will be easy. This Roundtable gives clear guidance how to best market and communicate from overseas into European economies.

The Opalesque 2015 Germany Roundtable was sponsored by Eurex and WTS and took place in May 2015 at the office of Feri in Bad Homburg with:

1. Amin Obeidi, CAIA, Senior Asset Manager Pensions, Nokia
2. Harald Sporleder, Investment Style Leader and Fund Manager, Allianz Global Investors
3. Claus Hilpold, CFA, CAIA, Managing Partner, Polaris
4. Steffen Gnutzmann, Partner, WTS
5. Lothar Kloster, Head of Buy Side Relations, Eurex
6. Marcus Storr, Head of Hedge Funds, Feri

The group also discussed:

- Why investors should seek diversification across risk premia and avoid market timing
- Risks and opportunities of alternative investment and hedge fund strategies as index or ETF
- How can marketers address negative sentiment or preconceptions regarding hedge funds and alternative investments?
- What is the Woodstock for hedge funds in Germany?
- How to capture additional yield through option strategies with new Eurex products
- Will the "AIF-Brand" over the next 3 years reach a comparable acceptance and positive reputation like UCITS today?
- Access Restricted: When regulations hurt investors
- Rumour: By 2018, the German investment tax law may be dramatically simplified
- Infrastructure investments: Too expensive from a risk-return point of view?
- Fees: Under which conditions is the Nokia pension fund happy to pay 30% performance fee?
- Costs versus net return: What pensions are missing when presenting their TER
- What is wrong with Solvency II?

Enjoy!

Matthias Knab  
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## Participant Profiles



(LEFT TO RIGHT)

Matthias Knab, Steffen Gnutzmann, Lothar Kloster, Marcus Storr, Harald Sporleder, Claus Hilpold, Amin Obeidi.

Cover photo: Cologne, one Germany's insurance centers, with the river Rhine.

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# Introduction

**Lothar Kloster**  
Eurex

My name is Lothar Kloster. I am representing Eurex, the leading derivatives exchange and I am working in the Marketing and Sales Department, responsible for institutional sales and relationship management.

**Marcus Storr**  
FERI

My name is Marcus Storr. I am heading the Hedge Funds / Alternative Department at FERI. FERI is an asset manager managing 27 billion of discretionary assets, of which 1 billion is invested in hedge funds and another 2 billion in private equity.

FERI has the largest alternative manager selection team in Germany with dedicated analysts for each strategy. We invest into hedge funds on a global scale and are currently invested in offshore and UCITS hedge funds on behalf of our clients, which are mainly German speaking institutional investors in Europe.

**Steffen Gnutzmann**  
WTS

My name is Steffen Gnutzmann. I am a lawyer with the German firm WTS, working in tax and regulatory law. With more than 450 team members, WTS is delivering tax, legal and consulting services. Our team advises numerous hedge funds and other AIFs, also mutual funds with regard to German tax and regulatory compliance. We also help non-German funds to enter the German market or the European market.

**Claus Hilpold**  
POLARIS Investment Advisory.

My name is Claus Hilpold. I am Managing Partner at POLARIS Investment Advisory. POLARIS is based in Zurich. We have teamed up with a carefully selected range of alternative investment managers to represent them in our core markets Germany and Switzerland and support them with business development services such as marketing, sales and client servicing. This way, our alternative asset managers gain efficiency by not having to open an own office and/or hiring additional marketing staff in those markets. For our institutional clients this means we provide them with support and reporting in local language and time zone without additional costs.

**Amin Obeidi**  
NSN Pension Trust.

My name is Amin Obeidi. I am the Global Pension Fund Manager for the NSN Pension Trust. The NSN Pension Trust is responsible for managing and investing the global Nokia pension assets. We have a broadly diversified investment approach, which contains mature investments in alternatives.

**Harald Sporleder**  
Allianz Global Investors

My name is Harald Sporleder. I am heading the European long/short business for Allianz Global Investors where I am the lead manager for two different hedge fund strategies.

# 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.

We help investors get more from the market and maximize capital and cost efficiencies. [www.eurexchange.com/rates](http://www.eurexchange.com/rates)

**Eurex Exchange – the home to the euro yield curve.**



**Marcus Storr:** How do we read the current market environment? There are two external driving factors together with a number of internal driving factors why we see in particular institutional investors allocating to alternatives. When I say alternatives this combines offshore hedge funds, hedge funds in UCITS wrappers, as well as private equity and real estate.

Real estate is obvious, because it's offering some yield. We have low yields across the board and that's why people allocate. So, why also into hedge funds and other alternatives? The drivers are actually the same. The big institutional investors have between 75% and 85% of their allocation in long-dated Triple-A or similar bonds, whatever they determine to be safe bonds. This is due to regulatory pressure and they can't really go into major other asset classes, in particular equities. That might differ from some pension funds, but in particular insurance companies are restricted with their risk and therefore their risk appetite for things like equity is limited.

*If we look at insurance companies in Germany currently, they have only 3-5% in equities. But the yield environment is putting these institutions with their back to the wall. So that is my first point. They must move sooner or later.*

The second aspect is education, particularly to increase the pension managers' understanding of what kind of hedge fund alternative strategies risk premia are available. This also is an evolution and takes time.

Some pension funds are ahead of others regarding that knowledge, or they have already gained some investment experience with UCITS hedge funds, or maybe even having invested in offshore hedge funds and seeing and selecting managers themselves. All such activities lead to a better understanding of alternative investments, the different risk premia they offer, and how to integrate those into a larger institutional portfolio.

*These two elements – low yield environment and understanding of different strategies – leads to investment. And that is speeding up as we speak.*



**Amin Obeidi:** Marcus is right, there are a lot of external factors that are pushing people to start thinking about making investments into alternatives. When we talk to other investors, we see a lot of them thinking about an investment in alternative investments, but yet taking the step to invest is still another topic.

A lot of them have regulatory issues, *some of them could invest into alternatives, but they still may have a certain fear or hesitation to do it.* Also, you need to keep in mind that taking into account the returns of last year and even year-to-date returns on most of the traditional asset classes, there is no immediate pressure to do anything else. And therefore, if a pro-active pension fund manager, for example, is discussing new ideas and presenting them to his board, they can often get a reply like, *“Okay, but explain to me why do you want to do anything new? Everything is performing well! You are earning enough money without going into risk.”* Because for them alternative investment is synonymous with risk. So you have a major hurdle on the inside of some institutions.

But of course, if you dig deeper into it, alternative investments are not generally more risky. A lot of hedge fund strategies, for example, are even less risky than being for example in credits right now, or investing into high-yield bonds.



So, I am appreciative that even before I joined the NSN Pension Trust, the fund was already invested into alternative investments. At that time we even had offshore hedge funds in our allocation; right now we don't. For us, hedge funds aren't an asset class on their own but rather a collection of strategies that helps you invest in equities, fixed income, real assets, and so on.

We invest in a broad basket of what we call absolute return strategies. We allocate to different strategies and change these strategies over time, depending on our market outlook. We are also invested in a fund of hedge fund, because we still think it offers value. The fund of funds makes also sense, because the invested amount in this fund is not that big that we could spread that on e.g. five or ten single managers right now.

*Looking forward we want to invest more into alternative investments, not just hedge funds. We also have infrastructure, real estate investments and other strategies e.g. in the loan space. Although we already have invested more into alternatives compared to other institutions in Germany, we are still looking for additional and new investment opportunities, because we believe they could help us to deal with the challenges going forward.*

**Matthias Knab**

Amin mentioned some people still have fears and hesitations when it comes to investing in alternative investments, because they are perceived as “risky”. Marcus, what do you tell those people when you talk to them?

