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Editor’s Note

Alternatives are being adopted more and more by the Australian retail market. More researchers and consultants understand the value of alternatives which include CTAs, and more are understanding that a hedge fund oriented portfolio is not necessarily a more risky portfolio, it could also be a less risky portfolio (see pages 7-8).

The bank and wholesaler / dealer platforms play a major role in the Australian retail space, and some of them are now putting **up to 20% alternatives in the model portfolios,** resulting in significant inflows for local hedge funds. These groups have become more focused on ‘goals based advice’ and adopting absolute real return objectives, and are also more reluctant to pay the fees for standard traditional relative return type funds in the current environment. The look for investments which are a bit different. Also Australian family offices are searching for good risk adjusted returns, and they are happy to pay for the skill and in some cases limited capacity of an active manager (pages 15-16).

But things look much different on the institutional side where the well known **super funds are increasingly unhappy with the low returns of hedge funds and their fee take** of the gross return, which can be as high as 50%. The supers therefore tend to reduce their hedge fund allocations with some putting more into liquid alternatives, or **special situations / credit / co-investments** (page 16). However, hedge funds who are willing to agree to a "fair" fee split may still be able to work with the supers (pages 11-12).

The 2016 Opalesque Australia Roundtable, sponsored by Eurex, took place in Sydney with:

1. Bruce Tomlinson, CFA, Portfolio Manager, Sunsuper
2. Aongus O'Gorman, Senior Investment Consultant, Willis Towers Watson
3. Jonas Daly, Head of Distribution, Bennelong Funds Management
4. Nick Griffiths, CIO, Pengana
5. Greg Goodsell, Global Equity Strategist, 4D Infrastructure
6. Peter Fricke, Head of Representative Singapore Office, Eurex

The group also discussed:

- How to raise money in the Australian retail market (pages 7-9)
- Caveat emptor: Product proliferation leads to crowdedness in smart beta, risk premia & unintended risk (pages 15, 18-19)
- How many trillion US$ needs to be spent on infrastructure by 2030 globally? (page 10)
- Why do investment consultants recommend hedge funds? (page 10)
- Fees and how to disclose them in the new Product Disclosure Statement requirements of new regulation RG97 (pages 11-13, 14)
- New opportunities for US investors as Eurex expands VSTOXX volatility products and trading hours (page 14, 19)
- What is Sunsuper’s process when investing in special situations and doing co-investments? (pages 16-17)
- Why do more Australian hedge funds launch Listed Investment Companies (LICs)? (page 20)

Enjoy!

Matthias Knab
Knab@Opalesque.com

Participant Profiles

(LEFT TO RIGHT)

Peter Fricke, Nick Griffiths, Greg Goodsell, Aongus O'Gorman, Bruce Tomlinson, Jonas Daly, Matthias Knab

Introduction

Peter Fricke
Eurex

My name is Peter Fricke. I represent Eurex, the derivatives trading part of Deutsche Börse Group. I am responsible for the Singapore office from where we service markets like Southeast Asia, Singapore and Australia, including both sell- and buy-side institutions. I am with the group for the last seven years over which I have had different roles covering project management as well as direct sales functions.

Greg Goodsell
4D Infrastructure

I am Greg Goodsell from 4D Infrastructure. We are a newly minted global listed infrastructure manager based here in Sydney. We are part of the Bennelong Group. We cover all four regions of the world, as we define them, so North America, emerging markets, developed Asia and Europe. My role is Global Equity Strategist and that really involves being in charge for the policy framework and outlook for the business.

Aongus O'Gorman
Willis Towers Watson

My name is Aongus O'Gorman. I am a Senior Investment Consultant at Willis Towers Watson (WTW) in Sydney. I am responsible for hedge fund research and consulting in Australia. I have been at WTW for about 18 months. I have a background in hedge funds and investment management through my days at QIC in Brisbane and prior to that as a hedge fund manager.

Jonas Daly
Bennelong Funds Management

My name is Jonas Daly, Head of Wholesale Sales at Bennelong Funds Management. Bennelong Funds Management manages around A$7.5 billion, mainly across Australian equities and also absolute return strategies, and then more recently have added two new boutiques, one being 4D Infrastructure and Quay Global Investors, which is a Global Listed Real Estate manager.

We were originally founded by a family office, headed up by Jeff Chapman, and then we have grown into an incubator of boutique fund's management businesses. We have in the past typically taken an equity stake of up to 40% in the investment boutiques, for which we then do all of the distribution, marketing, payroll, IT, and administration services. It's clear that we need to have a high conviction in a manager and conduct stringent due diligence before we provide seed capital.

We have also recently announced the opening of a London office and are close to announcing our first new specialist asset management businesses that will be established under the UK business.

Nick Griffiths
Pengana Capital

Nick Griffiths from Pengana Capital where I am a Director and the CIO. I have been with Pengana since 2003, when the business was formed by Malcolm Turnbull and his colleague Russel Pillemer, our current CEO.

We have a similar business model to Bennelong. Currently, we run six strategies with a combined asset base of about $2 billion. Common elements of those strategies are that they are benchmark unaware, more focused on absolute rather than relative risk, they are transparent and daily priced. We also have a particular focus on the retail market.

