

# Opalesque Roundtable Series '16

# UK

Opalesque Roundtable Series Sponsor:



# Editor's Note

## After Brexit shock, global investors rethink hedge funds and alternative investments

For anyone dealing with hedge funds or alternative investments, it's probably worthwhile to remind ourselves where we were in January, February of this year, when a number of investors were asking what the value of hedge funds was, relative to the fees paid to those hedge funds, and what they could get from other products?

Fast forward to today, many investors sit back and say, *"Well, given the current level of market uncertainty, what has my hedge fund portfolio done for me relative to my other assets? What has my volatility been? Going forward, do I want to own a portfolio of solely long equities and long bonds in an environment where, for example, we have recently seen the entire Japanese yield curve going negative, or should I also own a less correlated portfolio of hedge funds?"*

Fact is that investors are still very much interested in hedge funds and CTAs. The mainstream press seem to have focused their attention on the few institutional investors who have exited their hedge fund investments, and not those that are increasing or the real reasons behind any of the above decisions. The underlying trend is that many more institutional investors are actually getting with more and more assets into hedge funds.

## *Sure, a number of strategies are up, but what if your hedge funds are down?*

But it's also true that investing in hedge funds is a very intensive business, at least doing it properly is. A lot of hedge fund have performed poorly over the course of the last year-and-a-half or so, and many investors had a relatively miserable experience of investing in hedge funds, and they worry that it might be their fault for picking the wrong ones (the trend to direct investing has probably tended to favour investing in the big, brand name hedge funds, which hasn't always helped). Whoever carried that particular responsibility may not look that smart now, and so quite a few investors are wondering whether they should do it differently as fees on outsourcing this are now much lower, while the cost of doing the work properly is only going up.

The expected return on traditional assets, which don't look great, is forcing many people into alternatives, even if they're a bit reluctant. The current returns also explain some of the resurgence of interest in non-correlated strategies: **The CTA Index is up 4% as of early July, Short-Term Traders Index is up 6%, Global Macro is up 2, Discretionary is down 2, and Volatility Traders are up 4.** Institutional investors sitting on a portfolio of pure long equities and bonds are somewhat nervous. There is a lot of interest in these strategies, and also equity market neutral and stat arb.

## How to make a return without resorting to illiquidity?

A majority of liquidity provisions is 90-day liquidity or less, and so the collapse of liquidity provision for people trading less liquid securities, notably single name credit for example, is really striking. All of the liquidity has moved into index trading [see our discussion of ETF trading and consequences on price discovery in our recent France Roundtable. This means that quite a lot of conventional and very successful hedge fund strategies, for example some of the credit long/short strategies, can only be done on longer time horizons than managers have for their client capital. Managers and multi-managers are shying away from anything that looks less liquid, even though the expected return from it is clearly better. The challenge is how to make a return without resorting to illiquidity? Find out in this Roundtable script how the industry has innovated to get fees down and capital efficiency up to address this key issue.

## Unstable managers: Fund turnover is the hedge fund investor's biggest headache

The biggest problem with our entrepreneurial industry is the large fund turnover. It's incredibly hard when you look at the industry now to remember what it looked like in 2006, so just ten years ago. It's astounding how many of funds have disappeared, and when they disappear they normally take you for a loss at the same time; generally they don't go out at the top. But if you do the work an underlying pattern becomes visible, and the reality is that there are certain strategies in which the turnover is much higher than others. This Roundtable discusses certain inherent characteristics of strategies and identifies typical blow up strategies and also some that can be much more stable.

The Opalesque 2016 U.K. Roundtable, sponsored by Societe Generale and Eurex, took place in early July at SG's London office with:

1. Heath Davies, [Global Head of Hedge Fund Research, HSBC Alternative Investments](#)
2. Keith Haydon, [Chief Investment Officer, Man FRM](#)
3. Paul Marriage, [Head of UK Dynamic team, Schroders](#)
4. Jean François Comte, [Managing Partner of Lutetia Capital](#)
5. Dr. Murat Baygeldi, [Senior Vice President Equity and Equity Index Sales London, Eurex](#)
6. Bill Geake, [Multi strategy Prime Brokerage Sales, Societe Generale](#)
8. Duncan Crawford, [Hedge Fund Sales & Capital Introductions, Global Head Prime Services, Societe Generale](#)

The group also discussed:

- How were UK equity hedge funds positioned going into Brexit? Why did some investors mix their EURO STOXX 50 position with VSTOXX before the vote? What's their strategy now?
- How does the London financial elite interpret the outcome of the Brexit vote? What's the real risk longterm? Should Brexit happen, how do UK based hedge funds see their future?
- How can investors come to terms with the problems of investing in hedge funds via very small teams?
- Which fund vehicle is the best understood onshore structure? In which respect is a 40 Act fund quite different from a UCITS?
- Why are low fee and high fee investments often better than those sort of mid fee investments?
- How do fundamental equity managers compete with quants?
- Fees are a price for capacity. But what are 'fair' fees?
- What's the difference between smart beta and alternative beta?
- What is required from a prime broker to be identified both as strong and partnership-oriented?
- Can also a fund with zero assets attract Man FRM's interest?
- Is merger arb an alternative to bonds?

Enjoy!  
Matthias Knab  
[Knab@Opalesque.com](mailto:Knab@Opalesque.com)

## Participant Profiles



(LEFT TO RIGHT)

Bill Geake, Heath Davies, Paul Marriage, Jean-François Comte, Dr. Murat Baygeldi, Keith Haydon, Duncan Crawford, Matthias Knab

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# Introduction

**Duncan Crawford**  
Societe Generale

I am Duncan Crawford, I head the hedge fund sales at Societe Generale and have been in the same business for the last 25 years, and over those years I went through various iterations of Fimat, Newedge and finally we integrated into Societe Generale in May 2014.

Hedge Fund Sales incorporates Prime Brokerage Sales, Capital Introductions, and an area which is somewhat different from our competitors that we call Alternative Investment Consulting, which is a team that works hand in glove with the Capital Introductions team, producing a wealth of information on the hedge fund industry from what we believe is the most detailed and diversified database from which we produce the Nelson report, which goes out to investors monthly and aims to include 100% of managers in any particular strategy to the eight SG Indices we produce, of which a number are industry benchmarks.

And finally, the consulting team also writes white-papers and educational thought pieces on the industry. Although we are known for our FCM business where we are by far the largest PB for managed futures and macro managers, what's maybe lesser known is that we have been servicing equity managers since 2000. Let me also add that back at Newedge we didn't have the various bells and whistles that an investment bank has for the equity PB business, and since the integration into Societe Generale we have inherited Societe Generale's equity finance business which is one of the biggest equity finance businesses on the street. In addition to that, we also have Societe Generale's equity research, algo trading and so on and so forth. I will leave it there so Bill can speak more about our equity offering, however it is the fastest growing part of our business, and we are very excited about that.

**Jean-François Comte**  
Lutetia Capital

I am a Partner and Fund Manager at Lutetia Capital. We have offices in London and Paris. Lutetia is a specialist independent investment manager in arbitrage strategies, we manage mainly UCITS funds. I am the portfolio manager for merger arb strategies on two UCITS vehicles. One is the Lutetia Patrimoine UCITS Fund and the other one is on the Lyxor platform and called Lutetia Merger Arbitrage. Those two funds together aggregate about EUR 500 million in AUM and we advise and manage another EUR 300 million on other arbitrage strategies including VIX long/short and multi arbitrage strategies.

The firm was created in 2009, we initially come with an M&A advisory background, which drives our very qualitative and disciplined approach to arbitrage, and we've integrated quant skills to our team over the past years.