**Marcus Storr:** Obviously when Amin refers to risk then I think I know what he points at. People still talk about long-dated bonds, high-yield, credit as being less risky compared to alternatives, and that is certainly not the case. Obviously it depends on the market environment.

But what we are advising clients is to look at alternatives, to look at different strategies – let it be a market neutral equity strategy; let it be a credit long/short strategy – but going away from the normal risk premia in an asset class, which is credit, equities, long-only.

So the advice goes towards diversification across risk premia, and risk premia is inherent in hedge funds. So when we talk about risk, then risk is in some traditional asset classes, according to our judgment, higher than in alternatives.



**Matthias Knab**

How about the product providers? What do you say?

**Claus Hilpold:** When we speak to institutional investors, both in Germany as well as in Switzerland, we see different approaches to engage with alternative investments. *Some institutions treat them as an alternative to fixed income.* As Marcus mentioned, the biggest part of the allocation of pension funds and insurance companies in general is in fixed income. Given the low yield environment, they need alternatives as a bond substitute. Topics like Senior Secured Loans, Insurance Linked Securities, Unconstrained Fixed Income, Infrastructure or Direct Lending Strategies are therefore alternative investment strategies that attract investors' attention.



Another approach to the alternative asset class is from a *real asset* perspective. Especially during the heights of the Euro crisis, many investors started to think about investing in real assets.

Asset classes such as Infrastructure, Private Equity, Real Estate, Timber, Farmland or sometimes commodities have been put into the spotlight of investors to gain exposure to real assets.

A further way to approach alternative investments we have experienced when talking to institutional investors is to build a bucket in a portfolio that seeks *pure diversification*. Alternative Strategies like Global Macro, Insurance Linked Securities, Equity Market Neutral and CTA Strategies are usually the ones that are at the top of the agenda.

Finally, there are those approaches where alternative investment strategies are seen as “*real*” *active styles of investing* within each asset class. Within the equity bucket investors get exposure to some very liquid and efficient markets (for example US or European large-cap) through efficient and cheap beta exposure via ETFs. In addition, investors add some talented active managers through selected Long/Short or Equity Market Neutral strategies. They follow the same approach in Fixed Income and Credit. So you see there isn’t just one way to Rome!

We have also witnessed more and more new institutional investors entering the arena over the last few months by approving a small alternative investment quota for the first time in order to get familiar with these asset class(es) / different investment strategies. Some focus on infrastructure, some on private equity and others on private debt, whatever they choose to start with.

Usually they start with 5% which is obviously only a kind of dipping a toe into the water to get familiar with the asset class, the administrative aspects and of course the different risk/return profiles of alternative investments. I would expect that over time, as those institutional investors get more experienced with alternative strategies, this alternative bucket will grow, and *I would not be surprised if within, let's say, 10 to 15 years we talk about quotas like 30% and not the 5% we see today.*

**Harald Sporleder:** I am a hedge fund manager, so I can only comment about the hedge fund business. Claus is right, investors are searching for alpha and they are looking at alternative strategies across the board. But there is something that I have learned across the world, and especially in Germany, that *a lot of clients are speaking in general slightly negative about hedge funds without actually having had any experience of having invested in them.* I guess in Germany this kind of negative perception has been well created by the local press and politicians over the last decade.

Nevertheless, the external, extraordinary shock which kicked in via low interest rates is creating now additional pressure on the committees and the decision makers to come up with something different to secure investment yields. So now, these committees have to start to thinking and ask themselves *what else they can do beside the normal fixed income allocation which they have done for many decades?* So while there is a real need to do something different, the biggest challenge for all the product providers or consultants which present hedge funds or even funds of hedge funds is to start with the right education and to change the negative perception.

When this kind of perception might be changed for the biggest economy in Europe, then we have a huge client group which will move the needle, and this is exactly what we should expect from the Germans in the next two to three years.



**Matthias Knab**

So how do you address the negative sentiment or preconceptions regarding hedge funds and alternative investments? What is your message, how do you educate the committees?

**Harald Sporleder:** You have to convince the investors only via real numbers. When you are predicting a low return with low volatility, then you have to deliver low returns associated with low volatility.



So when you are able to do that over time, clients will also be convinced over time. *I guess we have to consider that this one is not a sprint, this one is becoming a marathon to convince German clients that they have to allocate to alternatives, that in fact it's a must. In the end, they have no flexibility at all, they have to do it.* But again, we have to consider this one as a longer journey, engage in education and be aware that this development will take a while before the right products are allocated and the right returns are reflected in the asset mix.

**Steffen Gnutzmann:** I would like to support what Mr. Sporleder just said. I have been advising hedge funds for 15 years or so. Our clients are the investors of the funds, and the funds themselves. Insurance companies, at least from our perspective, are not the large group of investors; some are, but there are not so many, at least so far.

Mr. Sporleder just said that it will take long to convince German clients to allocate money to alternatives; I would almost phrase it a bit harder. *It's almost like some people are analphabets with regard to funds. They may know long-only bond funds or equity funds, but all the other animals out there in the market are very strange to some investors.* You, Mr. Sporleder, probably know much better than we do.

What we see right now is that the administrative guidance on the investments of insurance companies has just been altered at the end of March 2015. AIFs with very few restrictions are now allowed to 7.5% of the committed assets of an insurer. That is quite a change compared to the past.

We saw a comparable change in 2004 when many German funds went into US mortgage-backed securities without understanding what they were doing. I sometimes wonder a bit whether something like that may happen nowadays. Again, Mr. Sporleder just pointed out that it is a job of educating the investor to do the right thing. And that is, I absolutely agree with the previous speaker, quite a challenge.

So the news from the regulatory front is 7.5% of the committed assets can go into AIFs without many restrictions right now. That is the important regulatory change that was just announced. The question is whether the investors are equipped to make use of this possibility; there could be quite a way to go in Germany.



**Amin Obeidi:** When we are talking about educating institutional investors on alternative investments, I think one problem or *one mistake that the market – so in a way we all – are making is that we are just talking about alternative investments as a single, uniform investment.*

For people who are not aware of the depth alternatives offer, the concept may appear almost like a black box, although they may be aware to some extent that different approaches and strategies like hedge funds, private equity, and so on are part of the alternative investments universe.



Two weeks ago I was speaking at an investor conference here in Germany about hedge funds, and I was quite happy that about *24 people were sitting in the audience. I mean 24 listeners, that is almost like Woodstock for a hedge funds topic here in Germany.* But jokes apart, the audience had a lot of questions and I was very happy about that. Remember I am an investor, so I didn't come with a marketing agenda, but my points were rather how hedge funds could help us in this environment.

I think it's really important when you talk to an investor who is not invested into alternative investments that you are able to show him an approach or a part of the solution *to address the low yield environment*, for example.

I was also talking about unconstrained fixed income strategies, which we are looking at for quite a while now, and I think that this is exactly what not just we but a lot of other market participants are looking for. With an unconstrained bond fund, you are still invested into bonds, so you don't have to take on certain exotic things or strategies that would maybe scare a lot of people in the investment boards – it is still a bond fund, but with a more flexible approach.

In a real unconstrained bond fund the manager has the flexibility that he needs so that he can invest as well into derivatives, high-yield, credit, ABS – basically the whole variety of fixed income should be possible. This could definitely be one part of the solution to face the low yield environment.

So, at this conference I was able to discuss this with other investors, and I could see that in a way a new understanding was formed. *The majority did not think of the bond fund necessarily in terms of a hedge fund but they start to think of it as one possible part of the solution.* In a way I was able to open up new ideas and solutions to them, and even though this is not my job, I am very committed to professional education, and that is probably also the reason why I am on the CAIA Board here in Germany. Circling back to what I said earlier that the concept of alternative investments really needs to get broken down into the more specific strategies, that is what I did with my talk, and showcasing a specific solution for investors, and not just talking about alternative investments in general terms.