Four of the strategies are managed in-house and two are managed by external managers overseas. The model we have in place with all the funds is very similar; they are joint ventures and we share the profits generated by the fund.

Bruce Tomlinson
Sunsuper

I am a Portfolio Manager at Sunsuper. Sunsuper is $35 billion Australian superannuation / pension fund. I look after the hedge fund or liquid / alternative strategies portfolio, which is about 6% of that capital, so $2 billion.

I joined Sunsuper in 2007 to set up that program, and I think it's one of the longer running in-house hedge fund alternative strategy programs of any superfund.

I have been in the finance industry 25 years, including a dozen years with AMP Capital, both in Sydney and London. I also am on the Investment Committees for a couple of entities. One is Future Generation Investment Company, a listed investment company. They have two Listed Investment Companies (LICs) which invest in a number of Australian and global alternative equity managers. The other is the endowment for the NSW Cancer Council.

Matthias Knab How has the Australian hedge fund industry been doing lately, what are some of the latest development from the fund management as well as from the investor side?

Jonas Daly: Alternatives are being adopted more and more, with the advisory market and the large distribution platforms increasing education and awareness of such strategies. More researchers and consultants understand the value of alternatives who after the global financial crisis added value with their low correlation to mainstream asset classes. That put them on the map and made investors realize the benefit and the role alternatives play in a portfolio.

Based on the ageing population and growth in the retirement sector, we are seeing further demand for low volatility funds, and whether you are doing that in different ways through shorting index futures or taking risk off by simply short selling stocks, we have seen a genuine demand for that.

Particularly with pensioners and retirees who are looking for an allocation to the market without the volatility of equities and potential 'draw downs'. So, those type of funds have been popular however it is difficult to find good ones with long term track records.

As we all know, the large bank and distribution platforms play a huge role in the retail market here, and we've seen a steady increase in flows mainly off the back of some of the largest dealer groups allocating up to 20% to alternatives, which is encouraging for the whole industry.

Matthias Knab How has the Australian investor base been embracing alternative investments?

Jonas Daly: What we have seen on the investor side is that over the years **alternatives are being adopted more and more by the retail market**, and that not just by the moms and dads, but also more by the advisory market and the bank distribution platforms. More researchers and consultants understand the value of alternatives which include CTAs, which after the global financial crisis added value during that time with their low correlation to mainstream asset classes. That put them on the map. That really was the time from which on people have been educated on the benefits of those types of structure.

More recently we have seen demand for low volatility types of funds, and whether you are doing that in different ways through shorting the SPY or and taking risk off by that or just short selling stocks, we have seen a demand for that in the market. Particularly pensioners and retirees are looking for an allocation to the market but without the volatility of equities. So, those type of funds have been popular.

As we all know, the bank platforms play a huge role in the retail market, and we've seen an increase in flows, but also the dealer groups are now putting alternatives in the model portfolios, up to kind of 20%, which is encouraging for the whole industry.

Nick Griffiths: About five years ago we moved our distribution more from an institutional investor focus to a retail and high net worth investor focus for these very reasons. Over the last few years we have also increasingly seen dealer groups and advisors become more focused on 'goals based advice' and adopting absolute real return objectives, getting away from the standard traditional relative return type funds. They are now more reluctant to pay the fees for the latter type of funds in this environment. Many advisors are looking for investments which are a bit different.

A lot of this is driven by their clients who want to reduce their exposure to volatility in their investments. They understand that this is a low return market. If a fund can provide cash plus 5% in the current environment, most retail investors would be very happy with that.

But there are some limitations on what some advisors and dealer groups can and can't do. Some advisors are constrained by their Financial Planning groups and Approved Product Lists in terms of how much they can invest into hedge fund type investments.

PI insurance is another issue that they face, which can limit their permissible hedge fund exposure. A group called ARRIA (Association of Real Return Investment Advisers) is working with brokers at the moment to try and address that and help the insurers understand that **a hedge fund oriented portfolio is not necessarily a more risky portfolio; and could be a less risky portfolio.**

Still, we do see some big changes within the independent advisor community, who have the freedom to implement a core satellite approach, or to reduce traditional investments altogether, and can focus on absolute return hedge fund type funds. The product choice is increasing and more funds are now structured for daily pricing, offer transparency and provide better disclosure through ASIC Regulatory Guide 240.

Matthias Knab You both talked about the dealer groups including more hedge funds, alternative investments, what is their selection process, who do they pick, which funds do they put into a model portfolio?

Nick Griffiths: It's still largely research house driven. **To raise money in the retail market, you need to be on a platform,** you need to have the demand from an advisor and to get to that point you need to have a research rating from one of the recognized rating groups. So, if you don't have a research rating, it's very hard to raise money, but also it's quite hard to get a research rating unless you have got some money. So it's a chicken and egg scenario and you end up balancing a few things when trying to get to critical mass.

Matthias Knab What's the critical mass or the critical size a fund needs to have?

Nick Griffiths: It depends on the fund and the fee scale, between A$50m-$100m, that's probably about right here in Australia.

Getting onto an investment platform is an arduous process, but it can be done. I'll give you an example. We started a fund at the beginning of 2016, a global equity market neutral product, and that has just got on to one of the major platforms. It required about 9 or 10 months to get to that stage.