We have a partnership with Société Générale since the end of 2012. The SGI platform has built tracker indices (e.g. SGBVMAU2) on our arbitrage strategies, providing a more global format, with adjustable exposure.

**Bill Geake**  
Societe Generale

I am Bill Geake. I have been working in the hedge fund industry for 20 years; for two of those at Societe Generale, where I joined to help develop the equity PB offering.

As Duncan raised earlier, Societe Generale fully acquired Newedge in 2014 and integrated it within existing business lines to create a new Prime Services division within the SG Corporate and Investment Bank. Being integrated with SG has really enabled us to become a **fully functional cross-asset Prime Brokerage business**. The combined SG Prime Services group is ideally placed, with the correct tools, management commitment and investment to be a key partner directly to the hedge fund community.



SG has always been long inventory, and in fact, hedge funds often get surprised by the size of inventory at SG, which is created through the structured products and hedge book, to which we also have access.

We believe we have a strong cross-asset class offering. Post-crisis many PBs have become more selective and have been hesitant to take on new business in capital intensive sectors like commodities, OTC clearing or FX PB. We, on the other hand, have a fully integrated, transparent model where everything is housed under one roof, so we can be a partner to the multi-strat funds and are very much open for business from the funds who still have the need for an FX PB and a clearer or still want to trade commodities.

We are also very focused around cash management and collateral optimization, which is becoming increasingly complex and important in the current low or negative interest rate and fast evolving regulatory environments.

**Keith Haydon**  
Man Group

I am Keith Haydon, and I work for Man Group. Man is a listed company in the UK that owns a broad group of liquid hedge funds. It owns the AHL group of funds, which now extend beyond trend-following to a wide range of systematic trading techniques; Numeric, which focuses on quant equities; GLG, which is very largely a discretionary manager, and; FRM, which offers a broad range of custom solutions to help people invest in hedge funds.

The basic philosophy of Man Group is strong active fund management and alpha production, whether it be in hedge fund format or long-only format. Our approach to investment management is entrepreneurial and therefore as the business grows, we work hard to preserve the entrepreneurial identity of each of the businesses, that we buy or build, hence the different brand names we now have under our umbrella. We also recognize the need for substantial and robust institutional backing across technology, legal and compliance, all of which are provided by the listed entity.

FRM was founded in the early '90s; I am the CIO. It was acquired by Man in 2012 which wasn't as radical a change as it first looks because Luke Ellis, who was a key part of FRM between the late '90s and 2007, moved to Man and then acquired FRM from there, so essentially he was buying a firm he in a large part helped to build. I came with the acquisition and our principal focus now is to adapt our skill-set as a fund of funds manager to the changing conditions of the hedge fund market and the investor demands of today.

**Dr. Murat Baygeldi**  
Eurex Exchange

My name is Murat Baygeldi. I work for Eurex Exchange. We are a subsidiary of Deutsche Börse Group with close to 200 people working in the London office which we opened in 1997. Before joining Eurex I worked for banks and brokers and also for the CTA and managed funds space. So I have seen both sides of the river, which not only was very interesting but also helpful in order to understand the markets and our current client base.

As an exchange, **Eurex covers over 2,000 different products**. Many years back we used to be known as the Bund/Bobl/Schatz and DAX® Futures provider, while nowadays we provide products covering not only Europe, but also Asia, Africa, and the U.S. markets.

As an example, around four years ago some clients asked us whether we could launch MSCI Index Options and Futures. We obviously have offered STOXX® Indexes like the EURO STOXX 50® for quite some time now. It's a very well-known product, but we were able to respond to that client demand with more than 70 different MSCI products covering more or less the whole world, and in particular MSCI World and Europe. We also just launched EURO STOXX 50® Index Quanto Futures, to name a few.

The reason why I mentioned those products is because we as an exchange have to fulfill a number of roles. On one hand the regulators ask us to get ready for the OTC clearing side and provide certain services, and on the other hand there seems to be a trend from users and investor for more listed products. Another example where we also got active before the legislation started kicking

in, is in so-called Flexible Contracts where users can select a certain maturity or strike price if it's an option, both for American and European style.

**Paul Marriage**  
Schroders

Paul Marriage, I run the UK Dynamic team at Schroders. We run an equity long/short strategy and a UK equity long product as well, focusing on UK small & mid-caps.

The long/short funds were established at Cazenove in 2005, Cazenove was acquired by Schroders in 2015 and we re-branded our range as Schroder UK Dynamic. We manage about \$1bn of equities across three funds.

**Heath Davies**  
HSBC Alternative Investments  
Limited

My name is Heath Davies, I am Global Head of Hedge Fund Research at HSBC Alternative Investments Limited (Hail). HSBC has been allocating client capital to hedge funds for over 20 years. Our clients can access hedge funds via advisory mandates, discretionary mandates, fund of funds or a relatively new line of business called alternative investment solutions/liquid alternatives. Hail invests across all major hedge fund strategies, so it's a fairly broad platform. We continue to look to connect our client base to what we believe are good opportunity sets on a forward looking basis though good quality managers, cognizant of client suitability and risk appetite.

# 70

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**Paul Marriage:** We are running UK equity funds, so Brexit has been pretty central to everything we have been thinking about probably for the last nine months, and now even more as the market got called wrong here. As we know, the market was expecting a remain vote we had a portfolio that wasn't positioned for an exit aggressively, but rather tardy neutral.

I think most UK equity investors would take a view that UK equities did not have a very strong outlook in 2016, regardless Brexit risk. Now we are on the other side of the vote, and we are out, and there is a lot of coffee smelling to be done by investors and deciding where they want to be positioned. It is quite possible that we will go into a UK recession of some form - however mild, hence the biggest call as to how we trade that.

Our positioning sees us **fairly short UK domestic and long global long-term winners**, of which there are actually quite a few in the UK. The UK has quite a healthy quoted group of small and mid-sized companies that are winners on a global scale. People often compare it to the Mittelstand in Germany, which is clearly private; in the UK more of that part of the economy is public. So long positions in those type of companies which we see as long-term winners and shorter UK domestics would be a top level portfolio positioning.

If we took a snapshot of the portfolio returns in June 2016 we'd be thinking that June wasn't great, but having run this strategy for 11-plus years now, we have had tough months before. We have actually bounced back pretty sharply historically. Even though it's probably a bit overused now, I think we are in a situation where it's about "keeping calm and carry on." I think we Brits are pretty good at that, and actually the UK market is very much like that too.

I think the dislocation that surprised people particularly is the FTSE 100. I actually came to the office at half past 2 on the Friday morning and bought the VIX and sold the FTSE 100 Futures through our Singapore dealers, which helped me look like a guru for a few hours. But it became pretty apparent that very quickly people bought into the well-known currency beneficiary factor of the FTSE 100, being a very international index, and they probably bought into that much quicker than most investors, including us, would have expected.

I think we were expecting say a bigger derating, seeing the index down 10 or 15 and then people buy the overseas earners, but people bought the overseas earners with the index down 5, and as we have seen, it has bounced strongly since then.

So I think we will see a situation here where domestics face a pretty tough summer and early autumn. The FTSE could remain the place to be in akin to rather incongruous a safe haven, as the currency seems relatively stable after its initial falls. All in all we are enjoying the challenge, and are keeping very close to investors, doing a lot of conference calls, a lot of client meetings, which is absolutely what you need to do in my view when it's a bit tougher and people are looking for some clarity.

We are also beginning to think about where we may have some pockets of panic selling and overselling, where there will be opportunities. On the short book, we have got lots of things that have fallen 40% now, that doesn't often happen in short books in my experience. Here we are looking what do we need to close, and where do we need to have more protection?





