



Opalesque Round Table Series '09

WEST COAST

Introduction

Dear Reader,

This new Opalesque Roundtable focuses on the U.S. West Coast. From 1999 to 2001, particularly the San Francisco area boasted a whole flurry of long-short equity managers specializing on tech, small and micro caps. With the tech-meltdown in 2002, many of those went away. The participants of this Roundtable discuss the segments of the local hedge fund industry which are still standing up; one sector has even set a global standard.

A large part of this Roundtable deals with how hedge funds and start-ups can overcome their biggest challenge: securing seeding/funding, how to raise assets and how to "become institutional". Seasoned hedge fund investors and consultants offer in-depth, detailed advice and strategies how hedge funds and start-up can successfully address these issues and grow their business.

The Roundtable also discussed how and why asset allocation has become the single-most commonly discussed topic among many allocators and hedge fund investors. The traditional 60:40 mix does not work - it subjects investors to undue volatility, and an "equities for the long run" is a rather naive approach. Asset allocation strategy turns out to be much more than an academic exercise, as these decisions have real human consequences. The billions in wealth destruction across pensions, endowments and personal savings will impose very real hardships on many people. The experts at this Opalesque Roundtable offer important insights and suggestions around asset allocation.

In addition, the Roundtable discussion highlights:

- The changed role and importance of service providers - what really matters?
- General partner risk - some questions investors should focus on
- Why despite delivering negative returns in 2008 institutions increasingly rely and invest into hedge funds and alternatives
- Specific West Coast advantages: things that hedge funds and investors can accomplish only from there
- A new approach to risk management: What are the "Five Pillars of Risk Focus" - none of which is a piece of software...
- and much more - 30 pages full of actionable intelligence!

The Opalesque West Coast Roundtable was sponsored by Carmel-based Welton Investment Corporation and took place on April 22nd at the San Francisco office of Pillsbury Winthrop Shaw Pittman LLP. The event united the following experts:

1. Judith Posnikoff, Co-Founder, [PAAMCO](#)
2. Paul Perez, Managing Director, [Northern Trust](#)
3. John Brynjolfsson, Co-Founder and CIO, [Armored Wolf](#)
3. Mitch Levine, Founder, [Enable Capital](#)
5. Christopher Keenan, Sr. Managing Director, [Welton Investment Corporation](#)
6. Kurt Braitberg, CFA, Managing Director, [TeamCo Advisers](#)
7. Michael Wu, Partner, [Pillsbury Winthrop Shaw Pittman LLP](#)
8. Robert "Bucky" L. Isaacson, Founder, [Futures Funding](#)

Enjoy "listening in" to the 2009 Opalesque San Francisco Roundtable!

Matthias Knab
Director Opalesque Ltd.
Knab@opalesque.com

Participant Profiles



STANDING (LEFT TO RIGHT)

Christopher Keenan, Paul Perez, Matthias Knab, John Brynjolfsson, Robert "Bucky" L. Isaacson

SITTING (LEFT TO RIGHT)

Micheal Wu, Judith Posnikoff, Kurt Braitberg, Mitch Levine

Introduction

Judith Posnikoff

PAAMCO

I am Judith Posnikoff from Pacific Alternative Asset Management. Our main office is in Irvine, California, and we also have offices in London and Singapore. I am one of the founding partners of the firm. We started our business in March 2000. We are a fund of funds, and our client base is made up primarily of institutions, largely U.S. pension plans, although increasingly non-U.S. as well.

Some of my partners have been investing in hedge funds since the 1980s. This means we have seen a lot of the ups and downs in the markets; 1990, 1987 in some cases, 1994, 1998, 2002, and now obviously 2008. It is interesting to see the similarities and differences of today compared to the problem periods of the past.

I play a couple of different roles. On the investment side I oversee the equity market neutral and merger arbitrage investments. I am also involved with client service, particularly with the clients from Asia and Japan.

Paul Perez

Northern Trust

My name is Paul Perez, I am a Managing Director at Northern Trust. Northern Trust is 120 years old and is the oldest and largest trust company in the United States. It has over \$500 billion in assets under management, including a fund of hedge funds having about \$1.3 billion in AUM. We have been managing this fund of funds since 2001. It has done well, particularly last year. The fund lost 10%, which was significantly better than most industry benchmarks. We also do investment management consulting for over 20% of the Forbes 400. As these families tend to be direct investors in hedge funds, we advise on many billions of dollars in direct hedge fund allocations.

I have been involved with hedge funds since 1996 (before I joined Northern in 2008), when I helped establish a family office. The strategic allocation included a range of alternative strategies.

Robert “Bucky” L. Isaacson

Futues Funding

My name is Bucky Isaacson and I am a consultant. I work mostly in Asia and Europe, a little bit in the Middle East. I am providing a vast range of consulting and advisory services to large Asian firms and Asian pension funds and social security systems. They may ask me to help them look at a venture capital deal, or help them do financial engineering of a product they want to re-market to their clients. I have probably been doing it for 15 years now.

John Brynjolfsson

Armored Wolf

I am John Brynjolfsson, I am the Chief Investment Officer of Armored Wolf. We are a newly launched global macro hedge fund, with a focus on real assets. We tactically manage exposure to either inflation or deflation. We do that in six specialty sector portfolios plus a broad market master portfolio. Those six sectors are commodities, global inflation-linked bonds, event-linked bonds, emerging market equities, emerging market debt, and emerging market FX.

Mitch Levine
Enable Capital Management

My name is Mitch Levine of Enable Capital Management. We are one of the largest and certainly one of the most active direct investment funds. Direct investments means providing working capital or acquisition capital to growth companies. Companies can be as small as \$50 or \$100 million in market cap, to much, much larger companies. Warren Buffett executed PIPEs when investing in Goldman Sachs and General Electric.

We privately negotiate private investments in public equity (PIPEs), registered directs, convertibles, preferred stock and common stock – any way that we can provide direct funding to a company to enable them to execute their business strategy, creating some kind of inflection point, which hopefully will give us liquidity. We have invested in at least 500 private placements. We launched the fund in July of 2003. This my 25th year in the securities business.

I was involved in developing the idea of PIPEs as a separate, distinct strategy back in the early 90s. At that time we literally had to spell PIPE for everybody; no one had any idea what we were talking about. PIPEs have been around forever, but were rarely used as a form of corporate finance. Today, PIPEs are in the forefront of financing. There were roughly 1500 PIPEs executed last year, and well over \$100 billion was raised.

Kurt Braitberg
TeamCo Advisers

My name is Kurt Braitberg, I am with TeamCo Advisers – Tax Exempt Asset Management Company. We are a San Francisco based, privately held firm formed in 2002. Our founders are David Perry and Rob McCormish who, prior to forming TeamCo, had formed another Asset Management business called Certus Asset Advisers in the 80s. Certus was a stable-value firm, a manager of managers business, whose client base was comprised of mainly corporate defined contribution retirement plans.

We build Specialty Products where we commingle investors with similar investment time horizons, liquidity constraints, performance objectives and regulatory considerations. Our inaugural fund is called STEP 1, the Select Tax Exempt Partners fund. It is a closed-end fund of funds which works a bit like venture capital or private equity. We prescribe a list of up to 20 managers in advance and call the capital down when those 20 managers have capacity. Once we have allocated the capital, we close that particular fund.

Our fees are quite distinctive in that we charge base fees that are scaled, reflecting the work involved in managing a closed-end fund. Once capital is allocated and the fund is closed, we recognize that, given lock-ups and limited liquidity, we have very few opportunities to actually steer the portfolio, and so commensurately, our base fees drop down to a level that is somewhere between three and five times less than what a typical fund of funds may charge.

We have incentive fees that are deferred for the first three years of the fund and tied to objectives that we think are commensurate with the objectives of institutions investing in hedge funds. The first of these is an absolute return hurdle, which we have tied to the average funding rate of the top 100 corporate defined benefit plans. The second is a beta measure against the Russell 3000, recognizing that many institutional investors allocate to hedge funds as a surrogate for equity, looking for an equity-like returns, but without the correlation with the equity markets.

Finally, we have a downside risk measure, where we strive to have a downside risk of less than 1/3rd of that of the Russell 3000. This means that if we don't earn these types of returns over a three-year period, we do not receive incentive fees. We have one client currently, a corporate defined benefit plan for which we have allocated approximately \$400 million among 18 hedge funds.

Michael Wu
Pillsbury Winthrop Shaw Pittman
LLP

I am Michael Wu, I am from the firm of Pillsbury Winthrop Shaw Pittman. Pillsbury is a full service law firm, and I am part of the Investments Funds, Investment Management Practice group and we represent clients in the U.S., Asia, and Europe. The breakdown of our practice is probably 60% hedge funds, 30% private equity and real estate funds, and 10% general legal matters.

Christopher Keenan
Welton Investment Corporation

My name is Chris Keenan, I am with Welton Investment. We are a Managed Futures / Global Macro firm based in Carmel, California, which is south of San Francisco. We have been around since 1988 and our flagship program is called the Global Directional Portfolio. We trade over 90 liquid global futures markets spanning commodities, currencies, equity indices and interest rates. This program is about to meet its five-year anniversary and has returned about 15% annualized with 15% volatility and was up about 23% in 2008. I've been with the firm for about seven years and I oversee strategic planning and marketing.

John Brynjolfsson

This is actually an interesting opportunity to talk about what is going on in California and the West Coast related to the alternatives industry, rather than generically talking about what people otherwise know about California. Also let me put my comments in the context of the current financial crisis.