That fund had a head start because it had a long-term track record from an offshore product. If you start from scratch it could take a lot longer than that. But it's worth it, if you can get on the platforms, get on the APLs (Approved Product Lists), then you can get a very nice diverse investor base. For example, we have a couple of products with A$500 million to $1bn in assets with 1000 to 1500 investors. And some of those investors are actually platforms, so within those numbers I've mentioned there are even more underlying individual investors.

So it is a long process, but if you can achieve it you end up with a very stable, secure and well diversified business as opposed to being reliant on larger allocations from a limited number of institutions or fund of funds.

Peter Fricke: From an exchange or market infrastructure provider perspective, Australia has always been a good and stable market for Eurex particularly with respect to our fixed income derivatives through global macro funds and CTAs.

Over the last two to three years, more long-short equity managers have started to use some of our broad-based index products for global exposure and diversification as well as other services offered by the Deutsche Boerse Group. For example, STOXX's smart beta index offering or Clearstream's triparty repo and collateral management services. These are some developments where we have not only seen the Australian hedge fund industry evolving but also that the general buy-side community is looking for international partners and is willing to work closer with exchanges and infrastructure providers.

Matthias Knab Greg, what's your take on infrastructure investing from an Australian or global perspective?

Greg Goodsell: Around the world there are only a dozen to maybe 15 specialist global-listed infrastructure managers, and probably ten of those are based in Australia because of Australia's history of privately financing infrastructure.

Those 15 fund managers manage around A$60 billion in funds under management, while the listed infrastructure market globally is something like $2 trillion. So this market is actually very under-serviced in terms of specialist managers. That's the first point I would make.

Second point I would make is that the room for growth is enormous because around the world governments have underspent on infrastructure for the last 30 years, and that's really everywhere, so in developed and emerging markets. We've also seen that infrastructure has been a theme in the 2016 Presidential election in the US where both Trump and Hillary Clinton were saying we are going to spend big on infrastructure.

The B20 is the business arm of the G20 in terms of government organizations, and their estimate is that something like **US$60 trillion needs to be spent on infrastructure by 2030 globally.** Having said that, coming out of the global financial crisis (GFC), most countries around the world are really fiscally constrained since post GFC most have big debts and are already running deficits, they are just struggling to pay operating expenses. This means they are not going to be able to fund this infrastructure spend.

So the point I am getting at is, huge amount money needs to be spent, otherwise the global infrastructure arteries of the world will slow up. But that funding cannot all be done via government because they just don't have that capacity. Therefore a lot of privately financed infrastructure will come online over the next 20 years as an absolute necessity in a market.

Now we are in the listed market, and there is obviously also a big unlisted market for infrastructure investment in Australia and around the world. All the pension funds are looking to line up long dated liabilities with nice long dated assets, it's just an enormous opportunity in our view and we expect rapid growth over the next decade.

Matthias Knab Thank you for those insights on infrastructure. Aongus, you are consulting with institutions, what are some of the themes and trends you are seeing?

Aongus O'Gorman: As a firm we do recommend hedge funds to clients. We have a strong focus on diversification, probably more than most other consultants. Although, I have to say that getting them into client portfolios is generally a challenge.

There is a spectrum of approaches in hedge funds, incorporating skill-based strategies and alternative beta.

Our clients are generally quite open to considering capturing underlying alternative betas that can be delivered at fees of 50 to 100 basis points. This fits with the market down here, which is very fee focused. Whilst perhaps not as diversifying as the unconstrained skill you should capture from a quality hedge fund, the lower costs are attractive.

There is really no such thing as an average hedge fund, but if there was, it would basically have a reasonably significant exposure to equities alongside an exposure to cash. Such a fund is not going to deliver much in this low return environment because for one thing its fees will be too high. Setting aside this issue and considering a quality, skill-based hedge fund our clients are challenging us, saying something like, "Well, I am going to take risk here, I'm doing something unconventional, right? Therefore I can expect a return, right? What's that expected return?" From an absolute return perspective, with cash rates close to zero, the expected reward for this complexity is often not sufficient relative to the fees that are being charged.

A net absolute return of 5% or 6% could be fine when it costs you 50 basis points, but if it's 300 or 400 basis points in fees, that's a difficult conversation at the moment.

So I would say we find it much easier to have a conversation about capturing the underlying risk premia, and disrupting the hedge fund products that exist today. If we move away from that factor side of things and just focus on skill based hedge funds that's a more difficult conversation. We still see the benefit of this approach versus inflation or liabilities but it's a challenge to convince clients.

Bruce Tomlinson: If you look at the average fund of fund, which is still the way many institutions invest, or when you have a diversified portfolio of 10 to 20 managers, for most of those investors the outcome and the returns for two years running really have been close to zero or low single digits. And then, as I said, if you look at the fee take of the gross return it's as high as 50%, and that's just unsustainable. Investment committees of pension funds, I think around the world, are looking at their fee spend across all their asset classes, and they go, "This just doesn't add up..."

If these investors allocate to infrastructure, real estate, or even private equity, they may also pay a fee of 1% to 3%, but they are earning 10% to 15% net. *If you're only earning 2% or 3% net from your hedge fund, and paying 2% or 3% in aggregate fees, it just doesn't work.*

So what you are seeing is **institutional allocations to traditional active hedge funds being reduced,** and obviously not just the big names that you hear about in the US, but also here in Australia to some extent. I don't believe many pension fund investment committees are currently adding to hedge funds.