**Jean-François Comte:** As an arbitrage manager, we are in a slightly different position because we are not correlated to the market per se. Although there is a mild correlation between volatility and arbitrage spreads – and I am talking here about pure merger arb; announced and definitive deals, as opposed to hostile situations that may suffer in such circumstances – we were not really affected.

Short-term, we saw a bit of widening in the spreads on Friday and Monday, just as the VIX went up, as Paul mentioned, so there was a very limited negative mark-to-market impact. As a matter of fact, if you look at pending transactions with UK companies, which I think is interesting for anyone to look at, there are a few transactions pending, like SABMiller/InBev, Rexam/Ball, and Home/Sainsbury, and the impact on these deals' spreads was insignificant.

So that's very interesting to see that basically when you have definitive transactions you are not really exposed to such types of event.



On the longer term, I think the question for people in our universe is probably “how will Brexit affect M&A activity” in general. Generally, Brexit consequences are perceived as negative because of the medium-term uncertainty, but they are not necessarily negative from an M&A standpoint. Starting with a weaker Sterling, that may trigger opportunistic cash acquisitions in the short term. Sure, companies might be forced to move operations in or out the UK, but eventually we don't think that there will be less UK M&A than before.

How Brexit will play out on the medium and long-term will be very interesting and I don't think there is any certainty right now.

**Keith Haydon:** It's extremely hard to form a view that isn't colored by the fact that you are in the middle of it. We as Londoners are part of a financial sector that is global in its reach, so we have to try to get a feel for what it means to everybody else, as opposed to what it means to us as locals.

I used to be a foreign exchange trader and I had developed a soft rule that you don't trade the pound because it's the only thing you really know anything about first hand, I have the same feeling now to some extent. I mean, personally, I think it's extraordinary that the various political leaders who brought this question to the table and then guided the population to an answer did so with so little forethought about what might happen, and with so little willingness to pick up the pieces afterwards – government primarily, but opposition as well.

To the wider world, I think there are two groups of questions which I have come to consider in more detail. The first is the structural flaws in the EU. Either they move to a tighter structure than it is now, or they slide backwards with the concomitant risk of disintegration. Clearly, they will try to move towards a tighter structure.

Europe either goes forward or it goes backwards, but it can't stay where it is, and the thing that will be very interesting to watch over the next few months are the tensions that emerge across the rest of Europe as it tries to draw to a tighter structure. And perhaps one obvious example of that is the discussion which has immediately emerged over the Italian banks. It's not a convenient moment for the Germans to have to confront the question about how much public money can be made available and under what circumstances it can be used to solve a bad debt problem in Italian banks.

This may be important in its own right, but it's also an example of the kinds of questions that we now have less time to address than we did before the Brexit vote. Every now and then European politics repays a huge amount of attention, and now is one of those times. If Europe heads towards the disintegration route, then clearly the Brexit theme becomes a small story relative to that on the global stage.

The other question which is also remarked upon is whether the UK has become a barometer of a populist vote in an electorate which can't cope with a global labor market anymore?

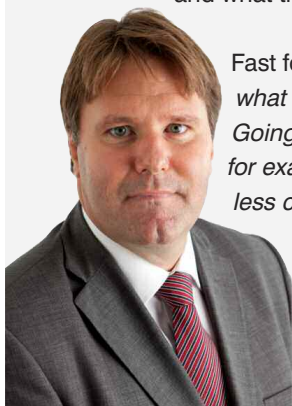


**Is the UK symptomatic of something which is genuinely strong in say France and, even more importantly, America (I think this is a yes), or is this rather something quite small and local?** That's a crucial question.

If you go back to major financial crises over the long distant past, they have often had **very unstable political reactions, not immediately, but over the course of the next few years**, and if this is what's beginning to emerge now, then again, the significance for us is much bigger than the fact that we have just dropped out of Europe.

In terms of how Brexit might affect the Man Group business, I think I would go with the other participants here who said it's extremely hard to tell at this point until we know what the arrangements are going to be. Until then, it's very hard for us to actually do anything. For us as a business, we can't yet see any way in which we think it will be materially damaging to our business and a lot of our business isn't domiciled in the UK anyway.

**Heath Davies:** I think it's worthwhile making the point of reminding ourselves where we were in January, February of this year, when a number of investors were asking what the value of hedge funds was, relative to the fees paid to those hedge funds, and what they could get from other products?



*Fast forward to today, where investors sit back and say, well, given the current level of market uncertainty, what has my hedge fund portfolio done for me relative to my other assets? What has my volatility been? Going forward, do I want to own a portfolio of solely long equities and long bonds in an environment where, for example, we have recently seen the entire Japanese yield curve going negative, or should I also own a less correlated portfolio of hedge funds?*

From a research perspective, I would say that we are as focused as ever on the evolution of opportunity sets, of macro, along with the evolution of technicals and liquidity.

**Matthias Knab**

So the whole Brexit shock along with the increases in volatility that we have seen, is this an opportunity for alternative investments to demonstrate they are worth the fees and investors should include more of them in their portfolios?

**Heath Davies:** I think any market disruption event where managers are running less than 100% net long risk assets provides an opportunity for those managers to demonstrate why this particular asset class or method or style of investing, has a place longer term in their investor's portfolios.

As you know, particularly in the US, we have seen headlines about large, very well-respected investors wanting to exit or reduce their hedge fund allocations. I think recent events have continued the debate around what a thoughtfully constructed portfolio of hedge funds can do for an investor's overall portfolio, over the longer term.





**Bill Geake:** Change always creates opportunity. Obviously, there is going to be a period whilst the industry works out exactly what this change may bring. As both Paul and Keith mentioned earlier I think it is a case of “keep calm and carry on”.

However at Societe Generale we are well-placed, because we have operational and legal hubs in both the UK and continental Europe. We therefore expect to be able to continue to offer clients flexible solutions from both in and outside the EU and are well placed to adapt to changes. With regards to the volatility in the immediate aftermath to the vote result, whilst this is certainly a challenging time for all, we feel we are well-placed to provide our clients with the stable and flexible solutions that they will need going forward.

**Matthias Knab**

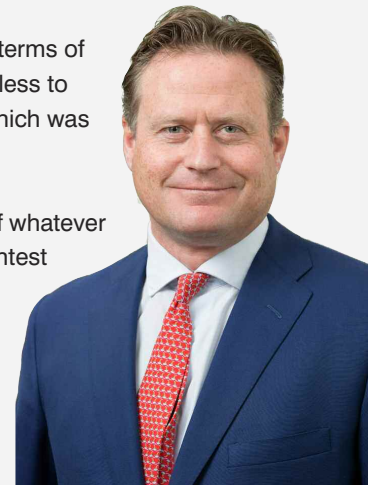
Duncan, you are doing hedge fund sales, are people buying hedge funds these days, CTAs?

**Duncan Crawford:** Contrary to what has been reported **investors are still very much interested in hedge funds and CTAs.** In fact, the underlying trend which we are seeing is that many more institutional investors are actually getting into hedge funds rather than exiting. The underlying trend which we are seeing is that many more institutional investors are actually getting into hedge funds.

The current returns also explain some of the resurgence of interest in non-correlated strategies;. **The CTA Index is up 4% year to date, Short-Term Traders Index is up 6%, Global Macro is up 2, Discretionary is down 2, and Volatility Traders are up 4.** Institutional investors sitting on a portfolio of pure long equities and bonds are somewhat nervous. So there is a lot of interest, particularly in the strategies I had mentioned, and also equity market neutral and stat arb as well, but the point is **people are looking for some kind of protection** as they become increasingly concerned about how they are going to achieve the returns they need with a traditional bond and equity allocation.