As players in the financial industry, we all read the big global macro pieces about what is happening with the bailout or what is happening in politics and so on, but apart from macro news there are some pretty dramatic developments at the personal level, where the fallout from the crisis means that 60,000 people have been or will be laid off on Wall Street, with a similar story in London.

What I am getting at is this: as a new firm, we found it very easy to recruit super talented senior executives who see our firm as an opportunity - in some cases precipitated by financial crisis, but in many cases even prior to the financial crisis. We have seen countless examples of senior executives in London or in New York are asking themselves "how do I want to spend the rest of my career, and is being part of a "rat race" corporate skyscraper culture what I want?"

We found people were jumping on planes and flying out to California when they heard about the opportunity of joining a startup out here. Perhaps moving to California and joining a startup is the ultimate fantasy of every executive. All in all, the current climate has been a wonderful environment for attracting talent.

A second aspect is that now is also a wonderful environment for finding investment ideas.

John Brynjolfsson



There is an intellectual discussion going on whether the corporate structure with CEOs' option packages and professional managers is the right "capitalistic institution", in contrast to the more bucolic, capitalistic institution, which would be like a sole proprietorship or partnership.

What I am getting at is this: as a new firm, we found it very easy to recruit super talented senior executives who see our firm as an opportunity - in some cases precipitated by financial crisis, but in many cases even prior to the financial crisis. We have seen countless examples of senior executives in London or in New York are asking themselves "how do I want to spend the rest of my career, and is being part of a "rat race" corporate skyscraper culture what I want?"

We found people were jumping on planes and flying out to California when they heard about the opportunity of joining a startup out here. Perhaps moving to California and joining a startup is the ultimate fantasy of every executive. All in all, the current climate has been a wonderful environment for attracting talent.

A second aspect is that now is also a wonderful environment for finding investment ideas. A year or two ago, in order to meet certain performance and risk targets, in many cases you had to bake three- to five- or maybe even seven-times leverage into the equation, just to get returns. We obviously know that levering up in a low volatility environment is a recipe for disaster, especially if that low volatility environment is accompanied by tight spreads or high valuations.

At the moment, we have a much more welcoming investment environment. Volatility is so high and markets are so inefficient that you can, in fact, accomplish the same target performance with no leverage whatsoever and a cornucopia of investment ideas and opportunities. The collapse in

bank capital - tangible and intangible - means that virtually every prop desk on Wall Street and Fleet Street has cut their daily risk taking to zero.

I have talked to prop traders on major Wall Street desks, the largest prop traders in a given industry segment, and of course what you hear is "well, our prop capital has been cut back". When I probed perhaps somewhat pryingly - "How much has it been cutback? How much prop risk do you leave on your books overnight?" - the answer was zero. Any positions they take on during the day, they plan to close out by the end of the day. If they haven't closed out by the end of the day, then it is a miscalculation or a mistake. This creates a cornucopia of potential excess returns or alpha opportunities for risk capital deployed to teams of talented people.

I have talked to prop traders on major Wall Street desks, the largest prop traders in a given industry segment, and of course what you hear is "well, our prop capital has been cut back". When I probed perhaps somewhat pryingly - "How much has it been cutback? How much prop risk do you leave on your books overnight?" - the answer was zero. Any positions they take on during the day, they plan to close out by the end of the day. If they haven't closed out by the end of the day, then it is a miscalculation or a mistake. This creates a cornucopia of potential excess returns or alpha opportunities for risk capital deployed to teams of talented people.

However, we have also found some investors who say that many funds they could invest in have been locked up, but now, to some extent, have a waiting line to get out, so as funds re-open, any money coming in will probably just be matched by other shareholders liquidating. This means that investors who invest in legacy funds are not really putting in new capital, but are basically providing an exit vehicle for old capital which is trying to leave. The punchy phrase one of our prospects shared with us was that they "didn't want to pay for someone else's redemption."

John Brynjolfsson



At the same time, most clients do not have any capital to allocate because they are either retrenching for the possibility of redemptions, or the possibility of another downturn in the economy or similar events. For capital pools which do have money to allocate, their knee-jerk reaction is often to allocate to large established funds that did okay in prior years.

However, we have also found some investors who say that many funds they could invest in have been locked up, but now, to some extent, have a waiting line to get out, so as funds re-open, any money coming in will probably just be matched by other shareholders liquidating. This means that investors who invest in legacy funds are not really putting in new capital, but are basically providing an exit vehicle for old capital which is trying to leave. The punchy phrase one of our prospects shared with us was that they "didn't want to pay for someone else's redemption." That was obviously music to our ears, because this is one of the advantages of a startup. I can remember as a "legacy" portfolio manager, at my prior firm, I tried to be disciplined by practicing "zero"-based budgeting when re-examining portfolios monthly. I would try to reexamine each position, to confirm that it deserved to be in the portfolio. At a start-up, that same process need not be part of a discipline, ...we are literally building a portfolio, starting with a Tabula rasa!

Judith Posnikoff

Regarding West Coast based hedge funds, I've found that the industry here over the last 10 or 12 years tends to be fairly up and down. I am sure Paul and Kurt will remember that in 1999 to 2001 we had a whole flurry of long-short equity managers, particularly here in the San Francisco area, that were focused on tech, small and micro caps, and then they all sort of went away after 2002.

There is another segment of the local industry which is still standing up. There are several equity market-neutral managers here in the Bay area; a lot of them came out of BGI, Barra or their predecessor organizations.

From a geographical perspective, San Francisco seems to be the hub of hedge funds on the West Coast - there are some in L.A., some in Seattle and San Diego, and then a few in Hawaii, but not

too many in Orange County. I have found it interesting over the years that there are very few hedge funds in the region between L.A. and San Diego, whereas both L.A. and San Diego have at least a small community of hedge funds.



Regarding West Coast based hedge funds, I've found that the industry here over the last 10 or 12 years tends to be fairly up and down. I am sure Paul and Kurt will remember that in 1999 to 2001 we had a whole flurry of long-short equity managers, particularly here in the San Francisco area, that were focused on tech, small and micro caps, and then they all sort of went away after 2002.

There is another segment of the local industry which is still standing up. There are several equity market-neutral managers here in the Bay area; a lot of them came out of BGI, Barra or their predecessor organizations.

Judith Posnikoff

As I said, the hedge fund game here has been very cyclical. In the last few years fewer hedge funds seem to have been set up in San Francisco or in Los Angeles than in years past. It's been a long time since I actually spent a full day visiting managers in L.A., whereas five, six years ago, it was common to go and see startups there. Now, you don't see that many.

I do agree with John that with the current dislocation, some of the larger firms here on the West Coast will be retrenching a bit and let go of some senior people who then will create the new hedge funds that will be here two or three years down the road.

Christopher Keenan

To complement your geographical perspective, we are two hours south of here in Carmel. Looking at the start-up hedge fund space, I was just reading some HFR industry data yesterday which reminded me that half of all hedge funds have less than \$100 million under management. When you consider rising costs and the fragility of these businesses at these asset levels, it helps explain the high attrition rate among small hedge fund managers. As a result, our industry relies on new waves of entrepreneurs to continually replenish the manager pool.

John mentioned the working culture here on the West Coast, which I'd offer has some special traits tied to the culture of Silicon Valley. For example, our firm started there too over twenty years ago, and I think that leads to things like an egalitarian corporate culture, flat structures, and people that are empowered.

Michael Wu

If I look at 2008 and now in 2009, we still meet with a lot of people who are interested in starting hedge funds, but the problem that they are running up against is funding. To get funding is the toughest hurdle for a start up manager. There is no shortage of people with ideas and talent, but for whatever reason, they are just having a hard time raising capital.

This means that a lot of the clients that we work with at this time tend to be the larger, more established funds. But even here it happens that they have to keep pushing back the initial closing or launch date, because they are experiencing difficulties in raising capital.

If I look at 2008 and now in 2009, we still meet with a lot of people who are interested in starting hedge funds, but the problem that they are running up against is funding. To get funding is the toughest hurdle for a start up manager. There is no shortage of people with ideas and talent, but for whatever reason, they are just having a hard time raising capital.

This means that a lot of the clients that we work with at this time tend to be the larger, more established funds. But even here it happens that they have to keep pushing back the initial closing or launch date, because they are experiencing difficulties in raising capital.

Michael Wu



Matthias Knab

We mentioned funding as the number one issue. I spent some time at Bucky's office and I witnessed he gets everyday two, three, or four calls - because he has been in the industry much longer than he told us in his introduction - of people asking him for advice, for an introduction and intelligence about "how can I grow my business, where can I get assets, how can I become institutional"? What are you telling to these people?

Robert "Bucky" L. Isaacson

I tell them to take my name off eHarmony... OK all jokes apart, what you said is very accurate. A lot of new managers call me - I don't represent them, I don't do third party marketing - but a lot of managers get infatuated with the process of trading, and when they are putting their business plan together, they don't spend enough time figuring out how much will cost them to market.

For example if you go to Asia, unless you are flying coach, a week in Asia is \$15,000, unless you're staying at the YMCA, where of course you are not going to stay. Secondly, you have to know that it will take you about one year to get any traction in any one country, as the business is much more relationship driven in Asia and Europe.

Young people often think that you can do marketing with BlackBerries and emails, but in Asia, Europe and even some spots here, you have to develop that personal relationship with the senior guy, before you are going to ever get any money.

So when they call me, one of the things I tell them is to sit down and figure out how much time they can spend on the road and how much money they can spend on marketing. The key thing is to develop a realistic marketing plan as a function of the business.

A lot of new managers call me - I don't represent them, I don't do third party marketing - but a lot of managers get infatuated with the process of trading, and when they are putting their business plan together, they don't spend enough time figuring out how much will cost them to market.