**Marcus Storr:** I always ask myself, German institutional investors or German people in the financial world are not less smart than the Anglo-Saxon world, as human beings and education-wise. *Why then is it that they are so hesitant?* One aspect may be that we have hedge fund managers active in Germany for only about ten years now, and as a group we probably don't count more than two hands of hedge fund managers in terms of their education of knowing how to structure a hedge fund book, etc.

Another phenomenon here, and correspondingly probably in other parts of the world as well, is that probably all the institutional investors are mainly approached by Anglo-Saxon funds, no? Or are there a lot German speakers distributing Anglo-Saxon funds? We know that this is not the case, so at the end of the day it's this kind of parachuting in from the Anglo-Saxon world together with the *"I will tell you how you have to eat your breakfast"*-type of behavior.

And of course, people in Germany think, "No, no, no! I would like to have this conversation in German!", even though they may understand the salesman's English perfectly. I am just reflecting here, and so for sure there are number of reasons why the skill set in respect to alternatives in Germany is not that well advanced. That in my mind also has to do with the much smaller industry here on the product and the promoter side. If the alternative industry in Germany on the product side would be deeper, broader and longer around, there would have been much more opportunities for the buy side to get acquainted with both the products and the people active in alternatives over the last 10 or 15 years.

When you look at Scandinavia, when you look at the United States or London, you will see that over many decades there have been a lot of activities on the product side together with a consistent flow of new talent in new boutiques, so in a way someone on the buy side cannot really avoid over time getting in contact with these guys and learn about their strategies and products. That is also, to some extent, one of the reasons why institutional investors in Germany don't have the skill set.

So of course the only way out is deep and ongoing education, which we are consistently offering to our clients. Again, structurally the German financial market is led by rather big elephants, and we are missing a diversified boutique culture. That, in a way, has a number of disadvantages and investors in the end could be negatively affected, all in all.



Obviously within an elephant you might have some smart hedge funds strategies, but that's just not the typical structure. For example, I can think only of one larger German asset manager having taken the risk of putting their marketing foot down and saying, "We run a hedge fund and we are committed to alternatives!" So it's probably also on the product side where we don't really have enough talent capable of providing new boutique or hedge fund strategies.

### Steffen Gnutzmann

I agree with Marcus, but I am not sure about the reasons. In Germany, few people talk about finance. In a way, it's not cool, it's not sexy to be in money managing. Also, who has fathers or mothers who are in this industry? Germans produce cars, but not funds. Maybe it's that simple.

**Harald Sporleder:** I think the number of successful boutiques that set up in Germany over the last decade is something between two and five. This is more or less a nightmare for the biggest economy in Europe, which is just reflecting very well that the asset management business outside the traditional long-only business is not really considered to be our own home task in Germany.

What we have observed from our investors, which is probably typical for German investors across the board and a reflection about the level of their understanding, is that they first of all would like to have a good returning product – strong returns and a long track record, and then also a track record when it comes to operation procedures, which have to be state-of-the-art. This tends to be the normal way of thinking in Germany.

In Scandinavia, Switzerland or the UK, you can get a 100 million euro ticket, sometimes without having any track record and just delivering an operations structure which in some cases is even bought or outsourced to somebody else. There, the whole way of thinking of international investors about boutique style asset managers is completely different to Germany, and that is just stopping the growth of boutique asset managers out of Germany.

When it comes to our home grown talent, I disagree with Marcus – *my take here is that we do have the talent, but unfortunately we don't have the room, the flexibility and therefore the opportunity that this talent can grow here in Germany*. That is really blocking new asset managers and small asset managers which otherwise would be able to be grow fast and be profitable.



What that means is that the local industry is made up of the four elephants, plus two or three boutiques, and that's unfortunately the make-up of the German asset management market. Altogether, this is of course not enough in terms of creating a nice and attractive bunch of players. So that is something we and in the end all investors are missing, but I guess we have to be honest that this will be more or less impossible to change over the mid or even long term, and that in a way we have to accept this kind of market structure in Germany.

### Matthias Knab

Over the years I could see that a lot of the talents Harald referred to have left Germany to set up their boutique in London or Switzerland. These are very qualified people, and a good number of them were very successful in building an asset management boutique somewhere else. Some of them also say publicly that they felt they had to leave Germany not only to be more successful in asset raising from international investors, but also because they felt they were not supported by the German regulator.

Therefore, a lot of the things we have been discussing so far is actually showcasing the enormous opportunities the German market is offering now and way ahead into the future for international product providers because of this lack of depth and options from the local players in regard to alternative investments.

Lothar, an exchange like Eurex can often spot trends and opportunities in the market first. What do you see from your side?

**Lothar Kloster:** Yes, for example, Amin mentioned fixed income allocations – given the current yield environment, we saw a bit of decline in trading volumes of our 2, 5 and 10-year benchmark futures contracts in 2014 but a strong rise in trading activity beginning of this year.

We observed more interest in managing exposure in the 30-year segment of the yield curve as evidenced in increased volume in the 30-year BUXL futures contract. So we see an opportunity to expand our 30-year fixed income product range.

Furthermore, we also saw constantly increasing volumes in the options on Bund-, Bobl- and Schatz futures. Investors are apparently seeking to capture additional yield by applying option strategies, for example as part of quantitative asset management strategies. We expanded our option products with the introduction of weekly Bund options on 20 April.



**Matthias Knab**

Can you specify where the volume increase is coming from, are these domestic players or international? I know you have people trading Eurex products from all around the world.

**Lothar Kloster**

Yes, we have directly connected member firms as well as institutional end clients from all around the world trading our products. Honestly, we cannot exactly identify the region where the orders are originated as institutional clients usually execute their orders through a number of brokers located in different regions. However, anecdotal evidence from conversations suggests that buy side firms across all regions and especially from Germany are active users of our products.

**Marcus Storr**

It's interesting to see the volume on the longer end of the curve. I mean, if we have a flip of interest rates on the 30-year level, this sounds rather painful. I mean, in case at some point of time we have a move upwards in terms of interest rates and not downwards, then obviously the 30-year level would be very, very painful.

**Lothar Kloster:** I agree. However, some asset managers have apparently increased their exposure to longer dated bonds and or to peripheral markets in order to capture somewhat higher yield. For example, our futures contracts based on 10 year Italian government bonds, which are used as a proxy tool for gaining exposure to the EU peripheral markets has been very successful and we received interest to look into launching a 30-year BTP contract. Hedging positions in these futures would allow mitigating potential losses in case of increasing bond yields.



**Marcus Storr**

Can I ask a question? I remember that we had contacts to Eurex four-and-a-half, five years ago when there were some internal discussions where some hedge fund indices or sub-strategy indices might be launched as an index by Eurex. Is that something that is still on your radar? Or is there any alternative product which might be provided as an underlying for options for swaps or any other derivative?

**Lothar Kloster**

Well, we continuously expanded our equity index product suite beyond our well established benchmark products DAX and EURO STOXX 50 futures. For example, we have launched a suite of 47 dividend derivatives based on MSCI indices, MSCI global, regional and country indices.

Furthermore, we launched derivatives contracts that are based on dividend indices as well as on a number of ETFs.

**Marcus Storr** But with regards to alternatives?

**Lothar Kloster** You mean specifically as an index?

**Marcus Storr:** Yes, if you think of investment banks who for example have created algorithms how to replicate, for instance, merger arbitrage as a strategy, they even wrap this in products.

I remember that maybe four-and-a-half years ago we had this discussion with Eurex that if investment banks can create algorithms or index methodologies or structures, wouldn't an exchange be able to probably provide an index even as a benchmark to say, for example, a fund like Harald's is performing well because a 'listed' X, Y, Z hedge fund index is a comparable equity market neutral allocation substitute?