Coming back to Brexit, as you might have guessed, Friday after Brexit was a huge day for us in terms of volumes; I believe it was ONE OF our biggest days ever . Although not surprised, we were needless to say all very glad to see there were no trade breaks or any other such issues through that day, which was testament to the robustness of our systems.

As Bill already mentioned, we have a dual platform which puts us in a strong position in terms of whatever the future relationship of the EU-UK will look like. We are a bank that is built on some of the brightest French engineers, and also our legacy from Newedge was always also very much client-driven, producing solutions for those clients, so from that perspective the present time is another very exciting opportunity for us.



**Dr. Murat Baygeldi:** Also on Eurex, our volumes jumped after the Brexit vote. Eurex Exchange listed Futures and Options volumes jumped from an average daily 7 to 8 million to 13 million contracts.

We also saw that strategy trading jumped on those days. For example, Eurex VSTOXX®, it's a volatility product which can also be used for strategy trading We saw that some clients opened new positions or closed old positions before the Brexit.



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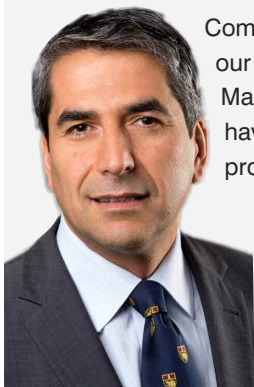
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What's interesting is that if you had the **EURO STOXX 50® position mixed with VSTOXX®**, you had actually a minimal change in your profit and loss, so it was very neutral positioning, and again, we saw some investors opening these positions beforehand. So that was probably a good daily management of positions using a derivatives overlay.



Coming back to Brexit for a moment, we just saw the official statement of the Futures Industry Association on our website. I think this is an interesting document, they called it "What Now For The Cleared Derivative Market", which is one area they cover, but they also go into other questions such as what impact will Brexit have on the UK relationship with non-EU states, and then they go into some important details around listed products.

It is clear that many open questions remain, even for FIA. It's probably a good idea to check the FIA website now and then, they are very good in liaising with different locations of the European Union and that's what we all to do on our website, try to filter and display relevant information for the market.

**Matthias Knab**

Keith, you had briefly mentioned the changed roles of a hedge fund of funds today. In this context, is a disruption like Brexit helping you making your case and get more business from your clients?

**Keith Haydon:** There are of course different timeframes in play here. There is the immediate post-Brexit period, and typically our kind of investors don't react that quickly, and then there is the structural perspective, which is more interesting. There are two obvious drivers. First, since 2008, there has been a structural move towards large institutions managing their own investment portfolios of hedge funds because they think it gives them more control and it's also cheaper, given that they tend to entrust those investments to small teams.

But **investing in hedge funds is a very intensive business, at least doing it properly is, and often when things are difficult, the confidence wavers**. Right now, there is a certain amount of wavering going on. To Duncan's earlier point, that there is a lot of inquiry and interest for hedge funds, I believe we are at a critical stage, and there are several drivers for this. The first one is **poor performance in hedge funds** over the course of the last year-and-a-half or so. Many investors had a relatively miserable experience of investing in hedge funds, and they worry that it might be their fault for picking the wrong ones (the trend to direct investing has probably tended to favor investing in the big, brand name hedge funds, which hasn't always helped). Whoever carried that particular responsibility may not look that smart now, and I think there are quite a lot of people who are wondering whether they should do it differently: fees on outsourcing this are now much lower, while the cost of doing the work properly is much higher. Our own pipeline of activity at FRM is actually fuller than it has been for any time since before 2007.

The second driver is **the expected return on traditional assets, which doesn't look great**, whether for bonds or equities. This is **forcing many people into alternatives even if they're a bit reluctant**. Whenever in the past institutions have gone into hedge funds, they have mostly done it in meaninglessly small size. Pension funds may have put 5% of their portfolio in at five vol, but that won't make any real difference to the risk or return profile of their overall fund.

Now they can't avoid the idea that they need an alternative return source, and it has to be of material size with material risk. I believe, from speaking to many investors, there is a serious attempt to come to terms with the problems of investing in hedge funds via very small teams, and a lot of people now need help.



Keith Haydon

People need to look at it in terms of its contribution in risk terms. Historically, whenever they have done that it has forced them into CTAs, because they trade at a higher volatility and generally they have a lower correlation to the rest of the portfolio.

But that's a single, very concentrated factor exposure. There are now more rounded answers to this problem – and if you want those answers...come and talk to us!

Matthias Knab

Jean-François, coming back to Brexit: Lutetia Capital has offices in France and the UK, do you operate under dual registration?

Jean-François Comte

We are actually passported from France to the UK.

Matthias Knab

So if Brexit happens, do you have a Plan B how to run your business in the future? This is also a question for Paul, as I assume you also have clients in the EU...

Jean-François Comte

As we said before, I don't think anyone can anticipate what future regulations might be or how current regulations might change. I would be very surprised if any drastic action was taken to change what's been built and works. First and foremost, most of these regulations are not directly related to EU treaties. Whether it's the successful UCITS format, or passporting rules within Europe, we don't expect major changes as a result of a Brexit. And if there should be, we will adapt.

**Paul Marriage:** It's of course too early to make a sensible comment now, but I'll give it a try. We are clearly doing our best to run a product that people want to buy, and of course if someone wants to buy our product, we are going to make it available for them.



We have a lot of European investors, and we have a Luxembourg registration for our offshore fund. **I see absolutely no scenario where people have to leave us because we are running a London-based UK-focused long/short fund**, especially if that fund is delivering sort of solid long term returns like we have done for over a decade now.

I just see this as one of the bumps in the road. We will be going to go through any potential regulatory changes, we just need to make sure that we have people advising us and helping us, so that we can focus on running the right portfolio and being accessible to our clients. So I don't lose any sleep over those questions.



**Duncan Crawford:** We are a global business, and for the last couple of years there has been a **big move into liquid alts**, which in Europe of course means UCITS. If a manager wants to raise assets in Europe, they really need an onshore vehicle of some kind and the most appropriate vehicle is UCITS. UCITS is seen as a brand, which investors have become very comfortable with. You could of course also have an AIF or various other onshore structures, but **UCITS are probably the best understood onshore structures**. My advice is always to minimize the hurdles that an investor might face when investing.

UCITS can include performance as well as management fees. In the US with the 40 Act funds, it is possible to include the performance fee, but it's unusual to do so. Therefore, **a 40 Act fund tends to be a very different product**. Some people might suggest it's a watered down version of the manager's main alpha product. So, wherever you may be based as a manager, you will be looking at these different distribution channels.

We in fact launched a mutual fund version of our CTA index in January; the SG CTA Mutual Fund Index. There is interest from both managers and investors in this new benchmark.



**Duncan Crawford**

Interestingly, year to date the CTA index is up 4, whereas the mutual fund index is flat. However, for the month of June the CTA index was up 4.5 and the mutual fund index was actually up 5.6, and right now I cannot really say whether that's because there is more trend and less risk management involved in the models. But I think that's possibly a difference. If you just look at the year to date, it doesn't look great for the mutual funds, but on the other hand, they are outperforming the CTAs for June.

**Heath Davies:** We have seen a growing demand in Asia, the UK and Europe for liquid alts, and we are also seeing a growing interest for CTAs after several years of disinterest.

We have also seen interest from a large client for syndicated loans. We also find that certain advisory clients are interested in discussing non-traditional types of hedge fund strategies, where the economic drivers of returns are different to those of equities, bonds, currencies, or interest rates, so we need to understand what our clients are trying to achieve with them.