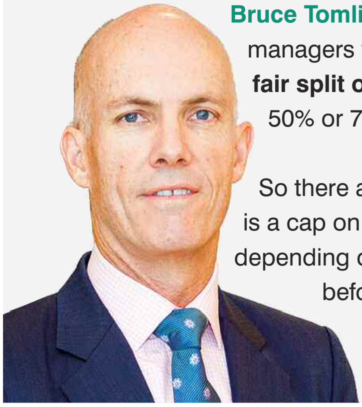
Recently we have seen product proliferation in the **liquid alternatives space,** including both alternative risk premia like merger arb, or traditional premias like value and momentum. A lot of capital is being allocated there, but in terms of traditional actively traded evergreen hedge funds, I believe that part of the industry is in decline. If returns don't pick up soon, by mid 2017 we'll have three years of low single-digit returns, and I suspect that many investors won't put up with that.

At Sunsuper, we are doing different things to address this issue. We are doing more in long duration, sometimes closed end, **special situations** investing. Often it's credit-based, although not always. We are also doing a lot of co-investing, with up to 15% of our program now in direct **co-investments.** That has worked pretty well for Sunsuper in private equity, and so we are doing it more in the alternative/hedge fund space as well.

Second, we are moving away from structures that charge one-half or two and 20 over zero paid annually. To me, that's poor alignment between the investor and manager.

Recently we have seen larger hedge funds going out of business or having redemptions halve their AUM in the space of 12-18 months. I doubt that money is coming back. In a world of lower returns I think their business model and their structures are inappropriate for many institutional investors.

Matthias Knab I think this is really interesting. We are seeing two very different views from around the table depending on whether it is coming from the institutional end of the market or the retail high net worth investor.



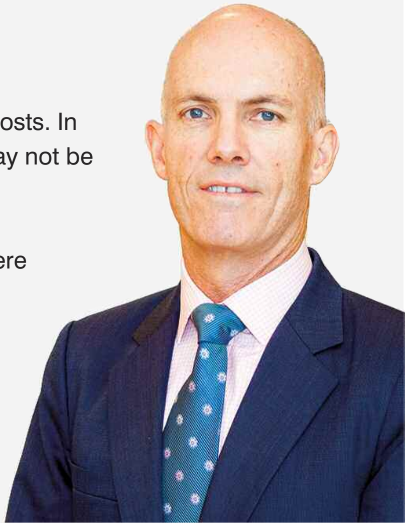
Bruce Tomlinson: I don't mean to come across as too negative; let me say that there is a subset of managers who are responding and changing. For example, they will agree with us when we say, we think a **fair split of the fee between our capital and your talent is 25-30% to you and the rest to us,** and not 50% or 75% to the manager.

So there are managers who will agree to that and we are looking at putting in place structures where there is a cap on their fee, with measurement over a rolling period of three years or whatever is appropriate, depending on the strategy. Plenty of managers will put in place a decent performance fee hurdle, 4% to 8%, before the performance fee or the carry is paid, and backended over those 3 or 5 years.

So I think there are managers that are willing and are able to change, but those who expect 20% over Libor every year, to me that's an old model that needs to change and I am hopeful in time it will change.

Matthias Knab On the other hand, management and performance fees that hedge funds have been charging are indeed in a downtrend globally and also probably here in Australia.

Bruce Tomlinson: In Australia we currently have a new regulatory requirement for greater fee disclosure, called RG 97. From Feb 2017 relevant pension, insurance, and retail funds have to report fees and costs, not by manager or by asset class, but in aggregate for the fund.



And it's not just management fees and performance fees, but it includes other costs like administration and custody fees, and transaction costs. It includes brokerage and leverage costs. In some cases you have to look at a spread and estimate an implied transaction cost, which may not be appropriate but nonetheless that is what is required.

We have gone to all of our managers and have received both estimates and actual costs where available. **The administration and transactional cost of alternative vehicles ranges from 50 bps up to a 200 bps.** This is in addition to management and performance fees, so these alternative structures are very expensive when you compare them to a long-only mandate in traditional equity or fixed income. These higher costs may become another impediment to investing in alternatives. Investors as well as managers have to look at their total costs. This issue is going to be more-and-more important as we go forward.

Aongus O'Gorman: It's also worth noting that these costs have always been there. They are part of net and gross returns, and the manager is hugely incentivized to minimize them, in close alignment with the investors.

From a trading cost perspective, a big difference between the long-only equity managers and more transactional, trading oriented funds is turnover; hedge funds tend to trade over shorter periods of time trying to generate a differentiated return over a long term buy and hold investment style. Bruce knows this, but I think that defining what is expensive and what's not expensive is determined by what the strategy is. I ran a hedge fund strategy, a low turnover strategy, and we were very conscious of our trading costs. This goes back to the late 90s and our costs were about 50 basis points, as a low turnover CTA.