My point here is that we don't really have good comparables out there for German onshore investors, and therefore it is hard to benchmark a strategy or a fund. Of course, there are a couple of UCITS hedge fund indices or alternative indices out there, but when an exchange would provide a hedge fund index as underlying, investors could probably request derivatives being structured. However, at the end of the day this could not replace the advantage of individual manager selection.

Of course, you would need liquidity and tradability for that, but I was just curious if there were some further thoughts or developments that could result in a step forward to get exchange traded elements outside the kind of 'oh-so-nasty' offshore world.



**Lothar Kloster** Well, Marcus, I see your point. As you have mentioned, liquidity is key prerequisite for derivatives contracts. So we focused on derivatives based on indices or individual underlyings that liquidly traded and could be used in various asset management strategies. One example in that direction are strategies based on volatility that have led us to develop futures and options based on the VSTOXX index, which calculates the implied volatility of options traded on the EURO STOXX 50 index.

**Amin Obeidi:** We have been approached from some product managers from the ETF side who will or already have launched some benchmarks together with an ETF for alternative beta strategies. Some of them have done it for one specific factor, and others for multiple factor models.

*That means we are starting to see some form of standardization in these alternative investment or hedge fund strategies into an index or ETF-based product.*

The future will tell us how good they work and how profitable they are. It would be interesting to hear how other market participants see this evolution and if they think that it makes sense. From my point of view, not all strategies can be put into an ETF structure, because the underlying liquidity may not be there. For example, if there are big ETF inflows or outflows in a real arbitrage strategy, it could destroy the whole strategy.



**Harald Sporleder:** I am a little bit concerned about these kind of product developments. I am now managing money for almost 20 years, and over that time I could see that *when products are becoming complex, the likelihood will also be pretty high that something goes wrong, or the combined fees will be eating the returns*. I am referring here to my experience about hedge funds, but it will be similar for other complex products. On top, there will also be challenges to deliver complete daily transparency.

At T-0 you have complete information, but you may still not really fully understand what's in the product. So let's say there is an index and then an ETF based on the index. In between you have two or three different fee structures included. Maybe there are some investors who may be open to such a concept, but the obvious risk is that in the end nobody is making money except maybe the investment bank which is structuring such a product.

So when we're talking about alternative products, my preferred route and recommendation is to keep it simple, and investors should prefer the direct way of investing and not such a complex, layered way. That's my personal view.



**Marcus Storr:** I totally agree, first of all, with regards to the current development, I can confirm that we see liquid hedge fund strategies wrapped into algorithms and smart beta products, hence replication. This reminds me of late 2007 / early 2008. I remember that I spoke at a hedge fund conference in Hong Kong in early 2008. It was a conference about hedge fund replication. The organiser approached me because they have been looking for a scapegoat on the panel being against replication. Excuse my sarcasm!

So I was there sitting on my own on the panel where everybody came up with a replication regression result of 0.95 saying, okay, we need three factors and we can explain a single hedge fund strategy over the long-term.

*It feels to me that the current smart beta hype, which in itself has a perception of risk premia investing, is in general understandable and acceptable. But to come up and to say, okay, we can replicate entire strategies within the hedge fund world I think is conceptually wrong, because at the end of the day we are talking about 9,500 hedge fund managers out there and the effort needs to be spend to find the best.*

If you just look at merger arbitrage as a single strategy, the dispersion of returns in 2014 for managers in this strategy was significant. So if you replicate merger arbitrage, which you can do to some extent because it has a short put payout structure, you are still able to select a strong positive performing manager or a loss generating manager within the same period.



So what I want to say is that it appears to be easy to replicate or even to use one or two factors to replicate a hedge fund strategy. And that's why I am completely with Harald, which is at the end of the day you have to keep it simple and you have to invest, when it comes to hedge funds, into a manager which obviously takes higher fees, but which is potentially able to go beyond the normal replication model, because when D-day comes, the replication model does not work. We have seen it in 2008.

**Claus Hilpold:** I totally agree with Marcus. I believe that a regression analysis can be a viable tool to get a first quantitative idea of the sources of returns for an alternative investment strategy. But you still need to question the fund managers with those results and see whether those alternative betas are really reflected in the positions within the portfolio at certain points in time.

But taking performance numbers of hundreds of managers and aggregating them to average index numbers, and doing the same again and on top turning this formula around and say to replicate long/short equity, you need a little bit of small caps long and a little bit of large caps short and add a pinch of Growth Style Long and Value Short is simply conceptually wrong.

It's like going to your favorite Italian Pizza Restaurant expecting amazing food and getting the Pizza out of the mixer – 'bon appetit', I would say! There are certain alternative betas where you might be able to replicate the average results of managers. Replication seems to work for certain factors like volatility where you can capture the implied volatility versus the realized volatility. Such factors are obviously kind of standardized. But then again I would ask the question: who wants to be invested with the average in an active play? We also saw in 2008 that active management cannot easily be captured in a simple rule based approach.

As an entrepreneur and a marketer I also want to make the point that a lot of what we see in the market is actually very positive. We do see a lot of demand for alternative investments, we simply have to put it in the right format and deliver it to the investor community in the right structure, with the right explanations and add the right name to it. We have all seen the immense money flows into absolute return UCITS fund structures, which are at the end of the day not called hedge funds anymore, even though they apply hedge fund techniques or strategies.

Amin mentioned before the unconstrained bond funds. In former days this strategy was called fixed income arbitrage – at least to some extent – nowadays unconstrained bond seems to be the sexier description which helps to open doors with Investment Committees (IC). If it helps to get it more "IC-friendly" why not - as long as everyone knows what's inside. High yield bonds works also better than let's say junk bonds.

*I would dare to predict that in three years the "AIF-Brand" that is now available for alternative investment strategies will reach a comparable acceptance and positive reputation like UCITS today.*

So, just repeating the point I made before, I would not be surprised if in 10 or 15 years we will talk about an allocation to alternatives of 30% or more.



**Matthias Knab**

Claus thinks the AIF brand has the potential to be as strong as UCITS. What do you think about that?

**Steffen Gnutzmann:** First remark, right now we see that the implementation of the Alternative Investment Fund Managers Directive in 2013 has made it more difficult for investors and funds to come together.

In Germany, at least in the past, private placement was handled in a very liberal way. As long as you didn't put up a sign in your shop window: freshly arrived, hedge fund ABC, from the Cayman Islands. As long as you kept certain liberal boundaries, it was easy to talk to each other, investor and fund. Under the AIFMD, this is much more restricted and private placement is no longer possible.

In the end, the fund investor has to find the fund and contact the fund. That is possible. But you cannot, upon the initiative of the fund manager, contact clients.

So, to a certain extend, gaining a positive image of the AIF fund is right now hampered by formal marketing rules. This may change in the future, and maybe there will be a passport at some point in time, but right now it is difficult to develop a positive AIF brand image.



**Claus Hilpold:** I see what you are referring to, and in fact we have a real world example for that.

We work together with an alternative asset manager in a very unique and successful strategy where we can service clients in Switzerland, but where we are restricted in Germany due to AIFMD rules. They considered running the strategy also in an AIF, but given all the hurdles linked to the structure, especially with the influence on their compensation scheme, they decided to wait.

But I would assume that's simply a question of time. *It's a learning curve. It's like with UCITS five or six years ago. Once everyone has learnt how it works and what you can do within this framework, once all the service providers have adapted their services to help investors and alternative fund managers alike to have solutions for every part of the value chain within alternative investment management, I am pretty optimistic that the industry and the brand itself will flourish.*



**Marcus Storr:** I hate to say it but I absolutely agree with Steffen. I give you a couple of anecdotes from our own day-to-day businesses.