For example if you go to Asia, unless you are flying coach, a week in Asia is \$15,000, unless you're staying at the YMCA, where of course you are not going to stay. Secondly, you have to know that it will take you about one year to get any traction in any one country, as the business is much more relationship driven in Asia and Europe.

Young people often think that you can do marketing with BlackBerries and emails, but in Asia, Europe and even some spots here, you have to develop that personal relationship with the senior guy, before you are going to ever get any money.

So when they call me, one of the things I tell them is to sit down and figure out how much time they can spend on the road and how much money they can spend on marketing. The key thing is to develop a realistic marketing plan as a function of the business.

Once you have a marketing plan, you also have to examine how you actually market, what is the process.

I also tell people who call me for advice to pick their attorney and administrator very carefully. Of course most of the professionals can do a competent job, but part of the benefit an attorney can give you is networking with potential capital sources. And the better they are plugged in, they may be able to give you some referrals, and the same refers to the administrators.

Robert "Bucky" L. Isaacson



Once you have a marketing plan, you also have to examine how you actually market, what is the process. The typical hedge fund manager, when pitching his fund, usually pull out their pitchbook, and it seems that the single most important thing for all is to jump right to the results page. But there are other ways of doing this. I watched a fund in Asia pitching to institutions. They only have institutional clients and they went right to their client list, and all of the sudden that got them attention. All of a sudden they were in the beauty contest. They were down 20% last year - which means they outperformed the markets with a healthy margin - but they had no redemptions from their client base.

I also tell people who call me for advice to pick their attorney and administrator very carefully. Of course most of the professionals can do a competent job, but part of the benefit an attorney can give you is networking with potential capital sources. And the better they are plugged in, they may be able to give you some referrals, and the same refers to the administrators. Getting the right industry updates is also important, the kind of comprehensive news that Matthias and his team are delivering daily on Opalesque. The manager has to focus on much more things than just trading.

Paul Perez

I get a lot of calls from people asking me to review their pitch books, and the big theme is, of course, funding. Many ask me to direct them to funds of funds who invest in emerging managers, which I think is still probably the most fruitful place that a start-up manager can go, both to get assets and to become institutional.

Either a fund can get institutional traction or not. It is the classic “chicken or the egg” thing. A fund needs institutional money to develop an institutional reputation, and I think the solution to that conundrum is an investor which sees and analyzes large numbers of managers, both emerging and emerged. My strongest recommendation is to find managers of emerging managers, and concentrate efforts there. To rely solely on the high net worth side is a very difficult slog.

Managers just starting up also need to show how they address other concerns such as transparency. Mitch and I spoke before about a platform that he is using, and by no means is he a start-up manager. The platform he uses is based here in San Francisco, and it provides transparency, real institutional risk management and things like that. Mitch is intrigued by the fact that most emerging hedge funds do not use such a platform, and I tend to be similarly intrigued.

Paul Perez



Either a fund can get institutional traction or not. It is the classic “the chicken or the egg” thing. A fund needs institutional money to develop an institutional reputation, and I think the solution to that conundrum is an investor which sees and analyzes large numbers of managers, both emerging and emerged. My strongest recommendation is to find managers of emerging managers, and concentrate efforts there. To rely solely on the high net worth side is a very difficult slog.

Managers just starting up also need to show how they address other concerns such as transparency. Mitch and I spoke before about a platform that he is using, and by no means is he a start-up manager. The platform he uses is based here in San Francisco, and it provides transparency, real institutional risk management and things like that. Mitch is intrigued by the fact that most emerging hedge funds do not use such a platform, and I tend to be similarly intrigued. We know that at least until last year half of all hedge fund failures probably resulted from operational issues. So it is entirely appropriate that investors want to have confidence in the operating and risk control structures.

Mitch Levine

I was a startup manager when we went launched in 2003, so I can share how we went through this period. First of all, our strategy is not the typical mainstream hedge fund strategy, so we had to prove the strategy as well as create a track record. I started with \$1.1 million, and to grow a fund from such a low base is nearly impossible. My plan was that over a 12-18 month period time we

could create a track record, and could raise enough capital to start attracting institutional interest or smaller fund of funds looking for a niche.

Five years later, we managed roughly \$450 million. So it can be done, but it can't be done without first-rate service providers, which gave us much-needed credibility.

We were subjected to such thorough due diligence by institutions that I can't understand how Madoff could have ever happened.... We continue to undergo very detailed due diligence by limited partners and prospective investors. I do not blame anybody at all; investors should conduct intense due diligence.

In July 2007 I closed the fund, because we had a lot of institutional interest and we felt we might be capacity constrained. There has to be deals in order for us to allocate our capital. We had large cash positions so we elected to close the fund to new investment. Then 2008 happened, and I learned to never close the fund again.

Let me come back quickly to the position of a start-up manager. Running the business of being a hedge fund is so complicated, so convoluted and most founders, including me, are money managers and might not have the capability to manage a business. Fortunately, now six years later, I think I have a good idea of how to do it, but not without our administrators who are there every step of the way. Conifer offers a plug and play platform for start up hedge funds. You have to have the right lawyers, administrators, and auditors. Service providers can be costly, but I cannot imagine managing our business without them.

I was a startup manager when we went launched in 2003, so I can share how we went through this period. First of all, our strategy is not the typical mainstream hedge fund strategy, so we had to prove the strategy as well as create a track record. I started with \$1.1 million, and to grow a fund from such a low base is nearly impossible. My plan was that over a 12-18 month period time we could create a track record, and could raise enough capital to start attracting institutional interest or smaller fund of funds looking for a niche.

Five years later, we managed roughly \$450 million. So it can be done, but it can't be done without first-rate service providers, which gave us much-needed credibility.

Mitch Levine



Kurt Braitberg

The roots of the hedge fund industry go back to high net worth individuals, and later foundations and endowments. But in 2008, high net worth Individuals and even longstanding foundations and endowments were large redeemers.

We believe that the hedge fund industry is going to become an institutionalized asset management business and the growth in the industry will happen through public and corporate pension plans. Our firm is an allocator on behalf of corporate plans. In our view, the most established, most tenured hedge funds are the most suitable for this constituency.

No disrespect meant to present company, but it has to do with the infrastructure required to be an institutional asset manager going forward. Consider the increasing cost of regulatory compliance. Further, it's not the fact that you have an administrator anymore; what matters is who your administrator is. It's not that you have corporate counsel or an auditor; it has become a matter of who these groups are. We have observed that the providers of these services to hedge funds now are far more discerning in terms of who it is that they will work with.

We find that the most established, the most tenured firms will have the best service providers and this means the best infrastructure available. There is a conundrum here. In our view, the hedge fund industry, like any other growth industry, will result in a few large survivors, and there will be opportunities for more niche players. We may end up with an environment of five to ten billion

It is not the fact that you have an administrator anymore; what matters is who your administrator is. It's not that you have corporate counsel or an auditor; it has become a matter of who these groups are. We have observed that the providers of these services to hedge funds now are far more discerning in terms of who it is that they will work with.

We find that the most established, the most tenured firms will have the best service providers and this means the best infrastructure available. There is a conundrum here. In our view, the hedge fund industry, like any other growth industry, will result in a few large survivors, and there will be opportunities for more niche players.

Kurt Braitberg



dollars funds, and then some \$200-300 million niche funds, but those in between may not be able to afford what it takes to take the next rung in terms of attracting institutional capital.

Robert "Bucky" L. Isaacson

The way how John is building his Armored Wolf fund, where he surrounds himself with senior people, has the infrastructure and is doing best practices already, is unusual for a startup. Most startups begin with mom and pop money, and they don't have that infrastructure. Then most of them fail to become a Kovner or Paul Tudor Jones, because they don't have the ability to bring in outside experts and senior people. They don't have the ability to delegate trading authority to other people, and as a result their capacity becomes limited.

Look at any firm like Paul Tudor Jones, Kovner, Renaissance, Tewksbury etc., they have got 200, 300, 400 quants working for them who are constantly looking for new strategies. They have enough capital, so those due diligence infrastructure problems aren't an issue. Most people are not able to grow in such a fashion and make that transition into a larger business, and they will find it hard to get into institutions as a result.

Judith Posnikoff

One of the things that I tell startups is that no matter how good you are in terms of performance, you also have to be able to support the group of people working for you. In today's tough environment, it could take two, three, maybe even four years without getting any significant outside capital.

And so sometimes people burn themselves out. Bucky was talking about taking marketing trips to Asia or other places. If you are the head guy at a five person shop and you are in Asia, who is watching the portfolio? But then again, it is the head guy who needs to go and see prospects, and people generally don't think about those demands before setting up.

One of the things that I tell startups is that no matter how good you are in terms of performance, you also have to be able to support the group of people working for you. In today's tough environment, it could take two, three, maybe even four years without getting any significant outside capital.

And so sometimes people burn themselves out. Bucky was talking about taking marketing trips to Asia or other places. If you are the head guy at a five person shop and you are in Asia, who is watching the portfolio? But then again, it is the head guy who needs to go and see prospects, and people generally don't think about those demands before setting up.

Maybe the best advice for a startup is really to just put their heads down and churn out the numbers, and once they do that, people will get interested in the numbers and then come to them. Right now, it is not possible to attract capital like earlier startups in 2004 or 2005 were able to do. But from an investor's point of view, that's great as this is what creates the opportunities.

Judith Posnikoff



Maybe the best advice for a startup is really to just put their heads down and churn out the numbers, and once they do that, people will get interested in the numbers and then come to them. Right now, it is not possible to attract capital like earlier startups in 2004 or 2005 were able to do. But from an investor's point of view, that's great as this is what creates the opportunities.