If I look at a high frequency CTA by comparison, it could easily be paying 400 basis points in transaction costs for some very high turnover strategies. Unfortunately most investors have no framework for assessing these relativities. Putting such cost statistics in the public domain without this understanding is likely to have unintended consequences. If investors misinterpret the numbers and perceive that they are paying 400 basis points to a high frequency manager, on top of the management fees, the reaction is likely to lead to reduced interest in the more diversifying higher turnover trading strategies, leading investors, as ever, back toward the passive holding of equities.

From my conversations with managers my impression is that the cleverest, largest, best resourced managers know exactly what their costs are and the poorest quality managers know the least about their costs. If not carefully monitored there is a risk that the managers who are going to get penalized / negatively assessed could be the ones who have the best disclosure and the best information, and that's the challenge for those managers.

Peter Fricke

What could a market infrastructure provider do to further support the industry in regards to these increased transparency requirements? With REGIS-TR we are already offering a service to help our customers to comply with European reporting obligations stipulated by MiFID 2.

Bruce Tomlinson

From an investor's prospective we are just asking our managers about these costs, so we sent them a set of questions. As Aongus alluded to, some will give you a lot of detail, others will give you some guesstimates, and one or two will really struggle. But we rely on them to provide adequate disclosure of all costs, and the managers need to work closely with all their service providers to accurately determine those costs.

Jonas Daly

At Bennelong we have a working group set up to tackle RG 97 and we have already started reporting to institutional and retail organizations.

Aongus O'Gorman

If a manager doesn't know their cost of trading, they shouldn't be trading. But also, on the other side, there is IP in knowing the cost of a strategy. As a manager I would never have disclosed that to my competitors.

Jonas Daly: Yes there will be a Product Disclosure Statement (PDS) in RG97 in the next PDS rollover scheduled before the 1st February 2017 deadline.

And we should never forget the **after fee return point of view** which should offset some of these transaction costs that go on in the fund. At the end of the day it's about strong net returns for investors with controlled risk, those are still the best outcomes for any equity investor. From a transparency point of view, we are happy to be transparent with our fees and our trading costs, I would have thought though that some of the higher turnover strategies will have more administrative hassles setting this up.

It will be interesting to see how far disclosure goes as the big institutional super funds invest heavily into non-listed assets, and I would assume there is a whole lot of other costs associated with these investments as well. So do you know more details about the disclosure of these costs in non-listed investments?

Bruce Tomlinson

Yes, RG 97 covers all of the assets in a pension fund, listed or unlisted. So yes, costs involved in infrastructure and real estate, and direct investments in those assets and structures, have to be declared. Things like legal costs, due diligence costs, underlying management costs and everything else is included.

Matthias Knab

Most investors are obviously very focused on fees for managed funds, but I have also heard the question about where is this focus, also from the regulator, when you hold a direct equity investment? There are often scandals around the management costs a company, and so an open question is if investors and regulators put the same amount of rigor into they are we getting in return for an equity investment versus how much is management or the company taking?

Bruce Tomlinson I believe the answer is no; most listed securities don't have to declare the fees that public companies' management is taking out. The playing field is not level between for example listed infrastructure and unlisted infrastructure, or listed property and unlisted property.

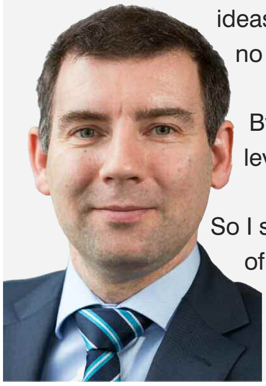
Matthias Knab Aongus, what is your take as a consultant regarding fees active investment managers charge?

Aongus O'Gorman: I suppose there are two ways you get volatility. (Well, a third one is losing a lot of money!) You take market risk or you take active risk, managed via net and gross exposure. Where we would have an issue with fees is when the manager is taking a lot of (net) market risk, because taking that risk is almost free. So if a manager happens to be 200% long and has no shorts, then we are not interested in paying a significant fee.

If a manager is running a high gross but low net, then, absolutely, that's much more interesting and the conversation moves on in terms of the appropriate level of base fee, because the risk being taken here is active risk. Generalized commentary about the base and performance fees misses the fact that it is **type and structure of risk taking that really matters.** This is the type of consideration you get into when investing in an institutional framework.

I would estimate that many equity long-short or market neutral managers probably run 200% gross leverage, and that probably works out at 4% or 5% annualized volatility. If someone is going to run at 400-600% gross, but charges a similar base fee, this is much more attractive, other things being equal.

With regard to the question about manager size / resourcing, *the first consideration shouldn't be size but rather is what they are doing interesting, differentiated and does the fee reflect the risks being taken?* After that you deal with the risks attached with the operational side and the size and such aspects. If you find an equivalent manager that's larger, with similar ideas, but with better infrastructure, then you go with that group, because there is no point in taking risk with no reward to it. If you can't, then you judge whether these risks are worth the potential reward.



By and large, for institutional investors, these kind of allocations are smaller parts of their portfolio, so the level of volatility is not necessarily a concern if it's value-adding volatility.

So I suppose that's a long-winded way of saying, you have got to look underneath the hood and see what type of risk you are taking to determine what fees you pay for it. And there are times when a reasonably high fee is worth it.

Peter Fricke: Speaking of volatility, we observe a trend where investors are directly trading volatility derivatives to either hedge their portfolio exposure, capitalize on broad market volatility or as a means to diversify their portfolio by adding a new asset class.