In particular, the Anglo-Saxon managers are fully aware of how European regulations have changed. *Frankly, I have never ever seen a European regulation scaring the death out of US multibillion dollar hedge funds. But the current AIFM regulation appears to do result in such a fear.*

We at Feri have the benefit of being able to contact these managers, because we have the offshore access, we are invested in a couple of dozen managers, and we have been doing this for 15 years. But the point is, with the new regulatory regimes in Europe, when you contact them now, some of them still ask you, "Can you send me a re-solicitation email?" But not all will ask for that, different funds judge the process of the approach and the related regulatory requirements completely differently. Some foreign managers are happy with receiving a re-solicitation email, others are saying, "No, I don't need this."

But what happened in the end is that regulations have more or less built barriers to entry in Europe, where the Anglo-Saxon managers are not really able to promote themselves into Europe. I am not sure about the motives behind the current regulation madness. Is it because the European managers are so much smarter, or that the regulators have to take care of the European investors to make sure that the bad Anglo-Saxon managers are not marketing their funds to anyone in Europe?

Sarcasm aside, the point is that it has become pretty hard for Anglo-Saxon managers to put themselves in front of investors, because they can't contact them, unless you have an intermediary like us.

And the other thing is that regulation is restricting most of the institutional investors in Germany to invest offshore, so they can only go with UCITS hedge funds. So also from that side, the investors here don't know the offshore vehicle, they only know the UCITS, so again, investors mostly lack the information to contact foreign managers.

All of those regulatory restrictions build up to a limitation of the options or the pool out of which the institutional investor can fish, I would say not by half, which would be bad enough, but probably by 90%. If we look at the global hedge fund world, then probably 90% of the hedge funds are outside Europe, if for the sake of this argument we consider the UK as part of the Anglo-Saxon world outside the EU. Might be realistic soon! However, this regulation really has reduced the manager pool out of which investors can fish by a very sharp margin. And that has also repercussions for the discussion we had earlier about what are the opportunities for institutional investors in Europe?



So, in this discussion, don't get me wrong: I agree that regulation where funds or fund managers must be registered and controlled, and marketing by managers is structured in a

certain way, makes total sense. But to restrict the majority of foreign managers from putting their products into their shop window results in an increase of investment risk for the institutional investors in Germany and Europe, because they are more or less cut off from potential good investments. Are we Europeans so much smarter when it comes to financial investments? The market will judge and neither the regulator nor the European governments!

**Amin Obeidi:** Marcus is completely right. The regulators think they are doing us investors a favor by “protecting” us. Well, *in an environment where you have enough investment opportunities, where you don’t have to battle to get some yield, it might be okay if the regulator thinks they need to cut off some specific investments. But nowadays, where you really have to dig deep into everything to find the last basis points of return to come up with your needed return, it has become really hard and in a way stressful for us. I mean, we are literally cut off from complete parts of the global investment market. There are hundreds of managers we are not able to see.*

The situation has become that bad that even if you as an institutional investor approach a manager proactively, they may turn you down simply because you are located in Germany. I've met a manager and asked him to send me an email so that I could have a deeper look into his strategy because it sounded really interesting. So he asked me, “Okay, but tell me: You are a global investor, but you are located in Germany, right?” I said, “Yes.” His answer was, “I am sorry, but we do not provide our product to German investors anymore because it has become such a headache.” I am sure he would be able to source low double-digit millions from German investors, but he decided to turn the business away. He added, “I would like to work with you, but we are not active in Germany anymore.”



**Matthias Knab**

Amin, can you tell us in more detail in which structures you can invest your pension assets?

**Amin Obeidi:** The good thing is that we are structured as a German CTA or Contractual Trust Agreement. That means we are not regulated by Solvency or the German Anlageverordnung – we can basically invest in anything.



That makes the episode I was just telling a real frustration. From the regulatory side, we would be absolutely able to invest in that manager, but those managers cut us out simply based on the fact that they do not want to do business in Germany anymore.

**Matthias Knab**

They made that decision, but I am sure that opens up opportunities for other firms.

Steffen, your firm also helps foreign fund managers to get their funds tax transparent and compliant for German investors. What's the trend there, do you see foreign managers working with you to access German investors, or are those managers in a way lost forever?

**Steffen Gnutzmann:** It depends on the amount of money that the German investor is going to invest into the non-German fund. If it's large enough, everything is possible.

The activity seems to happen in waves of investments. I'm not sure what drives this, but there are sometimes six months or one year periods where a lot of German investors are looking for and also buying into non-German AIFs. And then for some time the market seems more silent, until again new investments come up.

I can confirm what Amin said about the disinterest of a lot of funds in German money. Once we as advisers have explained what it means to have a German investor, some of them step back and say, "No, that is too much tax compliance, so much regulatory reporting and Solvency and what not - we don't need it. We have enough interest from less-regulated investors."

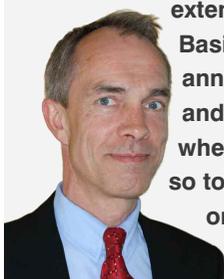
In this context, there is one development which is maybe good news, a bit of tax law here. There is rumor in the market that German tax law may change substantially, probably around 2018 which is still a while away. Nevertheless, many of you know that a German investor wants the fund to be tax-transparent and then it needs an annual tax certificate and published in the Federal eGazette, and so on. All of this is likely to go away. So, this compliance may be dropped completely. In the future, the funds could have a very simple tax law system. And the figures that I have seen: there's probably Euro 200 million of cost to the funds and the fund investors for the current tax law compliance. In 2018, this could go away.



**Matthias Knab**

What else would that enable? What other consequences or effects will that have?

**Steffen Gnutzmann:** Cost-savings on the one hand, and, on the other hand, an annual after tax return, which - to some extent - would be independent of the actual fund performance. It would be a lump-sum tax system. Basically, the idea is if the fund does not distribute - then let's say 1% of the NAV is the investor's taxable annual return. Whether the NAV of the fund went up by 4% or 5% or 10% doesn't matter. 1% is the tax base and only if the NAV indeed increased to more than 1%, so that gives a very steady cash-out of tax. And whether the fund NAV actually increased by 3% or 10% is irrelevant. It's a very stable tax law environment, so to speak. This may be a disadvantage of course, in the case of long term investments without an ongoing cash flow to pay the annual tax.



**Marcus Storr**

Would that potentially lead to the ability of institutional investors in Germany being allowed to invest into offshore Cayman structures which so far have been penalized?

**Steffen Gnutzmann**

Yes, that is possible.

**Marcus Storr**

And assuming that this 1% is in place whenever, that a Cayman structure could be investable for all institutional investors?

**Steffen Gnutzmann**

From a tax law perspective, yes. So tax-wise this will create a very level playing field and low-cost. I have to point out that these ideas are all plans right now, I don't know what the future will bring in the end.

Matthias Knab

How specific are those new plans? How far down the road do you think this is?

Steffen Gnutzmann

We expect to see the draft bill in the second quarter, so within the next one or two months.

Matthias Knab

Amin, you had mentioned you are on the Board of Education of the German CAIA chapter. That is obviously good news that CAIA is active in Germany, and probably growing. Can you give us an update on how the Chartered Alternative Investment Association is growing and about some of the trends you are seeing?

**Amin Obeidi:** The CAIA Association is the world leader and authority in alternative investment education. The association already consists of a global network of about 7,000 alternative investment leaders. It is growing, more-and-more people enroll for the CAIA program to earn the charter. Germany is still a small community but, as you said, it is growing, and that's a positive sign for the alternatives industry in Germany. CAIA is doing more-and-more initiatives to educate people and the whole market itself in terms of alternative investments. We have seen a lot of educational events and joint events with product managers in the past and you will see more in the future. There will also be some investor only events, to try to involve the investors who are scared of coming in touch with product managers because some of them have the fear that they will be contacted after that every week or so by product managers.