**Keith Haydon:** Interest in more esoteric strategies was something I last remember being a feature of the environment in 2006 and 2007, and I remember being asked by consultants for our views on film financing as a hedge fund strategy and things like that. There wasn't much of that stuff around after 2008 for a while and it's vaguely alarming to me that it is coming back; but honestly, I also haven't seen much of it.

Almost all of the money I help to manage is on 90-day liquidity or less, and **the collapse of liquidity provision for people trading less liquid securities, notably single name credit for example, is really striking.** All of the liquidity has moved into index trading.

This means that quite a lot of conventional and very successful hedge fund strategies, for example some of the credit long/short strategies, can only be done on longer time horizons than I have for my client capital. And the fear of getting caught up in a sort of a 2009 situation, where you find that you have got increasing proportions of portfolios locked up in illiquid and untraded securities, is something I am not keen to experience again in my remaining career...

So I am shying away from anything that looks less liquid, even though the expected return from it is clearly better. One challenge for us has been **how to make a return without resorting to illiquidity.** My answer to that, and I guess it's my answer also to your question about the new developments in our industry, is that we now try to access hedge funds or alternative investments on a **much more capital efficient basis.** What do I mean by that? Typically when you invest in a hedge fund, a lot of the money that you give to the manager will sit in T-bills. I can't really afford that – when I have a portfolio of 20 of these guys and the first thing they do is put half of my capital into T-bills, things don't look good.

Another thing I often can't really cope with is the **expense ratios.** After a small fee for me and a large fee for them, in an environment where there is a zero ambient return, there is nothing left. So, how do you get fees down and capital efficiency up? I think that's behind both of the two moves we have already discussed into liquid alts: people don't want to pay the same fees anymore.

I have found as a consumer of other people's products that I wasn't well served in that space. Three years ago we looked at it and couldn't find solutions that really solved the problem of greater capital efficiency, and I sort of mean higher vol and much less cash held on hand, and lower fees. So we ended up building it ourselves with AHL and Numeric. Essentially, the portfolios that I now run have 10-15% of the capital allocated to strategies which we built for this purpose, and which therefore take up to about 30% of the risk of our portfolios.

They are still alternative return streams, but they are explicitly designed to hit those two buttons: low fees and high capital efficiency.

I think the general move to lower fees is completely understandable in many cases. In our case, **the best returns we have had have come from these more highly levered, but most importantly, highly capital efficient and cheaper products.** On the other hand, we have also had very good returns, better returns in fact, from some of the highest fees we have been paying (for stat arb). As a very broad generalization, recently the low fee and the high fee stuff has all been better than those sort of mid fee investments.

This general rush for low fee products is quite interesting. If you look at the amount of money in hedge funds, say \$3 trillion, it doesn't have to be a zero-sum game to make you worry about how much return is to be split across an ever growing industry. But if you are going to worry about this, you come to the conclusion that **the competition for alpha is turning into an arms race.** And if there is an arms race, do you really want to invest in the guy who has such low fees that he can't compete? Do you really want the guy who has low fees and therefore has to raise huge assets to be able to compete? It's not obvious what you should do.

But if you look for hedge funds who have high fees and who reinvest those fees in their business as opposed to taking it out as an income to the manager, I think you find a subset of funds who have probably the most interesting business opportunities in front of them.



Many of those guys are quant funds. It's quite hard if you run a discretionary equity long/short fund with an investment team of say three or four, and somebody says, "You have made \$50 million more than you need, how do you now plan to reinvest \$50 million in running your small equity long/short fund?". That's quite difficult to do with a suitable ROE. But looking at the quant space, I have seen more creative solutions to the question about where you can go next and what you can do with regard to buying new datasets, the speed of execution, and so forth.

So my point here is that we are not one of those investors who turned around and confronted everyone with a lower fee demand, even though we do need some of it. It's more that the whole environment has forced us to look at things in rather different ways as a result.

By the way, Paul, that is in no way a question about your model as a fundamental manager, but in that context I was wondering if you see yourself in a kind of competition with the quant space?

**Paul Marriage:** I don't think I am in a sort of trench warfare with quants.. But jokes apart, **I do see a kind of intellectually led stock picking strategy like ours fighting harder to get airtime against something which is perceived to have some robotic certainty and therefore a little bit less risky**, which is a big change from five or six years ago when the perception of a great stock pick or a stock picking-led strategy was inherently superior to something that was black box driven. Clearly both approaches will be very right and very wrong some of the time.

So in essence investors have a very broad choice now, which is good news. We on our side are now also looking at how we can perhaps bring forward some of the more quantitatively based processes we execute in getting towards those stock picks - things like screening processes etc. - and explaining those a bit clearer to the client with the aim of helping the client understand that what we do is a bit more than a few guys sitting around the table and sort of chucking darts at the board as their small cap stock picking style.



So we show and explain some of our basic rules and screens, which we have actually always done since the beginning. *But also fundamentally, I guess its quite hard for a pure quant strategy to do what we do.* I've also come across some really interesting screens that I haven't yet seen in fund form, so maybe some of those strategies will come through. Maybe these would could include quant inputs and overlaying it with some stock ideas, and seeing whether we can come up with a kind of interesting hybrid. Lets see what the future holds there.

In terms of fees, there is globally more focus on value for money. We have always been a top value product not charging high end fees, but I think economics tell you that if someone is performing less impressively, then they have less pricing power. Like the London property market has probably become in the last ten weeks. It's probably a buyers market right now.

**Keith Haydon:** I have another question. Jean-François, one of the strategies everybody has been interested in is yours: merger arb spreads. So merger arb spreads are really wide, but actually the number of decent merger arb funds is quite small. You may now think that this is curious, because it's also a well-known arbitrage strategy. I guess the answer is that the returns aren't easy to generate. *Is it that the returns aren't necessarily enough after hedge fund fees have been applied to them throughout a cycle, and therefore, quite a lot of merger arb managers resort to high levels of leverage or concentration at some point in the cycle, thus bringing the survival rate down?* Each time you look at that sector you'll see a bunch of newish guys, who haven't been around a full cycle and one or two lucky survivors from the old cycle, if you like.



When we have been trying to allocate to merger arb, generally, we found not enough quality funds to go to at reasonable fees. Selecting a deal may be skillful, but at the same time there is an extremely close proximity of the returns of many of these managers to an index of merger arb returns. And I resent the idea of having to pay a 20% performance fee for something that is so close to, or looks like an index return. I am not saying it's easy or cheap to capture, so I don't mind paying fees for that, but a 20% performance fee is difficult to cope with. What is your fee structure, and how would you persuade me to pay it?

**Jean-François Comte:** I want to be very clear in answering your question about fees. First, you mentioned the kind of conversations that were going on back then in 2006, 2007, around offshore hedge funds essentially, which I remember. Obviously, these discussions vanished after 2008, when many funds gated and / or disappeared and the focus became capital preservation, liquidity, and risk in general, and not fees. And I'm pointing that out because, unlike in other strategies, most of the visible merger arbitrage managers are still around. And that speaks to the resilience of the strategy. You have mutual funds in the US managing \$5 billion in merger arb, which have been hard closed for 15 years.

When it comes to our standard 1.5 and 20 structure, you can look at it any way you want, but I believe a fair perspective is to look at absolute returns on a net basis, and what part of the P&L goes to the investor versus that which goes to the manager.

Second, I liked what you said before about reinvesting in resources. We also believe in that, and we've been doing it. For example, we added quant skills to our team over the past years to develop one of the most innovative algorithm for merger arbitrage. We have even been recognized by the French Ministry of Research for our quantitative research. I believe that benefits our investors. And this is a culture we are actively promoting within the firm.