This surge in interest for volatility trading in combination with macro events such as Brexit and the lead-up to the US elections has led to an overall 26% increase of our VSTOXX products. By making the VSTOXX options contract compliant for US investors as of February next year, we expect further growth in this asset class in 2017 and beyond.

Jonas Daly: I have talked about Bennelong's investor base before, which is more retail, but that includes the family office and high net worth side. We find that the latter type of investors are more focusing on **absolute return** and not really focused on index funds as much. For example, one of our funds is a market neutral fund which for the last 15 years has returned around 17% per annum net of fees. That fund has been a really strong performer for the family office and high net worth investors, and they have been loyal to that fund as they are obviously happy with after fee returns. But also, the manager has only taken up to around $730 million in that fund. The manager soft closed the fund as he does not want to impact returns by exceeding market capacity in certain trades.

If we offered that fund to institutions, it would be a different conversation mainly because institutions use alternatives as a tool in a broader portfolio for different reasons. It could just be purely based on volatility or it could be return driven or about accessing a certain type of strategy. Some institutions are also re-packaging funds through a multi manager and so can be more fee sensitive to get their own overall fee down to remain competitive.

Institutions may also have boards that may be vetted to the index, so they may have stricter objectives or remuneration structures that are relevant to the index or outperforming an index (even if it is negative for the year), and so you get this whole demand for beta and getting cheaper access to beta as well.

But as I said, family offices just want good risk adjusted returns, and they are happy to pay for the skill and in some cases limited capacity of an active manager and they don't have as many internal and external pressures going on. So these are very different constituencies, institutional versus retail and family office, they are quite separate in that regard from our point of view.

Over the years, institutional investors have become more sophisticated in the space of alternatives. They went through the fund of hedge funds phase and now are looking at risk premia and cutting through to more low cost alternatives and 'hedge fund beta'. So that space just keeps getting more sophisticated on the product structures and offerings. However, if I'd talk to the typical advisor about risk premia and these type of things, my impression is that they are not there yet and likely won't need to be as they can usually achieve their objectives by simply blending certain funds.

Bruce Tomlinson: I am becoming **concerned with these recent flows into risk premia from institutions.** When you go back to pre-GFC days, many institutional investors allocated to generic hedge fund of funds that followed a relatively simple top-down strategy. But many of those investors were disappointed with the results, as they didn't understand the directionality, leverage, and liquidity they were exposed to. I see similarities with the current trend to liquid alternatives / risk premia; i.e. investors don't really understand what they are exposed to.

So I don't think of risk premia as achieving more sophistication; it could potentially be another mistake. We all know investing in alternatives is difficult. It takes a lot of time and effort, and maybe now some institutional investors are thinking they can get a high alternative return outcome by simply investing in cheap risk premia.

We know that a lot of money has been raised in this space over the last few years. If you expand the definition to quantitative strategies in general, so I am including here things like risk parity and other generic risk factor investing, then many hundreds of billions of dollars have flown into these type of investments, and the reality is that we don't know how this will play out over the longer term.

I don't believe that investing in risk premia for 50 bps is going to give you the same risk adjusted outcome as a more actively managed alternative program, but we'll see...

Nick Griffiths: We manage an Asian long short event-driven equity fund, one of the strategies it employs is M&A or "risk arbitrage". This is an example of the risk premia that you can try and extract through quantitative methods.

But, from first-hand experience, I know how active the fund is, how much effort the team put into assessing every deal, the likelihood of completion, risks involved etc. This is *extremely hard to replicate with any sort of quantitative approach,* and you also can't replicate the strategy in a large size. It will always be a sub $1billion fund, which makes it very hard to access for larger investors. Maybe their only option actually in significant size is to follow the risk premia approach.

Matthias Knab Bruce, you said before that at Sunsuper, you have also reduced your active alternative investment managers, and now you explained you also have certain questions regarding the proliferation of things like smart beta and risk premia. Can you give us more details about how you are investing now and what is your process?

Bruce Tomlinson: I will try and answer that succinctly. Our program is always evolving and it has always been more bottom-up and opportunistic than top-down. To put that more colloquially, we don't sit in a Star Chamber once a quarter and decide to move 5% from long/short to relative value, for example. We have never had that approach.

And as I mentioned earlier, five years ago we started investing in closed-end vehicles, such as **special situations credit;** effectively bank capital replacement opportunities.

Post-GFC, banks had to recapitalize, regulators were forcing them to divest and get out of certain activities, and so we started to put money to work in that space and built a large allocation over the last five years.

Then three years ago we started to do co-investments with some of our managers. We also selected a fund of fund specialist partner to complement our direct manager allocations. This now makes up 15% of our capital.

We have invested in 11 transactions over the last three years, and reviewed 30 now. We are now reviewing one or two a month. These co-investments have becoming quite important for us and we expect that we will increase that activity and the capital invested there.

Let me also add that those investments generally have an *outcome or a catalyst* where to some extent we can underwrite the return or we can look at scenarios that give us a reasonable estimate what the outcome will be. They are not based on someone's trading alchemy that may or may not work in particular market environment.

This means that we are *moving away from some trading strategies*, and definitely are moving more of our money towards investments and strategies that are more outcome-oriented, particularly in credit, but to an extent in event-driven as well.