So all in all it is really a positive development, that's what I can say without going too much into details, and we hope that this will go on like that.



Marcus Storr

I have a question for Harald regarding the breakdown of the AUM in your products for which you are responsible. How much of your AUM comes from Germany and which is from outside Germany?

**Harald Sporleder:** You will probably be surprised with my answer. We have approximately 75% of our money from German investors, from all types of investors like pensions, insurance companies, and family offices. What's interesting is that 1.5 years ago, that ratio was just the opposite. So the assets coming from German investors and have grown almost exponentially, for the reasons we had discussed: the changing interest rate environment creates pressure for investors to change allocations. Some of the early starters have already allocated into our fund; and hopefully, more will join.

But I also would like to share a major concern of mine. Amin already pointed out how his options as an allocator are reduced as a consequence of European regulations. *So my question and my concern is where all the good funds will be coming from for the European investors that are desperate for yield and diversification, because all the good funds have capacity limits and many of the good funds are already closed. But then there are probably thousands of German clients who are now waking up to alternatives and want to allocate. And I believe that this one will be a typical industry mistake where you'll see a lot of products springing up in the foreseeable future and they will disappoint when it comes to performance numbers. But nevertheless, they will get money.* This has happened a number of times over the last 30 years. Some clients tend to come late to the party. They enjoy the party, but unfortunately, they are missing the end of the party.



When it comes to hedge funds -- only as a point of just a little effect -- when we have short stocks, we need availability. And availability is limited with full stock. It is physically limited. When this kind of asset class is growing, this availability is definitely limited. And this fund will create additional costs and a lot of failures when it comes to product level. This is my biggest concern that the wrong money is entering the wrong products, and it will happen again.

Matthias Knab

Harald, can you maybe also elaborate on your views on infrastructure investments?

**Harald Sporleder:** Infrastructure is a very specific asset class, and it has a long-term time horizon and limited liquidity. You need a dedicated skill-set and teams so that you can deliver superior returns. It's very similar to the hedge fund industry.



**Amin Obeidi:** We are invested in infrastructure, and I would agree to a certain degree. We have been investing into infrastructure for a few years now. We are not adding money to infrastructure anymore, not because we believe that the party is over, but because it has become too expensive from a risk-return point of view. Maybe too many people have entered the market. We've already seen the big insurance companies setting up their own infrastructure teams so that they don't need any funds as intermediaries anymore and can do direct investments. I agree with Harald that knowledge is needed, and that capacity is really limited. I am not sure if you can put together a team with 20 people who are all experts, which is what some large insurance companies are trying to do now.



Therefore you will end up having to educate people. And that will take time, while at the same time, they want to do the investment now. And Harald is right that there is a certain risk they will not always allocate to the right things, but time will show. In general I believe there are too many people in infrastructure fighting for too few interesting investments. Therefore, we are not investing into infrastructure anymore and I think you have to be cautious right now.

Matthias Knab

What other investments other than infrastructure are attractive for you?

**Amin Obeidi:** We are looking at different absolute return strategies, I had mentioned unconstrained bond funds, and we may look at real assets, but not infrastructure. We are mainly searching for active managers in the absolute return field, and some emerging market equity as well.



**Marcus Storr:** It's interesting to hear that somebody is actually searching for active managers. The normal reflex of nine out of ten pension managers is, "fees are too high. Give me an ETF." Now somebody says, "I am searching for active managers."

**Amin Obeidi:** Our view is that we are happy to pay performance fees for everybody who delivers. Let me give you an example. I am not happy to pay 2 and 20 but I will be more than happy to pay e.g. 50 basis points of management fee and 30% of performance fee if the manager delivers. I would sign that check right away. And we actually have done so a few months ago – a rather large amount for performance fee for one of our real estate managers. But he delivered, so why not? Because if he doesn't perform, he doesn't get any money as well. So therefore we are really happy to pay an active manager a performance fee when he performs well.



**Marcus Storr:** *But the conceptual discussion with institutional investors in Germany and possibly other parts of the world about performance fee is more that performance fee means “filling a manager's boots”, it's not “I am paying somebody for a good service or performance” It's “somebody gets a lot of money.” That is the general perception.*

Conceptually, I am absolutely with Amin to say, “Make it a low management fee and if you deliver I will pay a performance fee on top.” But in some places a performance fee is perceived as “ripping the client off”, while it's actually the opposite. It's a delay of payment, and the payment is only triggered if that person has delivered. Performance fee is also a negotiation point. We love to invest in managers, similar to Amin, with low management fee, and if they deliver, we say, “Please, take a chunk.”



*Ex-ante*, I know that my cost block is rather limited because the management fee is low. We are certainly not in general investing in managers charging 2 and 20, we are always negotiating fees. We are also happy to go into founder share classes with 80 Bps or sometimes even 75 Bps, and we are absolutely fine with a 25% performance fee for offshore hedge funds. We only need to pay that if they deliver.

**Claus Hilpold:** *From a purely economic point of view, I would obviously fully agree with Marcus. But all of us are also bound in a regulated environment. In Switzerland, for example, pension funds have to disclose the total expense ratio (TER) on a stand-alone basis within their annual report since the beginning of 2013. That means if they invest in a single fund or into a fund of funds, the performance fee also goes into this calculation.*

At the end of the day, the pension fund could be allocating say 5% to alternative investments while *in the cost breakdown that 5% can capture 30% or even more of the total cost, because on a cost basis, those investments are obviously the more costly investments.* Of course, then stakeholders might come back and ask “*Why are we in alternative investments with those 5% which will not have that much of an impact on the overall portfolio but consume 30%+ of our total expense ratio that we pay for asset management?*”

This can be a discussion you might face if you have to break-down those costs and disclose them without putting them into the context of the net returns and especially the risk-adjusted net return achieved with alternative investments. Sometimes well-conceived from a regulatory point of view is not always well done!



**Matthias Knab**

It's the same in Australia. What do you say then in this discussion?

**Marcus Storr:** It's the same in Austria as well. Austrian pension funds have to show the total expense ratio across all investments down to the subsequent single manager.

For example, if an investor invests into a fund of funds structure, the single manager have to provide their fees on a look-through basis to the total expense ratio. The reflex by the investor is obviously. If you have a total expense ratio which is perceived to be around, let's say 80 Bps because management fee it is ok. But then you have an extraordinary performing fund which adds another 80 Bps performance fee on top of it -- this creates the perceived problem of high fees! The fund audit report which goes out to the client or to the Board of doctors or the Board of architects or whoever controls the pension funds then has a page which says, "Total expense ratio: X,Y,Z." Make the total TER high; let's say 2.5%, because the funds received more performance fees. But on the same page, you don't see the net return. So there is no direct comparison of "What do I pay this cost for?" In audit reports costs should be compared against net performance on the same page.

If you would put the net return next to it showing that he outperformed average product by 10%, 15%, 20%, some people, even the doctors and the architects, might say, "Oh, he shot the light out, fine." But the point is, there's cost focus and, then a couple pages later you see the net returns. So *it's not seen as "What is the performance attribution for what I do pay?"* And I think, again, it's perception and reality. It's rather obvious everybody wants to get the cost down, but you always have to see, what to do you pay for what you get?



And the point, coming back to my initial remark is, performance fee is a structure which delays your payment. And the payment is depending on the success, and that's why I'm more than happy to delay my payment. If it comes up that it was a good investment, then I am happy to pay. However, to be honest, I don't think there will be a change, except if people change their set of mind how they think about performance fee.

**Matthias Knab**

That is a true dilemma for the industry, and also for pensioners, in the end, because their after fee yields are affected. How do you see the industry coping with this situation? What trends or developments do you see?