Another factor is getting the right service providers. Most of the good ones in many cases won't talk to anybody unless they have a commitment of \$100 million to start. It is really difficult to get good service providers, which is then a mark against a fund if they don't have the top administrators, the top law firms or the top prime brokers.

Paul Perez

I believe that general partner risk is the single biggest risk when investing in hedge funds, since the GPs can pretty much do anything with the assets entrusted to them. They will have to prove to potential investors that they present as little general partner risk as possible - and part and parcel of the "risk profile" is the GPs' personal financial wherewithal.

When startups or emerging managers come to me, I know that the conversations will have mutually uncomfortable aspects. I try not to be so crude as to ask about each partner's net worth. I usually begin with questions about working capital, particularly its sources. Irrespective of the sources of working capital, I always ask about the draws the partners are taking. I ask question such as: Do you all need to take draws? Are the draws proportional to ownership interests (that is, are some partners subsidizing others)? How are the spouses with this? How many years can these draws continue if asset raising is slower than anticipated? The responses need to seem to me to be plausible in light of the partners' backgrounds, pedigrees, lifestyles. Plausibility has to be the standard, as it is difficult to verify the answers to my questions.

In this particular environment, I believe that these issues are more important then ever.

I believe that general partner risk is the single biggest risk when investing in hedge funds, since the GPs can pretty much do anything with the assets entrusted to them. They will have to prove to potential investors that they present as little general partner risk as possible - and part and parcel of the "risk profile" is the GPs' personal financial wherewithal.

When startups or emerging managers come to me, I know that the conversations will have mutually uncomfortable aspects. I try not to be so crude as to ask about each partner's net worth. I usually begin with questions about working capital, particularly its sources.

Irrespective of the sources of working capital, I always ask about the draws the partners are taking. I ask question such as: Do you all need to take draws? Are the draws proportional to ownership interests (that is, are some partners subsidizing others)? How are the spouses with this? How many years can these draws continue if asset raising is slower than anticipated? The responses need to seem to me to be plausible in light of the partners' backgrounds, pedigrees, lifestyles.

Paul Perez



Matthias Knab

Do you see any changes happening in portfolio management? Are there lessons learned from 2008 and 2009 when it comes to how people create and manage portfolios?

Christopher Keenan

Asset allocation is the single-most commonly discussed topic we encounter when we meet with investors. After Q4 of 2008, we really had almost confessional sessions with investors who said things like "We need to completely rethink how we're investing in hedge funds".

I was just at a pension conference last week and many CIOs acknowledged that 2008 has forced them to take another look at their asset allocation strategy. The problem is that investors wanted, and still want, non-correlated, positive performance. Many investors thought their broad hedge fund allocations would provide this, but 2008 revealed that these traits are truly rare and that equity beta is prevalent. Strategies like managed futures and global macro are gaining recognition as “true alternatives”, particularly as more investors look back through history and rediscover that these traits have persisted across numerous market cycles.

I think 2008 also reminded us that asset allocation strategy is much more than an academic exercise, and that these decisions have real human consequences. The billions in wealth destruction across pensions, endowments and personal savings will impose very real hardships on many, many people.

Asset allocation is the single-most commonly discussed topic we encounter when we meet with investors. After Q4 of 2008, we really had almost confessional sessions with investors who said things like "We need to completely rethink how we're investing in hedge funds".

I was just at a pension conference last week and many CIOs acknowledged that 2008 has forced them to take another look at their asset allocation strategy. The problem is that investors wanted, and still want, non-correlated, positive performance. Many investors thought their broad hedge fund allocations would provide this, but 2008 revealed that these traits are truly rare and that equity beta is prevalent. Strategies like managed futures and global macro are gaining recognition as “true alternatives”, particularly as more investors look back through history and rediscover that these traits have persisted across numerous market cycles.

I think 2008 also reminded us that asset allocation strategy is much more than an academic exercise, and that these decisions have real human consequences. The billions in wealth destruction across pensions, endowments and personal savings will impose very real hardships on many, many people.

Christopher Keenan



Matthias Knab

What else is important regarding asset allocation?

Christopher Keenan

I think investors will return to the more enduring investment criteria, things like alpha versus beta, and true diversification, both of which have diminished in importance over time among investors. For example, if one examines the amount of assets within each of the broad hedge fund strategy classifications, one sees that about 70% of all hedge fund investments globally in early 2008 were concentrated in those strategies that had the highest correlations to equities, and the highest cross-correlations to each other.

Tom Schneeweis, a respected academic and one of the founders of the CAIA credential published an editorial in Opalesque in February 2009 which was directed at the investors of alternatives. In it, he expresses his astonishment with investors who were disappointed with hedge fund

If one examines the amount of assets within each of the broad hedge fund strategy classifications, one sees that about 70% of all hedge fund investments globally in early 2008 were concentrated in those strategies that had the highest correlations to equities, and the highest cross-correlations to each other.

Christopher Keenan



performance in 2008, which was broadly down about 20%. He makes a very impassioned case that there are no black boxes, that the various hedge fund strategies behaved predictably, and that 2008 revealed a need for better continuing education on the investor side.

John Brynjolfsson

Obviously, we're mainly focused here on hedge funds, but I get the opportunity to talk to people on the asset allocation question more broadly, and like any good sales pitch, there is always a positive spin on each asset class. The fixed income investors who, for example, focus on pure sovereign risk come out and say "we had a great year - we were up 6% or 8%." Or in the case of long treasuries, investors are up 30%! Similarly, some of CTA strategies generated great returns in 2008, and so they also have an easy time going to an investment committee and tell them that their past record proves that they should have a bigger allocation.

I get the opportunity to talk to people on the asset allocation question more broadly, and like any good sales pitch, there is always a positive spin on each asset class. The fixed income investors who, for example, focus on pure sovereign risk come out and say "we had a great year - we were up 6% or 8%." Or in the case of long treasuries, investors are up 30%! Similarly, some of CTA strategies generated great returns in 2008, and so they also have an easy time going to an investment committee and tell them that their past record proves that they should have a bigger allocation.

And on the other side, you have the equity managers who say "if you had 60% allocation to equities at the end of 2007, with equities down about 65%, you now obviously, want to increase that!"

I want to address here, as well, the negative headlines about to hedge funds which related to outrageous abuses of lockups and liquidity clauses. In one case, I heard about a hedge fund manager who defined a Dollar-Yen trade as an illiquid position - such practices are clearly an abuse and thankfully rare.

In the context of the rational asset allocation and logically planning to meet your return targets, a number of sophisticated tactical asset allocators are proposing a move towards alpha-beta separation. Here, we pay attention to liabilities, and, when it comes to generating alpha, move away from some kind of naive approach like "equities for the long run", and instead create an optimal portfolio of alpha strategies across a portfolio to diversify risks.

John Brynjolfsson



And on the other side, you have the equity managers who say "if you had 60% allocation to equities at the end of 2007, with equities down about 65%, you now obviously, want to increase that!" This would imply that the CIO or tactical asset allocator will ask the bond managers to liquidate positions in order to fund an equity portfolio, not exactly "rewarding" performance, and/or punishing those who failed to grasp the risk in their area.

I want to address here, as well, the negative headlines about hedge funds which related to outrageous abuses of lockups and liquidity clauses. In one case, I heard about a hedge fund manager who defined a Dollar-Yen trade as an illiquid position - such practices are clearly an abuse and thankfully rare.

Let's back-up a minute. A large percentage of the world's hedge fund assets are pension funds (either directly or indirectly). An average pension plan tries to achieve 8% or 9% returns. This is pretty hard to achieve using bonds alone, or, in the case of equities, cannot be done on the basis of an earnings yield or any kind of straightforward valuation. You could achieve these returns if you knew for sure that equities are going to bounce back to previous levels, but that is not really the question.

Therefore, in the context of the rational asset allocation and logically planning to meet your return targets, a number of sophisticated tactical asset allocators are proposing a move towards alpha-beta separation. Here, we pay attention to liabilities, and, when it comes to generating

alpha, move away from some kind of naive approach like "equities for the long run", and instead create an optimal portfolio of alpha strategies across a portfolio to diversify risks.

Drilling down a little bit into the hedge fund or the alternative space, there are a couple of observations. One, it seems to me, is that there has been a pretty clear disciplining of the industry to disaggregate liquid strategies from illiquid strategies. There is nothing wrong with illiquid strategies, but they have got to be acknowledged as such. This means, if a hedge fund is offering 30-day liquidity, monthly NAVs and so forth, they cannot be in strategies involving mortgage residuals, or distressed corporates, or bank capital where the workout period is in effect three-, five-years or longer periods. Those strategies, as attractive as they are, should be allocated to in a distinct process involving a structure with a three- to five-year lockup, so the liabilities match the assets. The hedge funds that do continue with these strategies will have to decrease their liquidity by bringing down gates or restructuring, will also have to increase transparency and make sure that their assets reflect that difference.

The obvious, related issue is that investors as a group are recognizing that there may be something wrong with the fee structure. A typical example would be a hedge fund which, over the past five years, may have clocked an accumulated return of 60% (of which 20% dropped into their own pockets) and then suffered a 50% drop. Lo and behold, there is no claw-back of their fees, so the fund ends up with huge incentive compensation and the investor ends up flat. This is quite rightly a model that's under attack.