Third, I agree with your statement that at least in Europe you don't have a lot of choice or alternatives when it comes to selecting quality managers in merger arb. One of the issues here is, historically, the lack of merger arb culture in Europe versus what you see in the US; there is no question about it. It is more difficult to raise assets with European institutional investors. In the U.S. and in Canada, large pension funds have their own merger arbitrage team and they understand the benefits of this strategy over time.

And that leads me to disagree with just one of your comments regarding the resilience of this strategy. If you look at the numbers, we have had actually very, very few blowups in that strategy versus what you have seen in other strategies.

**It's rather a long-lived or persistent strategy.** If you look at the well-known names in merger arb in the US for the last 30 years, either they are still around, or they became privately held companies, and there are a number of such examples. I think it's interesting to know that some of the bigger names in asset management, names that became very popular for other strategies, including Mr. Buffett or Mr. Paulson, were arb managers. Other well-known and respected names in merger arb – firms like Loeb or Allen – just changed the course of their business for internal reasons. But I don't agree with the statement or perception that visible merger arb managers would just lever up and then run into trouble. Also, if you look at the HFRI Index on merger arb, it's actually one of the cleanest indices that you can find as an index of funds.



To be exhaustive on the fee question, I will finally add that we are very sensitive and open to the question. Six months ago we launched a new share class that has discounted fees at 1.25 and 10 with a minimum investment of 25 million euros, and I think that's probably as competitive as it gets in the market.

**Keith Haydon:** When people generally talk about fees, they use the word “fair” a lot, and you referred to the split of the return between investors and managers, so I would be very interested to know what you think that fair split is.

My own view is that ultimately we are all in a marketplace and naturally **fees are a price for capacity**. If you overprice your capacity, you won't have any funds under management, but if you move your fees down too far you may hit a point where you can't produce returns anymore.

I think that will be more and more of an issue going forward as people discover that the cost of production of investment returns is a material issue. Up until now the fees have been too rich and people haven't had to worry about the efficiency with which they produce the returns. I suspect that as the market becomes tighter, that will become more of an issue.

But anyway, I would be interested to know what you think 'fair' is. I wonder whether there is a consensus about where that line is drawn?



**Jean-François Comte:** I think it depends on your proven capability to generate uncorrelated returns, the alpha that everyone is chasing. If a manager cannot do that, then nothing is “fair”. Why would an investor give even 30% of the P&L to a manager who is going to do exactly what an ETF would do? I don't see any good answer to that question.

So I think first of all, the concept of fair fees should be based on your outperformance compared to lower fee alternatives. I believe investors should focus on net returns and not just fees. Because net returns are, by definition, net of all fees and costs that not all investors are paying attention to.

For example, French funds (FCPs) like ours are not charged with administrative fees – they are paid by the firm. So a portion of our management fees goes to pay for the administrative costs of the funds. That's not the case in other jurisdictions.

Another curious case came up with negative rates in Europe as far as hurdle rates are concerned. If you have a hurdle rate for your performance fees of Euribor, for example, are you going to charge performance fees if the Euribor is negative? Let's say you achieve 0 performance and Euribor is negative, are you going to charge performance fees to your investors? We have addressed this specific case to avoid charging undue fees.

So all these questions need to be brought up in an open discussion with investors and addressed with full transparency.

I am glad, Keith, that you pointed the discussion towards merger arb. I don't know if one of you saw the interview of Bill Gross a few months ago. When asked where he would put money right now given the lack of visibility and poor bond yields, he basically pointed to merger arb and mentioned the Precision Castparts acquisition from Berkshire Hathaway, which was a pending merger arb situation at the moment, yielding about 5% annualized on a gross basis.



I can tell you that today we have many similar situations with LinkedIn or Virgin America or DreamWorks, which provide yield and visibility. You won't find a lot of discretionary managers who can tell you exactly how they are going to make money in the next six months. Merger arb managers can.

When the market is doing great and people are expecting to make double digit returns from the S&P 500, it's harder for a market neutral strategy to compete, but right now is our time.



**Heath Davies:** On fees we believe investors should pay basis points for beta, and something more meaningful if managers deliver true alpha. The question for alpha is what would the correct level of those fees be, given the manager's current AUM, and the remaining available capacity.

Many people have been working on alternative beta. To Keith's point about fair pricing for the alternative risk arbitrage beta that an investor could buy off the shelf, and what is a manager's added value relative to this alternate beta?

We have already seen fees reducing this year with several managers on our platform, and we continue to be thoughtful about the fees we pay.

HSBC also has a smart beta capability. So for us, it's really about **understanding the continuum of traditional beta, smart beta, alternative beta, and alpha**, and ensuring that clients are paying the right fees for their alternative beta and alpha exposures.

In terms of innovation we are looking at smart beta and alternative beta, and trying to understand on a forward-looking basis how that could evolve, bearing in mind that we need to continue delivering value for money to our clients in risk-off and risk-on environments.



**Matthias Knab**

You made a distinction between smart beta and alternative beta, could you please elaborate more on that?

**Heath Davies:** Sure, **smart beta** is a concept that comes more from the long-only perspective. For example, some investors believe that dividend yielding stocks outperform over the very long-term and in a low return environment, and they seek quality companies that pay an acceptable level of dividends. A smart beta product would in this example invest long only in quality, dividend yielding stocks.

**Alternative beta**, for example, would be a risk arb strategy where an investor buys the acquiree in all live deals versus shorting the acquirer in those same deals.



**Bill Geake:** We see similar pressures on pricing and liquidity provision. There has been a lot of industry wide focus over the last two or three years on balance sheet and collateral optimization, and we have been working very closely with our clients to adapt to the "New World".

Client relationships are increasingly more of a partnership. We actively work with and maintain on going and open dialogue with clients to work out how to most efficiently address their financing and clearing needs giving due consideration to the balance sheet, leverage ratio and RWA implications of a client portfolio. All of which are now central to managing our costs and enabling us to keep our fees to clients as competitive as possible.

*We acknowledge that to be a valued partner to our clients we cannot just cherry pick the most profitable pieces of their book. Our transparent approach enables us to look at clients*





holistically and work with clients to identify solutions which enable them to receive the services their strategy requires and us to meet our obligation on resource requirements. Often small tweaks and changes to items like term requirements, how margin or assets are held, can make a big difference to our reg cap costs and therefore the pricing we can offer clients.

**Matthias Knab**

What about cross-margining, isn't that a major source of fee reduction for funds?

**Bill Geake**

At Societe Generale we have, over a 15 year period, developed some very competitive cross asset class margin solutions. However pre crisis, the target was often to call a client for as little margin as was required to cover the risk of the portfolio. Now, however, there is a balance between meeting a client's leverage and counterparty exposure requirements, covering our risk and managing Reg Cap costs. Simply offering a client the lowest possible margin solution may increase our costs and therefore fees to the client. We therefore need to understand a clients leverage and capital usage requirements to ensure the margin solution most suitable for each client is implemented.

**Matthias Knab**

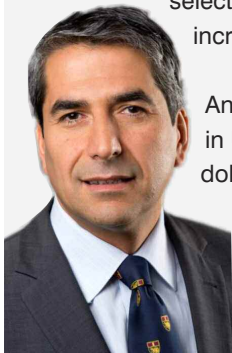
Murat, what are some other observations and comments you would like to share from Eurex' perspective?

**Dr. Murat Baygeldi:** One trend, a trend which actually started two years ago, and is a very interesting one, is the term sector products.