**Steffen Gnutzmann:** The pensions and also insurers need more yield; it seems difficult to survive on government bond funds. *In our practice, we don't see seismic shifts or larger developments except for that sometimes insurers or a pension of a DAX 30 member decides to allocate maybe EUR 500 million to hedge funds.* That happens occasionally. But for me at least, it's not a full trend at this time.

There are some interesting developments in the insurance sector we should focus on for a bit. The Solvency II regulation is coming up by January 2016. And basically this means that as long an insurer has the capability to measure risk, they can invest in almost anything. The standardized risk types in the current Anlageverordnung (insurance investment ordinance) will be abolished for many insurers in the future, and instead we will have the set of rules called Solvency II.

Maybe Mr. Sporleder can help us: how far are German insurers prepared for Solvency II? I mean, that's a change of the tide for them.

At present, they are bound by very formal risk limitations: "UCITS: yes; hedge funds: no!". While at the moment they can invest 7.5% in alternative funds, in the future there will basically be no boundaries for insurers. But they need the risk knowledge internally, otherwise the same thing could happen as in 2008 when many discovered: "Ooops, my ABS has just had a waterfall loss!"



**Harald Sporleder:** I can deliver only a limited contribution regarding insurers, but the only observation from all the corporate meetings which we are having with these listed companies is that they all know Solvency II is coming. And they know apparently as well that nobody has a standardized risk model. All of these companies, they all have different models and all of these models are approved from different regulators. That's just the status. That means everybody is just using different numbers and models which is not optimal.



It's just a matter of fact for the industry right now. *Therefore, as insurance companies are very conservative, they are using right now the most conservative approach, as far I know. This one excludes, unfortunately, many alternative strategies.*

And I guess it doesn't make sense to wait for any politicians right now. I guess the regulators are defining the frame, as they are defining the frame while on an Excel sheet. But we all have learned the lesson over the decades that capital markets are very hard to put into an Excel sheet. Therefore, *my optimism when it comes to the European insurance industry in terms of allocating a huge amount of money into the alternative businesses from the status quo right now is very, very limited.*

**Matthias Knab**

Do you think in any of these issues we have discussed, the regulator or the lawmaker will go back to the drawing board to improve the framework for the investors and practitioners?

**Marcus Storr:** The regulator is not changing anything in a proactive way – they typically change regulations according to what has happened. We have seen that after the financial crisis, the regulatory process for everybody in the financial market is getting tighter and tighter every morning.

So the regulator is not proactive, and he is not expected, certainly in our view, to provide a proactive environment. Hence, we have to start at the other side, which is innovation and flexibility. But most importantly, I think we all have to push for more education.

Coming back to the question whose fault is it, or what are the reasons for the current situation which is very unsatisfying? Is it not having enough talent in Germany being able to produce local innovative products? Or, on the other hand, is there not enough demand from investors with regards to their own knowledge?

I think that alternative events, conferences, and getting managers into Germany is basically the key. It's a long walk. Harald said it's a marathon, which I agree. And to be honest, I don't expect us in Germany to be at any point in time at the forefront of the financial market development, but I think education is key. And again, *we are not saying that our local investor base is lacking intelligence or general education, but where they are lacking is that they need to have more interactions with alternative managers.* They have to literally meet and touch those managers and their products, so that a better understanding and with that a higher propensity to invest and diversification through alternatives can develop.

Of course, similar to the infrastructure discussion we have had, you can say the analytical capacity within some institutional investors is rather limited. How, for example, can an insurance company build a team of eight, as we have, to look at managers? That is probably impossible. So it's a bit chicken and egg, but we have to start somewhere.



**Harald Sporleder:** I like to add an observation which I find quite alarming. We are all reading in the newspaper that the CEO of Munich Re is talking publicly, right now, about a kind of trend which is really concerning. *When such a low interest rate environment goes for more than two or three years, nobody knows how many insurance companies will face significant issues.*



*We can wait for this kind of trouble, because Draghi will keep the interest rates low for longer. And when already Munich Re is talking about that this one will be painful, I guess somebody in Berlin, or all of the regulators which are involved, they have to start kind of a proactive approach in terms of allowing much more flexibility for the investment size.*

It's just my hope that the politicians and all the involved parties learn the lesson much faster than in the past that we have to act now and not to react. Reacting is the normal way of thinking for regulators and many corporates.

**Matthias Knab**

So what should they do?

**Harald Sporleder:** Well, the lobbying work for all these kinds of groups in Berlin and in Brussels works actually quite well, but now they have to accelerate this kind of lobby activity to make clear to the politicians and to Draghi that when they are keeping the interest rates for longer at the current low levels, we will sooner or later read a headline in the newspaper that insurance X is bankrupt. And then you'll get the typical hurling and panic which is actually something we have to avoid.

*It may not be enough to have at some point maybe a new regulation which might allow a 75% allocation to alternative investment. That will be good if we get it, but actually the next step would be to mandate that the insurers or other investors who are in distress actually have to do it. So not only that "now you can do it", but, "now you have to."* Because buying a zero yielding bond means you are just destroying assets. You are just destroying values.

And destroying value just for the argument of being liquid is something which is even more stupid, in my view. But you have to do the same educational work on the political level in Berlin and Brussels. But, as I mentioned, the pressure in this case is coming from some fairly large corporates, so again, this one is serious. If the biggest players are talking about how the low yield environment is slowly killing their business, then it's something really serious.



**Claus Hilpold:** Over the last ten years, as we mentioned before, pension funds had 80% or even more in fixed income, and whenever a bond matured they could simply reinvest it in another 10-year Government Bond. And in hindsight, it was the right decision.



In today's market environment you need to be a bit more creative to make your living. So regardless whether interest rates stay low for some more time to come or whether interest rates will increase going forward, both scenarios need a conceptual amendment of the investment strategy of the past.

Therefore, something really has to change.

Back to the regulatory discussion, they actually don't have to change Solvency II. The only thing that the regulator has to adapt once it is in place is the capital charge for the individual asset classes.

For example, all government bonds should also get a certain capital charge, and alternatives should not all be stressed the same like today with let`s say 49% for hedge funds or 39% for private equity. It should be more granular and much closer to the real inherent risk for each individual investment strategy. *We have meanwhile data for many different alternative investment strategies going back quite some time and it would be an easy exercise to derive real risk-statistics on an individual strategy level in order to get more realistic capital charge numbers.* I am pretty sure that over time regulation will move into this direction even for the standard-model.

But first of all, the whole Solvency II framework has to come into effect on January 1st 2016, and then the industry can adapt and fine tune it over time.

**Marcus Storr:** Just the other day I heard a comment from a pension treasurer.

He said the worst week for him is the first week of the year, because at that time he gets all the bond coupon payments. About EUR 30 million are dropping on his desk as he comes to work the first week of the year, and the board is telling him, “Can you please allocate this?” And he goes, “Um, but where?”

I mean, it's pure desperation, the manager honestly does not know what to do with the money. Yes, he can invest it into triple-A bonds, but what's the point? IT's YIELDLESS RISK!



**Harald Sporleder:** Our discussion is a bit gloomy right now, but the fact is that these investors and the markets are in such a deadlock situation. *The regulation says, “hey, you are allowed to use alternative investments, but you have to have internal knowledge.” And of course, you can doubt whether the internal knowledge in the insurance companies is there or is going to be there soon. On the other hand, the yield is needed. So where is a solution? And with that, we have a number of agency problems as well. In the end, in the case of an insurance company, the insured and finally the taxpayer are going to bear the losses.*



**Claus Hilpold:** I would like to add that we see a lot of activity and also progress on the education side. Different bodies like CFA, CAIA, the European Business School or the Federal Association of Alternative Investments (BAI) are all educating the practitioners. When I meet with representatives from pension funds or insurance groups, I see a lot of young talent who achieved the CAIA, the CFA or other professional qualifications, and they are all eager to learn more, to meet managers and to dig deeper into those fascinating aspects of alternative investment strategies that offer much more opportunities than traditional long-only investing.