Paul Perez

Obviously performance is an issue when we look at recent hedge fund returns. I have been an advisor to ultra high net worth individuals for a long time, and many people have called me expressing great distress at the negative performance of their hedge funds or funds of funds during 2008. I always ask them about the reasons they invested in hedge funds in the first place and perhaps what exposure they reduced in order to fund the hedge fund exposure. If they wanted a high quality bond substitute, then they have reason to be distraught. If, on the other hand, they were seeking a less volatile equity substitute, then, gosh, hedge funds in general delivered the result they were seeking.

But, it wasn't actually the negative performance that most shocked investors and advisors. The thing that has shocked investors and their advisors more than performance has been illiquidity, the shocking discovery (despite having signed documents allowing a certain percentage of illiquid

Obviously performance is an issue when we look at recent hedge fund returns. I have been an advisor to ultra high net worth individuals for a long time, and many people have called me expressing great distress at the negative performance of their hedge funds or funds of funds during 2008. I always ask them about the reasons they invested in hedge funds in the first place and perhaps what exposure they reduced in order to fund the hedge fund exposure. If they wanted a high quality bond substitute, then they have reason to be distraught. If, on the other hand, they were seeking a less volatile equity substitute, then, gosh, hedge funds in general delivered the result they were seeking.

But, it wasn't actually the negative performance that most shocked investors and advisors.

Some very astute managers decided to take on liquidity risk, but while they may have been quite cognizant of the implications of that decision, I'm not sure all investors, particularly those mediated by institutional consultants, were aware of what was going on and about the risks involved. My speculation is that a lot of institutional investors and their advisors reasoned in the following manner: "the GPs have a great track-record and they are asking to go from 10% illiquid to 20%, and gosh, we don't want to be thrown out so we'd better consent..."

The ironic thing is that the managers who did not take on illiquid positions received as many or more redemption notices as did those managers who were side pocketing investments and invoking gating clauses; their LPs were seeking liquidity wherever they could find it.

Paul Perez



investments) that side pockets are there and that the investor is stuck with them. In my experience, in the boom years of 2003 to 2007, many managers sought LP approval for increasing the percentage of AUM that could be invested in illiquid positions. The GPs explained that the best opportunities required taking on this liquidity risk.

Thus, some very astute managers decided to take on liquidity risk, but while they may have been quite cognizant of the implications of that decision, I'm not sure all investors, particularly those mediated by institutional consultants, were aware of what was going on and about the risks involved. My speculation is that a lot of institutional investors and their advisors reasoned in the following manner: "the GPs have a great track-record and they are asking to go from 10% illiquid to 20%, and gosh, we don't want to be thrown out so we'd better consent...."

The ironic thing is that the managers who did not take on illiquid positions received as many or more redemption notices as did those managers who were side pocketing investments and invoking gating clauses; their LPs were seeking liquidity wherever they could find it.

As John said, many actions by managers are being scrutinized. But if I had to pick the one action that has not yet been fully discussed and accounted for, I would point to the process when investors and consultants consented to go more illiquid at their hedge fund managers' request.

Judith Posnikoff

Paul is right, I would say that there are three things that came out of 2008 and to some extent 2007, that will really impact the industry going forward. One was the degree of implicit leverage and concentration within many hedge fund portfolios, and the recognition of the mismatch in terms of the assets and liabilities both on the investment and then on the investor side.

The second theme which I believe will have a long lasting impact on the industry is governance, the question of who governs the actual investment relationships here in terms of the documents, the board of directors etc. A lot of the large institutional investors, the big state plans and so forth,

The second theme which I believe will have a long lasting impact on the industry is governance, the question of who governs the actual investment relationships here in terms of the documents, the board of directors etc. A lot of the large institutional investors, the big state plans and so forth, do not want to be subject to the whims of a million dollar high net worth investor who then aggregated as a group starts to impact what is going on in the portfolio (to meet their redemptions and so forth). Governance is going to be even more important, and that is why there is such a focus now on doing separate accounts. However, people don't realize how much work and what kind of issues are involved in running separate accounts. As a result, I think there will be a bit of a swing back once people do realize there is more to a separate account than just the initial set-up and they aren't willing to take on those responsibilities.

I also agree with Paul's other point that people often don't read the underlying documents (such as the PPMs and Articles of Association) that govern the investment in a hedge fund, and they don't understand what is in the documents, particularly as they relate to when and how a fund can suspend or limit redemptions. The managers will mostly say "well, my lawyer tells me to put the language in there, just for the worst case", and last year of course was the worst case when the managers did draw on all those clauses the documents enabled them to.



My third observation is that the business of running a hedge fund is much more important than many people previously realized (it's not just a manager's investment strategy and process), and many of these businesses are fairly unstable. The prime example is a manager who generated 15+% per year returns earning his 20% performance fee for a number of years and became very wealthy off that. Then the bad year strikes and he comes back to the clients and says "well, sorry, but if you don't re-up to a different high watermark, we won't be in business anymore." There's no money set aside for a rainy day or to back up the business.

Judith Posnikoff

do not want to be subject to the whims of a million dollar high net worth investor who then aggregated as a group starts to impact what is going on in the portfolio (to meet their redemptions and so forth). Governance is going to be even more important, and that is why there is such a focus now on doing separate accounts. However, people don't realize how much work and what kind of issues are involved in running separate accounts. As a result, I think there will be a bit of a swing back once people do realize there is more to a separate account than just the initial set-up and they aren't willing to take on those responsibilities.

I also agree with Paul's other point that people often don't read the underlying documents (such as the PPMs and Articles of Association) that govern the investment in a hedge fund, and they don't understand what is in the documents, particularly as they relate to when and how a fund can suspend or limit redemptions. The managers will mostly say "well, my lawyer tells me to put the language in there, just for the worst case", and last year of course was the worst case when the managers did draw on all those clauses the documents enabled them to. Governance is the big issue that comes out of the 2008 experience and will change how people invest going forward.

My third observation is that the business of running a hedge fund is much more important than many people previously realized (it's not just a manager's investment strategy and process), and many of these businesses are fairly unstable. The prime example is a manager who generated 15+% per year returns earning his 20% performance fee for a number of years and became very wealthy off that. Then the bad year strikes and he comes back to the clients and says "well, sorry, but if you don't re-up to a different high watermark, we won't be in business anymore." There's no money set aside for a rainy day or to back up the business. I think investors really revolted against that type of attitude, and it goes back to governance and leads to the subsequent demand for separate accounts and similar platforms to get away from these problems.

Robert "Bucky" L. Isaacson

A quick point regarding the discussion on managed accounts. The fund of funds, consultant, investor, whoever is getting daily trades, then sure, they have more transparency, but on the other hand, also more liability. What happens if the manager drifts away from what he is supposed to do, and you haven't picked up the style drift?

Judith Posnikoff

Correct, and there is more to that. For example, whoever gets the daily data or deals with such kind of reporting, not only has liability issues, but also you may have to change your internal trading policy, along with adding to compliance, regulatory reporting, monitoring and other such things. All of this creates a substantial operational burden and increases your overhead.

Kurt Braitberg

Listening to this discussion on lessons learned, it occurs to me that certain risks which have always lurked in hedge funds in particular and within the financial system generally, became more visible in 2008. One is the liquidity mismatch between assets and liabilities which existed at banks, and even at foundations, endowments and pension plans. This mismatch existed at the hedge fund level too, where liquidity terms didn't necessarily match their underlying portfolio.

Also the fund of funds industry is part of the game here, promoting mostly monthly or 90-day liquidity when really the only source of liquidity is the underlying managers. Unless you're funding it with incoming cash flows. Now, Ponzi has been redefined lately, but in a sense that is a scheme.

The other risk that was highlighted in 2008 is co-investor risk. Certainly in a commingled structure each investor should understand what the attitudes of the other investors are towards liquidity and time horizons. What is the nature of those investors with whom you are invested side by side? What are their goals and objectives? In 2008 we saw time and again that hedge funds were forced to make decisions as a result of the actions taken by some of their investors. Going forward, institutions will be much more focused on what their co-investor's expectations are. As long as we all have the same expectations, we are not going to act, or react, irrationally.

In 2009 and onwards, the focus will be much more on liquidity structures relative to portfolios, considering who the other investors are, what is the duration of a hedge fund's liquidity relative to the portfolio.

The other risk that was highlighted in 2008 is co-investor risk. Certainly in a commingled structure each investor should understand what the attitudes of the other investors are towards liquidity and time horizons. What is the nature of those investors with whom you are invested side by side? What are their goals and objectives? In 2008 we saw time and again that hedge funds were forced to make decisions as a result of the actions taken by some of their investors. Going forward, institutions will be much more focused on what their co-investor's expectations are. As long as we all have the same expectations, we are not going to act, or react, irrationally.

In 2009 and onwards, the focus will be much more on liquidity structures relative to portfolios, considering who the other investors are, what is the duration of a hedge fund's liquidity relative to the portfolio.

While lately manifestos have been written advocating separately managed accounts. I think that we will see the pendulum come back a little bit. We will end up seeing structures that ultimately commingle investors with very similar characteristics. This diminishes co-investor risk without taking on the administrative burden of separate accounts.

Kurt Braitberg



While lately manifestos have been written advocating separately managed accounts. I think that we will see the pendulum come back a little bit. We will end up seeing structures that ultimately commingle investors with very similar characteristics. This diminishes co-investor risk without taking on the administrative burden of separate accounts.

Separate accounts require a tremendous administrative effort both from the hedge fund themselves as well as the sponsor of that particular separate account. When providing services to hedge funds through separate accounts, be careful what you ask for, because then you become a counterparty for prime brokers or in swap arrangements etc., so you become the counterparty to things that otherwise the hedge fund had taken care for you.