So we have reduced, for example, macro, and to some extent long/short in favor of those type of investments which again, in our case, are bottom-up and quite active and opportunistic.

We know our **efficient decision making and execution capability** is an advantage. For example, we can get a coinvestment approved within a week, and funded in under two weeks. This gives us a big advantage over many other pension funds.

And this is helpful, because often the managers are looking for some completion capital and need to know within one or two weeks. They typically don't have anymore time than that. We are not as big as many sovereign wealth or the large pension funds, but we think we are more nimble, and so we believe we have some advantage there.

Aongus O'Gorman I am just wondering when you consider your co-investment portfolio in aggregate, what do you think it is going to deliver? What is your expected return, and what fee levels are you looking at with such co-investments?

Bruce Tomlinson: Well, the simple answer we expect to earn a higher net return, and part of that is lower fees. We won't do a co-investment unless the fees are significantly better than the master fund. *We usually are upsizing a core position in the manager's master fund.*

The returns are quite eclectic and different because the investment is different each time. For example, we have done a few equity spin deals, where companies are divesting a subsidiary. We have done pre-IPO equity stakes, and a number of distressed credit investments, where there is a liquidation or bankruptcy or trade claim.

Aongus O'Gorman So there is an equity risk premium or a credit risk premium to some of these investments, and then the skill of the manager to identify the deal?

Bruce Tomlinson: Yes, there is some market factor involved, but it's not anything you can easily replicate with an index. As you said, deal flow and structuring is key, and we are more than happy to pay the manager for that. Generally it's about completion capital, which means that the manager has already got a core position. They would rather raise $100m from their LPs than have to syndicate the deal to somebody else like a competitor.

Coming back to fees, we are not doing this at 1 and 20; it's often zero management and 10, maybe 15 percent performance fees over a hurdle, paid at the end when the deal is monetized. That's the starting point, because for the manager in most cases there is no extra staff or cost.

Aongus O'Gorman: I'm thinking about some of the commonalities between co-investments and alternative beta strategies. The example Bruce gave about the credit strategy where, after the withdrawal of the banks, investors step in and provide the capital. It is this "factor" that is driving the return; the structural reason for taking risk.

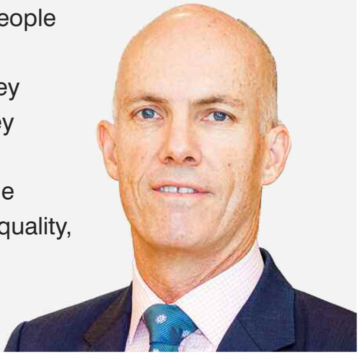
Finding this structural reason is something investors should do in any form of investment, even in active management, effectively asking "What's the reason I believe this will give me a positive return?" As Bruce said, the trading alchemy part is very difficult, and so we need to search for some kind of underlying factor or return to build conviction.

It's this approach that is the essence of WTW's work in alternative beta, the identification of the **structural reasons for returns,** combined with working with managers on smart implementation. I agree with Bruce, there should be skepticism in any factor investment, it's not active management, it should come at a lower fee, and probably it won't have as good a risk adjusted return as a quality hedge fund manager. *Strategies with low barriers to entry have high propensity for crowdedness and that's where any potential problems will be, mostly probably in the quant strategies.*

If you consider this approach to identifying factors, or risk premia and apply it to a co-investment portfolio it can give you a good sense of what you are exposed to. Whilst you have clarity on the specific transactions, returns are still generated as a result of various risk premia including equities, credit, and illiquidity. Perhaps, though, there is a greater level of skill being captured as the portfolio is quite concentrated, and this comes at a much reduced fee.

Matthias Knab Bruce, Aongus brought up the aspect of a potential crowding, and also you voiced some caveats around pensions that are moving assets from more actively traded managers like hedge funds into move factor driven, risk premia, smart beta types of investments. I am curious to hear if you had more to add, what are from your perspective some of the caveats around these types of investments?

Bruce Tomlinson: I can't really speak about other funds as I only know anecdotally what a few people are doing, but I guess the concerns would be that the groups who are packaging some of these relatively low cost factor and risk premia strategies might not have a strong capability for that. They may even be relatively new to quantitative investing or their models might be quite generic, or they might not be diversified enough, and they might not have the trading infrastructure. For whatever reason, they might just not be as good as some of the specialist active quantitative managers. The other thing I suspect is that some people will invest based on price, not based on price adjusted quality, if that makes sense. So time will tell.



Aongus O'Gorman: I think I have addressed this point as well with my last comment. At the end of the day, as Bruce said, there's a lot of **product proliferation** in this space. So that's what you have to be wary of, and then you have to be wary of the behavioral implications of that proliferation.

The lower barrier to entry strategies can attract a lot of capital quite quickly. There are plenty of quant shops who can build these strategies very easily, but they will have a knock-on impact. Those are the things investors should be worried about.

And, *if these are strategies are capturing alternative risk premia in a low return, integrated global environment, you can't expect that these investments will deliver a return significantly in excess of traditional risk premia,* as investors will seek out these opportunities. For example, even something perceived to be quite esoteric such as Reinsurance has seen risk spreads contract.