So I think that's a generational issue at the end of the day and that will solve itself over time.



**Harald Sporleder:** *We discussed the pains of insurance companies, but when you are reading the quarterly reports across the world from various listed companies, they all are suffering as well because they have to contribute more cash into the pension funds as their pension funds are all underfunded.*

That is, first of all, a disaster for the company because they have to use their hard-earned cash to put into their underfunded pension funds. This will continue because all the pension schemes need a return of x% just to refinance the pensioners.

But, also here, the pension fund managers are not getting the right returns on their investments so that they can refinance the pensioners. Cash needs to go into the corporate pension fund, which means less cash for the corporates. It's a real cost of capital for the corporates, and despite the infusions the two ends won't match up. That means they have pressure from two different sides, as it is also a disaster for a shareholder when a corporate is allocating always cash into the pension fund without using the cash for investments or the shareholders.



*The dilemma for the pension funds is also that they have to operate in this framework which does not allow them sufficient flexibility to move the assets in other, potentially higher yielding asset classes. Similar to the insurance companies, we may well see further acceleration of this problem. In our fund alone we have investors who have exactly this pressure. They may be able to tolerate this one for one or two quarters, but shareholders will be frustrated when the earned money goes directly to the pensioners.*

*That kind of shareholder pressure will become public and will go directly towards the politicians or to the regulators. Personally, I believe many of these regulated models are rather inefficient given those challenges.*

**Amin Obeidi:** Luckily, the scenario you are describing hasn't been a problem for our pension fund until now. I agree that the biggest problem for pension funds is now the ever-growing liability side, because of the decreasing discount rates. The only direction we were seeing is down and down and maybe eventually they will hit 0%, if it goes on like that. We are not far away from that.

Everybody is performing sensitivity analyses, and you can see that a 1% change in the discount rate will add up – depending on how big the fund is – another 100 or a couple of 100 million to the liability side. That's a major issue, because the funding status can go from bad to worse for some pension funds.

*No matter how good you are managing your asset side, if the discount rates are approaching zero, you can't be that good on the asset side to make up for that. Your funding ratio will get bad, no matter what. Therefore the biggest problem is definitely from discount rate side. As we have discussed earlier, this issue will have to be solved from the political side, or maybe the ECB has to change its views.*



**Matthias Knab**

Are there any other questions or comments?

**Claus Hilpold**

It might be interesting to hear from the other colleagues what they see, what kind of hedge fund strategies are currently in vogue and which ones are out of favor in today's markets.

**Marcus Storr:** Obviously our personal judgment; strategies on vogue are certainly CTAs currently, trend-following strategies. They are piling up a lot of money; a lot of the net inflow goes into CTAs, also into global macro strategies.

We avoid fixed income arbitrage at this point in time, because obviously the implied leverage has to be much, much higher because the arbitrage situations are getting much, much smaller.

What we are doing substantial research on and also seeing managers in is merger arbitrage, because M&A activity has increased. As a couple of large, big well-known deals blew off, spreads widened quite a bit, so that seems to be interesting.

We are certainly avoiding significant beta, long, net exposure, equity strategies. Rather market neutral strategies with flexible net exposure of probably +/-30, that's of interest.

And finally, which are consistently on our agenda, are dedicated sector funds and geography funds, so dedicated country funds and dedicated sector funds. This is what we are looking for.



We are certainly avoiding, as I said, fixed income arbitrage. We are not really that interested in global equity long/short managers because we don't believe that there are teams out there, as big as they might be, to be able to cover equities on a global scale.

But for example, like Harald has indicated, a German-specific fund or a European specific fund with a large analyst team behind, this is something which we look for, where we think, obviously to be proven, that there are smart managers out there being able to deliver some extraordinary returns. I don't want to use the word alpha because that's not a word which we have in our dictionary.

**Matthias Knab**

Where else do you see opportunities? Any other comments?

**Marcus Storr:** One comment I would like to add which we are also always trying to make with clients is, "Please, don't do any market timing." *Even we as managers are struggling to find the right timing, and we often see that things become worse when the end investor as the second or third derivative tries his luck in timing.* Therefore, from our perspective, for market neutral products there is always time to allocate. It shouldn't be a kind of wave or fashion.

I do have some concern when it comes to global macro. When I was a bit younger, my take was that global macro can only be successfully managed by say two or three people, but now we have hundreds of global macro guys, so also here I am just asking where all of these skill sets are coming from?

Therefore, I am a little bit concerned about global macro. If you are looking at a manager with a proven long-term track record that includes several of the crises periods we have had, this could be an argument for an allocation, but not a good-looking PowerPoint presentation of which we see a lot coming to us from the Anglo-Saxon world.



**Claus Hilpold:** When we speak to institutional investors we see demand within liquid alternatives, for market neutral equity strategies but less for long-biased or long/short equity managers. We also notice demand for global macro and for event-driven strategies. At POLARIS we are always open to look at fund managers within those strategies in order to find interesting candidates that we can support in their marketing activities in Switzerland and Germany.



*We see less demand for CTAs, in particular from Germany, despite their great performance last year. There are a couple of reasons for that.*

One is usually the volatility that institutional investors are looking for in absolute return UCITS strategies. Just to clarify, when talking about the term “absolute return” that means for many institutional investors that over a 12-month rolling cycle they expect with a very high likelihood that the return net-of-fees is positive. If you look at a momentum-based CTA strategy with a volatility of 12% to 17%, there is obviously a much broader dispersion around the target return and around that zero number as the higher volatility number already implies.

We also learnt that particularly in Germany many institutional investors have abolished the commodity quota totally or at least the agricultural part of the commodity sector which means that they also don't invest into CTAs where capturing trends in the commodity sector could be part of the strategy.

In other less liquid alternatives we see demand for direct lending funds, be it European direct lending or US mezzanine, or senior secured loans. That has become a big theme with the recent change of the insurance company investment ordinance.

Insurance companies and pension funds have the possibility to invest in loan funds now, and we have one manager in our POLARIS offering where we have quite a lot of meetings nowadays to discuss with institutional investors the market environment for this strategy and the different approaches. We also see tactical flows going out of high-yield and into loans due to the better risk-adjusted parameters currently.

And then finally private equity. The new investment ordinance is also positive for private equity: Section 13b says that apart from the 7.5% for alternatives, insurance groups, pension funds and so called Versorgungswerke can now invest up to 15% into private equity. There are a lot of institutional investors in Germany that have allocated to private equity for quite some time already. Those investors are now gradually allocating to single managers directly.

And we see those investors that are new to the asset class that usually start with an allocation via fund of funds, or they might use advisory solutions to gain exposure. In particular in mid-market buy-out strategies we see quite some interest and are always open at POLARIS to get into discussions with proven asset managers who consider to offer their expertise also to institutional investors in Germany and Switzerland.

**Lothar Kloster:** From an exchange perspective, we see opportunities to expand our product suite and clearing services that help asset managers to increase efficiency of trading and clearing.

In that context, we see on the asset managers' side to some extent a switch from OTC products to exchange traded products. They are easier to handle, it's operationally a much easier process, and it's a safe cost on their side.

Eurex launched futures contracts to support this development; examples include Interest Rate Swap Futures, FX derivatives or variance futures contracts. We are currently working with market participants from both the sell side as well as the buy side to make these products more liquid in order to give it a cheaper way of executing the trades.

From the clearing side, Eurex has introduced a portfolio risk management methodology called PRISMA which allows to cross margin both OTC and listed positions, which leads to margin offsets and reduced collateral requirements,.



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