John Brynjolfsson

Needless to say, ten weeks ago just post-Madoff, the immediate knee-jerk reaction was "we need separate accounts, so that we can have complete control and complete transparency" and so on. My impression, more recently, is that people who try to go down this path are realizing that this has many implications: setting up multiple trading relationships, counterparty relationships, custodial relationships etc. is relatively expensive. Unless you are allocating \$75 million per manager, you have to contemplate whether this makes sense.

We already spoke about some of the responsibilities that the investors shared when they "suddenly" found themselves in illiquid positions. You can't just put all blame on the manager. An investor I spoke to last December was lamenting the gates and lockups and so on. I alluded to him that we had some pretty high powered attorneys and some connections, and what he would think about us helping him to get some of those funds released? We thought, "let's be generous here," and of course we also hoped that maybe we would end up managing some of those assets.

The investor said, "wow, that would be great, that would be wonderful, that would solve all of our problems!" and then they asked "oh, by the way, what would you do once we got those assets unlocked?" I said: "well, we could liquidate them, because there are bids out there for these assets." His face literally went pale and he said "oh, no, no, you can't hit any bids, these markets are very thin and prices are already so low, we don't want them to go any lower."

So here we have a kind of a "king has no clothes"-type character to these markets, which means that the same investors who have funds locked up or assets locked up are not really sure they want those assets liquidated. If - God forbid! - some of those assets are marked above fair value prices, which these usurious hedge fund managers would have incentive to do so they could keep a higher management fee, there may be some financial institutions out there with those investments in these

hedge funds who will not necessarily point out that those funds are marked at higher than fair value prices, because then they would have to acknowledge those losses on their portfolios as well.

I'm not suggesting that there is this huge conspiracy going on, but there are some elements across the industry that deserve more scrutiny and a more open discussion.

We already spoke about some of the responsibilities that the investors shared when they "suddenly" found themselves in illiquid positions. You can't just put all blame on the manager. An investor I spoke to last December was lamenting the gates and lockups and so on. I alluded to him that we had some pretty high powered attorneys and some connections, and what he would think about us helping him to get some of those funds released? We thought, "let's be generous here," and of course we also hoped that maybe we would end up managing some of those assets.

The investor said, "wow, that would be great, that would be wonderful, that would solve all of our problems!" and then they asked "oh, by the way, what would you do once we got those assets unlocked?" I said: "well, we could liquidate them, because there are bids out there for these assets." His face literally went pale and he said "oh, no, no, you can't hit any bids, these markets are very thin and prices are already so low, we don't want them to go any lower."

If - God forbid! - some of those assets are marked above fair value prices, which these usurious hedge fund managers would have incentive to do so they could keep a higher management fee, there may be some financial institutions out there with those investments in these hedge funds who will not necessarily point out that those funds are marked at higher than fair value prices, because then they would have to acknowledge those losses on their portfolios as well.

I'm not suggesting that there is this huge conspiracy going on, but there are some elements across the industry that deserve more scrutiny and a more open discussion.

John Brynjolfsson



Another such element would be our different accounting systems. It could be argued that that the reason we have a banking system problem is because banking and brokerage accounting is better accounting than what we have in life insurance and other corporate structures. It is certainly much better accounting than what we would have in state pension plans or social security, where accounting for liabilities is absurd, cash flow accounting. Think about it: we are in this trouble because finance has the "best" accounting of all the different types, and not because they have the worst accounting.

Matthias Knab

Judy, in your introduction you referred to the historical perspective, comparing the current crisis with previous ones. How is the current crisis different and what is the same?

Judith Posnikoff

Obviously, there are some characteristics of 2008 that were very much like 1998, although 1998 was different in the sense that it was very short lived and other than LTCM, no other major entities went down. During 2008 we lost Bear Sterns, Lehman Brothers, and a number of other domestic and international financial institutions were affected, we had much greater ripple effects. For example, Lehman going down made people worried about their counterparties, prime brokers in particular. People pulled balances away to diversify their counterparty exposure which then became part of the forced deleveraging. These effects did not stop at the prime broker, but continued to snowball from there, it was very ugly there for a period of time. Interestingly, we have already seen money come back and financing opportunities have come back in certain areas seemingly almost as quickly as they disappeared.

The events in 2008 combined a market crisis with instability in the banking system or the actual

infrastructure of the system. When we talked about it internally at PAAMCO, it seemed to us a much more exaggerated version of some of the things that we saw say in 1991, rather than really 1994 or 1998. To some extent it was a combination of 1987 which was more spread out, together with effects from the 1990-1991 S&L crisis period in the U.S. Looking at events in this way helped us to partially understand the great unwind and the sequence of the events.

The events in 2008 combined a market crisis with instability in the banking system or the actual infrastructure of the system. When we talked about it internally at PAAMCO, it seemed to us a much more exaggerated version of some of the things that we saw say in 1991, rather than really 1994 or 1998. To some extent it was a combination of 1987 which was more spread out, together with effects from the 1990-1991 S&L crisis period in the U.S. Looking at events in this way helped us to partially understand the great unwind and the sequence of the events.



But on a larger scale, I believe it can be said that money is not going to come back to many of these hedge fund strategies for quite awhile given the exit of the various prop desks, which creates significant opportunities for active management, even in the very simple hedge fund strategies like merger arbitrage or old-fashioned mean reversion strategies, for example.

An equity market neutral manager told me how surprised they were to find that the strategy that they founded their business on, which subsequently was arbitrated away in 2001 and 2002, is now their best performing strategy.

Judith Posnikoff

But on a larger scale, I believe it can be said that money is not going to come back to many of these hedge fund strategies for quite awhile given the exit of the various prop desks, which creates significant opportunities for active management, even in the very simple hedge fund strategies like merger arbitrage or old-fashioned mean reversion strategies, for example.

An equity market neutral manager told me how surprised they were to find that the strategy that they founded their business on, which subsequently was arbitrated away in 2001 and 2002, is now their best performing strategy. At the moment, the markets are working in a different way, and there aren't the competitors that were there before. It is not likely that even with the end of the forced deleveraging things will snap back quickly. The disruptions were and to some extent remain so severe that for the foreseeable future a lot of opportunities can be seized in liquid and also in less liquid hedge fund strategies.

Kurt Braitberg

This is not an original saying but I think it still holds true: "once you have seen one crisis, you have seen one crisis."

Our role as an allocator is simply to put capital with who we think are the world's best money managers. Our managers confirm the "back to the future" environment that Judy just described. The supply of risk capital is diminished by magnitudes from where it was a year ago, such that strategies which were perhaps arbitrated away have come back now. The opportunities in the hedge fund space appear to be as good as they were perhaps five or even ten years ago. The investment opportunities for hedge funds seem to be quite strong, but they will only be available to those who will survive this period and be able to attract and invest capital.

Matthias Knab

What else do you see happening in asset allocation or asset flows?

Robert "Bucky" L. Isaacson

Some of the people that I talk to, particularly in Asia, which made large allocations to alternatives in 2006 and 2007 are just gun-shy. And then you have others like the large Korean and Philippine institutional users which are very aggressive now, because they didn't allocate in the years before and perceive some of the hedge fund strategies offering a great opportunity now. They see them rebounding.

Paul Perez

My experience is principally with ultra high net worth individuals, and I am not sure if they are particularly more or less subject to the phenomena that behavioral finance talks about, but “gun-shy” about investing in general and alternative investing in particular is a good description of how they feel right now. Some great

Some of the people that I talk to, particularly in Asia, which made large allocations to alternatives in 2006 and 2007 are just gun-shy. And then you have others like the large Korean and Philippine institutional users which are very aggressive now, because they didn't allocate in the years before and perceive some of the hedge fund strategies offering a great opportunity now. They see them rebounding.

Robert "Bucky" L. Isaacson



investors would argue that this stance by many investors makes it a great time to invest. However, very few individuals at the end of the day are contrarian. Investors feel as though they have been burned, particularly by their hedge fund investments, so it is incumbent upon their advisors or others to bring a bit of the contrarian view to them.

Regarding asset allocation, with illiquidity being one of the two or three great shocks of 2008, I would say people will look for more liquidity as one consequence. A second force will be the mandate on the corporate pension side for liability driven investment.

With regard to corporate pension funds, the question whether or not hedge fund portfolio assets constitute a true match to liabilities has been the subject of debate. While my pension fund experience is limited, in my view, the answer is no – at least for the present. It would take a pretty brave CIO at a corporate pension fund to make that case after 2008.

I see two opposing trends. I think there is more of a draw to fixed income, but also, from a macro economic and monetary standpoint, we will almost certainly have inflation. So is fixed income really the right way to go? I don't have the answer, but between the desire for stable value and the specter of inflation lays an opportunity for managers once again to attract risk capital. Managers who have demonstrated their ability to protect against the downside or against inflation will experience positive asset flows. My guess is that the opposite will occur in the case of managers who employ abstruse black box strategies or illiquid positions.

John Brynjolfsson

We can do a little bit of a retrospective on the guilty parties at the ball, and there is plenty of blame to go around. However looking forward is obviously much more productive. Looking forward, what we realize is that we cannot anticipate a return to “normal”, because the normal that we are familiar with involved people borrowing more than their income, a huge flood of resources into relatively unproductive areas, and leverage and government policies that promoted excessive consumption and excessive debt and so on.

The reality is that not only will we not get back to that “normal” we used to enjoy until recently, but we cannot even get back to a “regular normal”, where there is some form of marrying between supply and demand, or income and consumption, because we are still dealing with a hangover. And it looks like it could be a five or ten year hangover just to work off the overhang of debt the economy globally, the consumers and other constituents have taken on. All this is accompanied by underfunded pension plans and so forth.