So for example, the EURO STOXX® Sector Index Futures are very attractive now. Investors showed interest in the broadbased and sector products, like Bank sectors, Oil and Gas sectors, Telecom sectors, two years ago already. They asked, whether I can provide data for those indices such as ADVs, open interest, bid and offer spread and size. So they started analyzing the data already some time ago.

The sector product volumes, including open interest, exploded, and this trend started two years ago. Consequently, sometimes it seems to take so long to consume, digest the information and then make a decision.

The second trend is called investing in high dividend yield stocks. The term smart beta is often used by investors. So we have got the EURO STOXX 50®, STOXX® Global Select Dividend 100 product, where some people say, why should I bother in selecting the right stocks? I just invest in those products and will receive a high dividend yield. The open interest increased as well in those index products in 2016.



And then finally, we provide listed quant derivatives, where you have got the EURO STOXX 50® Index Futures in USD currency now. Due to client demand we launched the USD version recently. Some banks said, look, a dollar EURO STOXX® version would be very interesting for us. EURO STOXX 50® Index Quanto Futures allow to separate the EURO STOXX 50® Index performance from the EUR/USD FX development. USD exposed investors are keen to trade a listed USD denominated EURO STOXX 50® Index Futures contract with the transparency of a central order book and benefits of cross margining.

Keith, you mentioned before the phenomenon of the asset concentration towards the larger funds, and I was wondering, how do you select funds, what are your criteria, and to which extent do you include smaller or emerging funds?

**Keith Haydon:** I don't think there is a simple answer to this question, unfortunately, but I can tell you that we are certainly interested in smaller funds. Size is not really the issue, but I think there are a lot of strategies which are becoming increasingly difficult to operate in large size, so that tends to limit you to smaller managers.

Starting about three years ago, I became increasingly worried about the bleed in our performance that came from picking **unstable managers**; in the end the biggest problem with having an entrepreneurial industry like ours is that you get a big fund turnover, and it's incredibly hard when you look at the industry now to remember what it looked like ten years ago.

I mean, Jean-François countered my point about arb funds blowing up, and in that context, let me add a reflection. In FRM now you have five major funds of funds that were all stand-alone entities at one time, so we have what were once Glenwood, RMF, MGS, FRM, and so on. My point here is if you would take a good look at the lists of funds that we collectively invested in ten years ago, it's **astounding how many of funds have disappeared, and when they disappear they normally take you for a loss at the same time**; generally they don't go out at the top.

So I have done this exercise and looked across the data of all these funds of funds and our turnover, and when you do that it's very clear that there are certain strategies in which the turnover is much higher than others. Turnover is generally a bad thing. And on the whole they don't leave a very clear trace on performance. I mean, if something goes wrong with the estimation of the performance that comes from funds that are disappearing, calculating survivor bias is really hard, until, that is, you look at your delivered returns and then it shows!

Coming back to your question about selecting funds, one of the things that I think has changed most is my reluctance to invest in strategies where we have experienced very high turnover. In the past I used to think it was because we had a particularly weak analyst in that area or something like that. But actually, when you have gone through all the funds of funds I've mentioned, you realize this washes out the quality of an individual analyst and you begin to see certain inherent characteristics of strategies.



What are some of the strategies that according to your analysis have led to higher turnover and thus to performance lags?

**Keith Haydon:** There are various causes, and some are more obvious. For example, **complexity and leverage combined can be a big issue**. Volatility arbitrage is a classic blowup strategy, we used to turn over that strategy enormously frequently.



And then the other type are the inherently low return strategies. They are the sort of strategies which really struggle to make the target return for an investor like us, and they end up reaching for the stars and blowing up – that was what I was implying before about merger arb, and maybe Jean-François is right. Fixed income arb is a great example of a strategy which very often delivers 4%, and in order to deliver 6% or 7%, you have to run with enormous leverage. And if you run with enormous leverage, you are vulnerable to having problems on leverage and blowup. I can think of plenty of examples of fixed income funds which had a lot of assets and then suddenly went bang.

Let's also take a look at the strategies that have been historically very solid for us. **Stat arb**, for example, has been an immensely stable area. **Credit long/short** is another one. I think it's really easy to see why. Credit, for example, is a robust and easy strategy for the allocator. It has a bunch of factors as tailwinds (like fixed income carry), there are lots and lots of securities which have wrinkles and complexities in them, which a manager can know very well, so there is a potential source of alpha: for every equity there would be lots of separate credit instruments.

And often credit funds have liquidity restrictions, which means that investors are simply *unable* to panic out. For example, if there is a 180 days' notice period, by that time it could be either too late to get out or they no longer want to, or something has moved on. This means the capital base is also more stable capital in those funds. The funds also display a reasonably high Sharpe and in the end a low turnover for us. So, we found that credit and stat arb are two of the more solid strategies.

Coming back to fund selection criteria, if I had to pick one thing, why not try to pick funds which hit that target I talked about earlier, where they make a lot of money and they reinvest it all in developing their business, and where in fact their ultimate objective is to displace all client money with their own? There is a history in some of the high frequency, market neutral equity funds, for example, of doing just that. You can see it clearly written in their game plan to produce returns which are good enough and make them rich enough to be able to displace all of the capital from outside.

Now, of course you might think it's irritating when that happens to you, but on the other hand, if there is in the whole market something like a successful investment strategy, it's probably one where the manager wants it all to himself, no?

**Matthias Knab**

Does a fund need to have a certain minimum size before you really look at them and invest?

**Keith Haydon:** Actually, a fund doesn't even have to have any money, but let me also add that we don't want to get involved in equity stakes and we also don't want to end up locking our money up in illiquid strategies, where you effectively have given the money for longer than the manager needs to liquidate his portfolio.

When you have looked at the benefits as an investor in somebody who has very little capital that you can own in exchange for your startup risk, when you don't want equity, and you don't want to get involved in long-term revenue sharing, it's quite difficult to justify the extra risks. It's hard to pay yourself as an investor enough to take that startup risk. But the question here is not really about the size, it's rather an assessment of the startup risk, and how much I need to be compensated for that.

On the other hand, there are very good high frequency equity quant funds that are launching with no assets at all, where there is a big scrum to get capacity in those funds right from the start. So I don't think size is the issue.



**Heath Davies:** Keith has already talked about complexity and leverage, which is something we are also cautious of in our work. We typically do very little in dedicated fixed-income RV, however we do allocate to multi-strategy managers that have fixed-income arb books, and some with vol arb books, however these books are not the main drivers of overall risk in those funds. I also agree that complexity and leverage is a potentially dangerous mix, and we are very careful about the combination of these two attributes in funds.



We also don't invest to acquire long-term revenue shares or equity stakes, however, in certain circumstances, we have been involved early on with managers. We consider startup risk and business risk, and think about what visibility we have in terms of the potential longevity of the manager.

We also think about the stability and persistence of returns, and what a fund is bringing to us in the current environment. Similar to most other shops, we also have strategy calls on a quarterly basis to determine strategies where we have higher conviction relative to others, and where we want to be deploying marginal client capital.

### Duncan Crawford

I would like to ask another question. It is being suggested that merger arb can be an alternative to bonds, considering where bond yields are at the moment merger arb looks pretty attractive, what's your view here?

**Jean-François Comte:** First of all, as a disclaimer, I have nothing against fixed-income, nothing against bonds or long/short credit. I am not a fixed-income person to start with, so I have certainly no judgment on the ability of managers to generate returns with fixed-income strategies.

To start, let me go back to one of the key issues that was raised by several people on the table today, which is liquidity. At this time, no one knows when the next crisis cycle will happen, but the question is what is the next crisis going to look like? Our view is that **the next crisis is going to be a credit crisis**, because the problems that are most likely to affect the markets come from debt and leverage, whether it's in the public sphere, government debt, or in the private sector; we already mentioned banks in Italy reacting to Brexit.