Ultimately, let the buyer be aware and understand that whilst the underlying return of many alternative beta strategies may be explained by a unique factor, there will be times when that risk premium is affected by systemic events and general investor behavior. *Diversification is achievable over the long term, but not always in the short term.*

Matthias Knab What else is happening at your firms? Are you launching new products or services or working on some innovation?

Peter Fricke: There are two developments worth mentioning here: One is driven by demand, and that is the **extension of our trading hours** to overlap with Australian and Asian markets. We will start with offering our FX Futures 23hrs – this includes regional currencies such as AUD, NZD and JPY – as early as Q1 2017. Over time this will be extended to also include our benchmark products like DAX and EURO STOXX 50 Index derivatives as well as our Euro-Bund, Bobl, Schatz, BTP and OAT fixed income suite.

The other development is mainly driven by regulatory changes and how we can help our clients to continue business in light of increasing cost of capital, reduced OTC trading activity and mandatory clearing requirements.

On the trading side we are trying to accommodate some of these changes by standardizing the terms of settlement and delivery of a contract such that the contract can be listed on an exchange. Our main objective is to provide clients with CCP protection without compromising the flexibility that usually comes with an OTC trade. Both our MSCI product suite, where we have just passed the 1 million open interest threshold in September, and our newly launched Total Return Futures are two prime examples of these developments and with bilateral margin rules on non-cleared swaps to be introduced soon we observe a growing interest among our investor base.

On the clearing end, we are trying to increase direct interaction with the end customer. Eurex Clearing is the first clearing house to come up with a **direct clearing model for the buy-side** - what we call ISA Direct. It is an enhancement of our individual segregation model, where we allow buy-side customers to become direct members of the clearing house, but still involving the clearing broker as a clearing agent. The clearing agents will still be involved in the default management process and the contribution to the default fund. As direct members of the clearing house, buy-side customers will maintain the legal and beneficial ownership of the collateral placed with the clearing house while the banks reduce their capital and balance sheet impact in terms of RWA (risk-weighted assets) and leverage ratios. It also reduces concentration risks and increases portability likelihood in case of a default.

ISA Direct has already been rolled out for OTC IRS and repo transactions and a service for listed derivatives and securities lending transactions will be rolled out in the future.

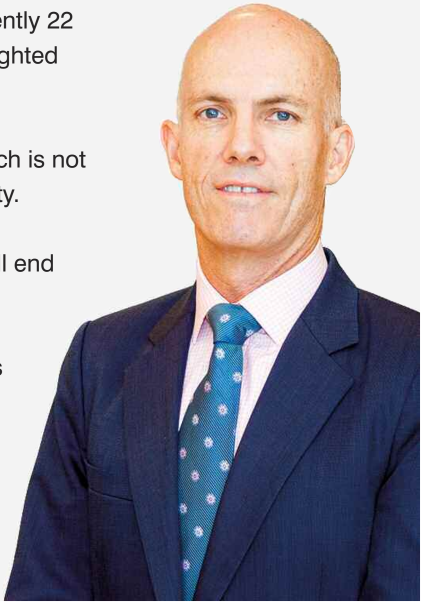
In the end it's all about addressing regulatory changes and allowing the industry to directly engage with the exchange and the clearing house to offer more cost-effective hedging tools and also less capital-intensive services.

Jonas Daly: One thing we have observed is an increase in demand for **managed accounts,** particularly from the retail advisory market. This is easy to do in the direct equity space, however it can be very difficult to implement an alternatives portfolio containing derivatives and high turnover trading. Some of the work arounds are via a LIC or an exchange listed fund, as they can bring it in quite easily through the security code, generally speaking there has been an increase in demand for managed accounts and we continue to support this innovation.

Matthias Knab Jonas just mentioned the Listed Investment Companies or LICs which for a manager have the benefit of getting permanent capital. I have heard that hedge funds and others creating more LICs and using that option to roll out products. Any comments on that?

Bruce Tomlinson: I just have my relatively limited experience working on the Future Generation Fund's Investment Committee. They have two LICs, one for domestic equities and one for global shares, and they are a mixture of absolute return and long-only equity managers, so effectively it's a fund of fund, but asset raising has been very successful with over $700 million in those two LICs.

One thing I would like to point out is that the communication effort is quite significant; there are monthly emails going out to shareholders; there are regular face-to-face briefings with road shows around the country; they provide additional transparency on the underlying investment managers on a regular basis. And the interesting thing about the Future Generation model is that the managers and service providers give their services pro bono to the fund, so that the LICs charge 1% of NAV which goes to a range of charities. There are currently 22 charities that focus on children at risk and mental health, and these charities also get highlighted regularly in shareholder communication.



So there is good connection between the shareholders and the purpose of these LICs, which is not only to generate an absolute return but also to help disadvantaged people in our community.

And so I wouldn't say that you just raise LIC capital and then you are done because you will end up trading at a discount and maybe management will be booted out. It's fair to say that the people at Future Generation, in particular Jeff Wilson and Lousie Walsh, are very good at communicating and creating a bond with all stakeholders. A good indication of that bond is the fact that 90% of option holders exercised their rights and put more capital in a recent raise that they did in the domestic LIC. So I believe the Listed Investment Companies are an interesting and exciting area and a lot more capital is going into it, but like anything, you've got to do it properly.