So what we have is a situation where the macro economy is in a state of dis-repair, and even if it gets “repaired” will still be much more muted than what we were used to.

Bernanke has, in effect, published his play book: his doctoral dissertation and his subsequent work on inflation targeting, on the Japanese experience which has is now going on for 19 years, and his work on quantitative easing. The latter is obviously the page in his book that he is playing right now.

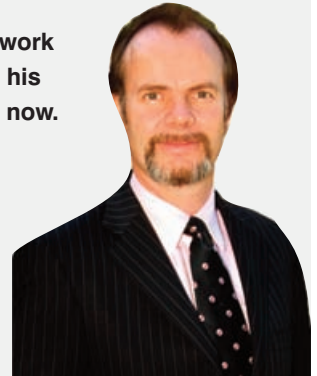
Looking forward, what we realize is that we cannot anticipate a return to “normal”, because the normal that we are familiar with involved people borrowing more than their income, a huge flood of resources into relatively unproductive areas, and leverage and government policies that promoted excessive consumption and excessive debt and so on.

The reality is that not only will we not get back to that “normal” we used to enjoy until recently, but we cannot even get back to a “regular normal”, where there is some form of marrying between supply and demand, or income and consumption, because we are still dealing with a hangover. And it looks like it could be a five or ten year hangover just to work off the overhang of debt the economy globally, the consumers and other constituents have taken on. All this is accompanied by underfunded pension plans and so forth.

Bernanke has, in effect, published his play book: his doctoral dissertation and his subsequent work on inflation targeting, on the Japanese experience which has is now going on for 19 years, and his work on quantitative easing. The latter is obviously the page in his book that he is playing right now.

All these things indicate to us what is coming down the track, which is nothing less than that freight train known as inflation. If there is one macro economic fundamental that determines success of investment strategies, it is knowing whether we are in a deflationary or inflationary episode.

John Brynjolfsson



All these things indicate to us what is coming down the track, which is nothing less than that freight train known as inflation. If there is one macro economic fundamental that determines success of investment strategies, it is knowing whether we are in a deflationary or inflationary episode.

This, in turn, gives the investors a very easy choice. They are on the track, there is a train coming down the track and they have a choice of sitting on the track and letting the train run them over, or getting off the track, letting the train go by and perhaps even profiting from it.

We discussed portfolio allocation, so let's take a look at pension management and asset liability management, for example. Traditionally, asset liability management means buying long-term treasuries to match the pension liabilities. Well, right now, treasuries yield 3.00-3.25%, which are 40 year lows, and 30 year swaps are trading through treasuries in this kind of knee-jerk irrational quest for nominal duration.

In my view, the ultimate asset allocation paradigm is moving towards alpha and beta separation, and an improved asset and liability management. I am not suggesting that we all should follow now another kind of knee-jerk financial engineering approach to those questions, but there are better ways to do asset liability management and for alpha/beta separation which will become more visible in the future.

Matthias Knab

What else are you excited about?

Mitch Levine

We do see exciting opportunities, because of uncertainty of the markets and the fear of investors. Today's discussion revolves around illiquidity and for good reason. However, apart from liquidity aspects, people invest in hedge funds because they want to diversify, meet certain risk-return profiles without market correlation. Investing in a hedge fund includes investing in people who are capable of running a complex strategy, strategies that often have different liquidity parameters than other forms of market investment.

In our case, it is going to take an extended period of time to unwind a position, since by definition we invest in securities that must go through the registration process. Once we exit a position, which could take a year or more, we retain warrants for potential upside. Maybe the expectation

towards liquidity needs to be adjusted a little by both the managers and the investors. If we can manage expectations of liquidity, we can take advantage of today's fractured environment, where opportunity exists.

We do see exciting opportunities, because of uncertainty of the markets and the fear of investors. Today's discussion revolves around illiquidity and for good reason. However, apart from liquidity aspects, people invest in hedge funds because they want to diversify, meet certain risk-return profiles without market correlation. Investing in a hedge fund includes investing in people who are capable of running a complex strategy, strategies that often have different liquidity parameters than other forms of market investment.

In our case, it is going to take an extended period of time to unwind a position, since by definition we invest in securities that must go through the registration process. Once we exit a position, which could take a year or more, we retain warrants for potential upside. Maybe the expectation towards liquidity needs to be adjusted a little by both the managers and the investors. If we can manage expectations of liquidity, we can take advantage of today's fractured environment, where opportunity exists.

For our strategy the outlook is splendid, companies need capital like never before. I don't think anybody got wealthy in this world by following other people, and especially when it comes to investing in hedge funds, I believe investors are highly motivated to find very well-thought out strategies, that cannot be invented overnight and it possibly have tremendous barriers to entry.

Mitch Levine



For that, we need to recognize some hedge funds are not meant to be short-term investments and are most effective when we let the cycles develop where the real returns can build up. If you took a venture capital fund and you gave them one year, an investor most likely will lose money. Certain strategies just need a longer perspective. We need to create the vehicles that reflect the opportunity but also liquidity. Perhaps the answer lies in separately managed accounts, or single LP hedge funds. Or simply recognizing the illiquidity of the strategy. There are great solutions, but panic won't bring any of those to fruition...

What else is exciting? Because of all that disarray, because everyone is running for the exits, all we hear about is what is wrong here and there, and yet you can make money. For example during the last six weeks, if you are an advisor and you haven't had your investors in the stock market, the clients are probably not happy with you....

For our strategy the outlook is splendid, companies need capital like never before. I don't think anybody got wealthy in this world by following other people, and especially when it comes to investing in hedge funds, I believe investors are highly motivated to find very well-thought out strategies, that cannot be invented overnight and that possibly have tremendous barriers to entry. Whether the environment becomes inflationary or deflationary, I think we are all smart enough to try to pick that up as it happens and take advantage of it. As hedge funds we can go long and short and have this flexibility to react to any economical climate like few other asset classes or investment options.

Kurt Braitberg

We are excited about where this industry is heading. I believe we are at the precipice of a maturation of this industry. Pension plans have begun to recognize that the traditional 60:40 mix does not work - it subjects them to undue volatility. The whole approach just doesn't work.

Another recognition of 2008 is that there is a better class of active managers out there and available. Conventional asset management firms that offer traditional products are no longer the keepers of investment talent. I believe that the hedge fund industry in particular will be recognized for what it is, namely a space where truly skilled investment managers exist.

I believe we are at the precipice of a maturation of this industry. Pension plans have begun to recognize that the traditional 60:40 mix does not work - it subjects them to undue volatility. The whole approach just doesn't work.

Another recognition of 2008 is that there is a better class of active managers out there and available. Conventional asset management firms that offer traditional products are no longer the keepers of investment talent. I believe that the hedge fund industry in particular will be recognized for what it is, namely a space where truly skilled investment managers exist.

These are the things which the dominant pension consultants will have to embrace, both in terms of diversification and recognizing strategies that are less correlated with the equity markets, but moreover that there is a pool of talent in so-called hedge funds, which in our opinion are still largely untapped by pension funds

Kurt Braitberg



These are the things which the dominant pension consultants will have to embrace, both in terms of diversification and recognizing strategies that are less correlated with the equity markets, but moreover that there is a pool of talent in so-called hedge funds, which in our opinion are still largely untapped by pension funds – a very exciting prospect for our industry.

Christopher Keenan

There's no question the consulting industry is at a crossroads after 2008. We've talked to numerous pensions and endowments who acknowledge that 60:40 is over, and some few groups consider moving 30% or so of their entire portfolio into alternatives. Where, however, will this

We've talked to numerous pensions and endowments who acknowledge that 60:40 is over, and some few groups consider moving 30% or so of their entire portfolio into alternatives. Where, however, will this advisory guidance come from? The need is there, because so few organizations have the resources to do it alone. I think it's pretty clear that as traditional beta-centric advice is further commoditized, the center of value in the consulting space is shifting to those groups with robust alpha-centric alternatives practices.

Christopher Keenan



advisory guidance come from? The need is there, because so few organizations have the resources to do it alone. I think it's pretty clear that as traditional beta-centric advice is further commoditized, the center of value in the consulting space is shifting to those groups with robust alpha-centric alternatives practices.

Matthias Knab

What more do you see happening at the institutional level? Obviously now is the time to go into alternatives, not when we have reached the next high.... How are institutions perceiving their options, and how is their process and action plan at this time?

Judith Posnikoff

We hear from our clients and prospective clients that they are committed to the hedge fund space and many actually plan to increase their allocations going forward.

Maybe the following example addresses your question. We put together a portfolio at the beginning of the year for a client who asked us to combine a mix of long-short equity and equity

market neutral managers as part of their long-only equity allocation. It has to be carefully managed because they have a prohibition there against any sort of credit sneaking into the portfolio.

We put together a portfolio at the beginning of the year for a client who asked us to combine a mix of long-short equity and equity market neutral managers as part of their long-only equity allocation. It has to be carefully managed because they have a prohibition there against any sort of credit sneaking into the portfolio.



This institution, a public pension plan, realized that they cannot take the volatility of a long-only equity allocation anymore and are looking at long-short to give them the benefits which hedge funds are supposed to provide - better returns with less volatility. So even as disappointing as 2008 performance was for long-short hedge funds, down 10 to 15% or so, from an institutional equity investor's point of view the hedge funds came through. They delivered what they were supposed to do, and people are recognizing that.