The problem that we were faced with in 2008 are only partially resolved. The fact that our governments are borrowing at close-to-zero, while potentially benefiting from negative rates on retail deposits, does not make a lot of economic sense. And the fact that we have this equation of quantitative easing and no inflation is going to create a huge problem; and nobody seems to care about that, or at least it seems that our leaders on a political level are not addressing those issues by reforming fast enough. There is only a small and limited window of opportunity to do what it takes, and I don't see it happening right now.

Going back to Duncan's question about a bond proxy, I think a key reason why a lot of people are looking at risk arb and merger arb today is because those do not have the same liquidity risk that you have in a lot of fixed-income strategies.

If you remember what happened in 2008, just think about what would happen with high-yield, for example, if we were in similar circumstances. Once again, managers would face no bid/ask situations, and investors would suffer from huge drawdowns, and no liquidity on their investments. So the same measures like gating, etc., will be applied, and therefore the question is, **when is the music going to stop on the high-yield side?** I think it's only a matter of time.

On the other hand, on the merger arb side, you don't have that problem, especially if you operate within a pretty constrained environment like the UCITS format. Leverage could be a question, but within UCITS that's clearly limited. And if you look at some of the parameters we, for example, impose internally in terms of portfolio liquidity management and risk management, it offers a lot of protection: only 30% of our portfolio positions can represent more than 50% of the ATV 90 days. No position can represent more than 1% of the market capitalization of a company.

The average market cap in our portfolio of target companies is about \$6 billion, so think about a portfolio of 50-60 positions with an average size of 2% of NAV: clearly with a portfolio of \$1 billion, you do not have that kind of problem on liquidity. Based on these metrics, you can liquidate 70% of your portfolio within a day and probably all of it within three days without much impact.



So I think one of the great benefits, to end the answer of arb versus fixed-income, is clearly the fact that you get higher yield without the liquidity risk. I think it's fair to assume that if you look at expected risk-adjusted returns, right now the arb strategy is a lot more attractive.

**Heath Davies**

So given how European Banks have traded year to date, and the issues that need to be addressed in the Italian banking system, for example, do you see bank financing risk to European deals at the moment?

**Jean-François Comte:** This is a very good question, and this is why I allowed myself to comment on the fixed-income side in that manner. You can assume that maybe half of the M&A transactions require some financing.

But, first of all, we are not in 2007, so you do not see the same kind of leverage on transactions to start with. The world has become a lot more conservative. You don't have the same levels of net debt to EBITDA that we had in 2007. Second, the offers are a lot more restrictive. For example, we don't see anymore conditional financing, even on markets where it's allowed. So, even when there is a need for external financing, you see commitment letters from major financial institutions.



Then the question that I think is more interesting comes up when you look at the refinancing of that commitment on the high-yield market, and this is where we spend a lot of time. You could then see, for example, that the pipeline on the high-yield financing for M&A transactions has been very dry for the last eight to ten months. And we have seen, for example, placements not being absorbed, at least on the proposed terms on the US market, and then subsequently being postponed and placed on the European market in Euro denominated bonds.

That should give a clue to people in Europe, *why would you buy something that the Americans are not buying right now?* This is a key question. I think we have to be very disciplined with our investment process on this aspect of M&A deals.

**Keith Haydon:** So the initial question was, can you use merger arb as a bond substitute? When someone puts bonds in a portfolio, it might be to obtain one or more of the following three propensities. One is yield, and in this example there is currently, probably more yield attached to merger arb. Two is liability matching or duration. Merger arb hasn't got any of that, so that doesn't count. And three is the diversification effect. I don't know about your fund, but on the whole merger arb programs look like they have got reasonably high equity correlation to them. Certainly in extreme markets that's true. Clearly we have got different terms of financing now, it's not as leveraged as it used to be in 2007, against which you might argue that the events of 2008 resulted in a pivotal change in the interest of the state against capital, if you like, in the way these deals are assessed. So now quite often we find that a government will step in and mess up a deal in a way that perhaps in 2007 it wasn't so keen to do.

But the critical point to me is that, when I am building a portfolio – and by the way, we like merger arb at the moment and we are buying it – I am not looking for it to provide the same defensive characteristics as historically you would have expected to gain from buying bonds. One further qualification, which is that anybody who owns bonds now in the expectation that they will provide good defensive qualities in the event of a big risk-off moment, has to tell me what sort of negative yield he thinks risk-free rates will actually go up to, beyond where we are now.





Keith Haydon

You could have done, and I would have got it wrong then, and I am probably going to get it wrong now, so I am not going to guess. But let's put it this way, if we have a big risk-off moment, I would not expect my merger arb funds to do very well.

**Jean-François Comte:** Keith, that's a very fair and constructive point, but also, each investor has to look in great detail what each manager is doing. This is actually also one of our challenges when sitting across an investor. We start pretty much all of our meetings by saying, "We do not do event-driven, we do not engage in special situations." And this is important because the majority of managers who are using risk arb or merger arb are mixing it with special situations and event-driven. And by the way, you can definitely put hostile situations into the same bucket: You cannot forecast a yield on terms that have not been accepted.

So, as a pure merger arb portfolio manager, I am very confident on that point. We will keep an extremely low correlation to the markets in case of a correction.

But you are absolutely right, Keith, that there is an extremely high correlation in terms of beta between special situations and event-driven to the market, because of course when the market enters into a correction phase or the VIX is soaring, those situations typically tend to fail.

Or take a hostile situation: if you are pursuing somebody and try to offer a 20% or 30% premium – when the market crashes, why would you go on? You are not. And so there is a big difference between pure merger arb, where you have yield visibility and no beta and event driven, where you have no yield visibility and a high beta.

For example, the current situation of LinkedIn and Microsoft has a 7-8% annualized gross return, and there is no financing risk, because obviously the acquirer has enough cash to finance the deal. What's then your risk? It's a contract risk or a regulatory risk, which unrelated to the market. The market could be down 20% tomorrow, but that will have nothing to do with an HSR approval or an FTC approval, or an approval from the European Commission. Therefore, those deals are out of the market sphere. I sometimes use a dark picture, but those stocks are basically under life support and their life as a public security is going to end soon, because they will be withdrawn from the public markets post the acquisition, so they don't really participate in the current life of the market anymore.



But again, Keith is absolutely right that you need to make a difference in portfolios in terms of yield and diversification, and in this context there is a key difference between merger arbitrage and event driven.

**Dr. Murat Baygeldi:** I have got another question. Over the last few months I could hear in conversations with some banks that increasingly they ask for **return on investment**. They said there are certain products in the listed world that they would like to be engaged more and less with others, because they would currently be driven by new internal policies where they look into return on investment.

I don't mention the percentage they mention, but let's say they would expect at least 5% minimum return on investment before they even consider touching the new product or going through the risk management approval process.

The question is, do you think it is a trend, or was it just because two banks in UK just recently received the management decision to say: 'look, only concentrate on return on investment of a certain percentage.' Have you seen those types of discussion before?





**Duncan Crawford:** The whole banking industry is going through this issue, where Basel III is constraining their balance sheets and risk-weighted assets. It varies to a certain extent from bank to bank according to what their portfolio is and on their business lines.



While historically banks appeared to have endless balance sheet to give to clients or to get involved in different businesses, it's clear now that some businesses are much heavier on the balance sheet. And so now they have to charge, they know now exactly what they need to make from that business for it to be worthwhile, whereas previously it didn't matter so much.

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