Judith Posnikoff

This institution, a public pension plan, realized that they cannot take the volatility of a long-only equity allocation anymore and are looking at long-short to give them the benefits which hedge funds are supposed to provide - better returns with less volatility. So even as disappointing as 2008 performance was for long-short hedge funds, down 10 to 15% or so, from an institutional equity investor's point of view the hedge funds came through. They delivered what they were supposed to do, and people are recognizing that.

Institutions are each assessing alternatives in their own, slightly different ways, rather than combining all in a so-called "alternatives bucket" or portable alpha component. We also are not seeing big reallocations à la "equity is down 50% so we've got to increase the equity exposure again", people just aren't doing that. Institutional investors today have become more sophisticated in how they look at their portfolios and the opportunity set, and they make decisions based on that, rather than following some kind of rules-based allocation.

Paul Perez

Institutions have typically used at least two definitions of risk in their management of portfolios. With traditional assets, risk has been defined as performance relative to a benchmark. In 2008, this definition of risk proved to be wholly unsatisfactory. I cannot imagine the typically institutional CIO saying, "gosh, we are really happy that Manager X was only down 45% when the benchmark was down 50%."

With liquid alternative strategies, risk has tended to be defined in absolute terms, that is, return should be positive or at least not negative under any circumstance. The question is whether having

Institutions have typically used at least two definitions of risk in their management of portfolios. With traditional assets, risk has been defined as performance relative to a benchmark. In 2008, this definition of risk proved to be wholly unsatisfactory. I cannot imagine the typically institutional CIO saying, "gosh, we are really happy that Manager X was only down 45% when the benchmark was down 50%."

With liquid alternative strategies, risk has tended to be defined in absolute terms, that is, return should be positive or at least not negative under any circumstance. The question is whether having two definitions of risk pertaining to the same pool of assets is the right way to think about risk. My opinion is that, with the passage of time, investors will come to appreciate the role that their allocation to hedge funds played in the market action of 2008. My guess is that a single definition of risk will emerge – and it will reflect more alternative than traditional thinking on the matter.

Paul Perez



two definitions of risk pertaining to the same pool of assets is the right way to think about risk. Perhaps both definitions of risk have proven unhelpful. My opinion is that, with the passage of time, investors will come to appreciate the role that their allocation to hedge funds played in the market action of 2008. My guess is that a single definition of risk will emerge – and it will reflect more alternative than traditional thinking on the matter.

Christopher Keenan

Yes, there is a categorization problem. The broad term of “hedge fund” implies a similarity between strategies that doesn’t exist, like the notion that all strategies are absolute return. Long-short managers always should have been considered an equity bucket allocation. So I agree with you completely, there is probably going to be a more refined sense of alternatives and how there is a continuum of alpha and diversification ability among them.

Matthias Knab

What else is there that we haven't mentioned on hedge funds or the West Coast alternatives industry?

Judith Posnikoff

I want to add a point which I believe is important to the West Coast. I think the geographical position and the time zones that West Coast based managers can access during their normal day hours is creating significant opportunities. One of the aftereffects of 2008 has been that the big multi-strategy hedge funds have closed a number of research offices in Asia. For a while there was this push into Asia with a lot of the big players putting up an office in Hong Kong, Singapore, Beijing, Shanghai, all through Asia – and now they’re pulling back. A lot of them have closed those offices, and I have even heard people say that they are closing their London or European offices.



For people based on the West Coast, we have the advantage that we are in the same time zone as Asia for at least part of the working day, which makes a huge difference when dealing with anybody in that time zone, as you are able to talk to one another during business hours. Here on the West Coast, we sort of cross everybody. We can talk to Europe in the morning, the East Coast mid-morning, Asia in the afternoon – there aren't many places like that elsewhere. This time zone benefit helps on the investment side as well as on the client-service side.

Judith Posnikoff

That makes the opportunities for managers and investors who can access that space extremely interesting because, again, there is less competition there. For people based on the West Coast, we have the advantage that we are in the same time zone as Asia for at least part of the working day, which makes a huge difference when dealing with anybody in that time zone, as you are able to talk to one another during business hours. Here on the West Coast, we sort of cross everybody. We can talk to Europe in the morning, the East Coast mid-morning, Asia in the afternoon – there aren’t many places like that elsewhere. This time zone benefit helps on the investment side as well as on the client-service side.

John Brynjolfson

I would echo Judith’s comments. We can work normal hours, like getting up at three in the morning and.... no, very seriously, I have worked that way for 20 years, there is no traffic when I am going into the office, it works very well for a global organization.

I wanted to make sure that we touched on risk management, because obviously risk is front and center on every institutional investor’s radar. Part of it involves the due diligence we have talked about, but I want to address a misconception that I sometimes sense from investors regarding risk management.

The misconception here is that risk management involves a piece of software, some other kind of analytics and formula like looking at mortgage prepayments or housing data. I want to offer a

concept of risk management that includes five pillars of focus. I can't take full credit or partial credit for this, actually. I heard it from the Chief Risk Officer of AEGON, a large insurance company.

The pillars that I rely on for risk management are culture, governance, incentives, diversification, and objectivity, and none of these is a piece of software. Culture obviously relates to a whole fiduciary mindset. I don't want to pick on any individual or class of individuals, but a hedge fund run by prop traders who spent their whole lives in front of screens can give an investor a much different experience than a hedge fund run by people who have worked with clients and who understand that the money they are managing is not a number on the screen, that it is not about how many people you can take advantage of, but rather about what kind of value you can create through partnerships and relationships. All this, and more, is part of a firm's culture.

I would echo Judith's comments. We can work normal hours, like getting up at three in the morning and.... no, very seriously, I have worked that way for 20 years, there is no traffic when I am going into the office, it works very well for a global organization.

John Brynjolfsson



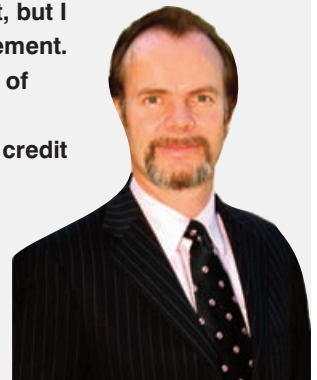
Governance obviously is key because, as we discussed, if the governance is properly structured, then risk management, both within an organization and risk management with the investors or partners of that organization, would make sense.

Part of the collapse that we saw in Wall Street was a function of very distorted incentives, incentives at the CEO level and incentives from mortgage brokers to sell products to homeowners. I did not want to say unsuspecting homeowners, because I suspect that a lot of the homeowners knew exactly what was going on when they borrowed money at a teaser rate in order to invest in real estate, where they could put no money down.

I wanted to make sure that we touched on risk management, because obviously risk is front and center on every institutional investor's radar. Part of it involves the due diligence we have talked about, but I want to address a misconception that I sometimes sense from investors regarding risk management. The misconception here is that risk management involves a piece of software, some other kind of analytics and formula like looking at mortgage prepayments or housing data. I want to offer a concept of risk management that includes five pillars of focus. I can't take full credit or partial credit for this, actually. I heard it from the Chief Risk Officer of AEGON, a large insurance company.

The pillars that I rely on for risk management are culture, governance, incentives, diversification, and objectivity, and none of these is a piece of software.

John Brynjolfsson



Diversification is the fourth pillar. In the context of true risk management, diversification goes beyond investing theory 101 that says you've got to diversify and just looking at historical correlations. We also need to understand that there are clientele effects, the herding of crowds and these affect what the correlations or the diversifications between strategies will be. Long-short managers, in order to be uncorrelated with the underlying strategies, actually have to be long-short managers, meaning meaning that they've got to be tactical – they cannot just be closet long-only managers.

The last pillar is objectivity. While investment management is all about having a subjective opinion

on the direction of markets or the direction of an asset or the value of an asset, risk management is not the place to express that objectivity.

I have heard so many times in the genesis of the housing crisis this subjective idea that this asset class can go up a little bit or go up a lot. And most people fail to recognize that the first rule of objective risk management is to start with the assumption that any upside of an asset is probably mirrored on the downside. In some cases, where there is tail risk, the downside can be even greater.

accurate

professional reporting service

No wonder that each week, Opalesque publications are **read by more than 600,000 industry professionals in over 160 countries**. Opalesque is the only daily hedge fund publisher which is actually read by the elite managers themselves



Opalesque Islamic Finance Briefing delivers a quick and complete overview on growth, opportunities, products and approaches to Islamic Finance.

Opalesque Futures Intelligence, a new bi-weekly research publication, covers the managed futures community, including commodity trading advisers, fund managers, brokerages and investors in managed futures pools, meeting needs which currently are not served by other publications.

Alternative Market Briefing is a daily newsletter on the global hedge fund industry, highly praised for its completeness and timely delivery of the most important daily news for professionals dealing with hedge funds.

A SQUARE is the first web publication, globally, that is dedicated exclusively to alternative investments with "research that reveals" approach, fast facts and investment oriented analysis.

Technical Research Briefing delivers a global perspective / overview on all major markets, including equity indices, fixed Income, currencies, and commodities.

Sovereign Wealth Funds Briefing offers a quick and complete overview on the actions and issues relating to Sovereign Wealth Funds, who rank now amongst the most important and observed participants in the international capital markets.

Commodities Briefing is a free, daily publication covering the global commodity-related news and research in 26 detailed categories.

The daily **Real Estate Briefings** offer a quick and complete oversight on real estate, important news related to that sector as well as commentaries and research in 28 detailed categories.

The **Opalesque Roundtable Series** unites some of the leading hedge fund managers and their investors from specific global hedge fund centers, sharing unique insights on the specific idiosyncrasies and developments as well as issues and advantages of their jurisdiction.

OPALESQUE

www.opalesque.com