



Opalesque Roundtable Series '17

NEW YORK

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Editor's Note

Many investors have large allocations to illiquid assets in PE, real estate, private debt, or infrastructure. And this could become a problem.

One of the most recurring themes with investors today is diversification.

*Many investors have large allocations to illiquid assets in the private equity, real estate, private debt, or infrastructure sectors. Those assets are often classified as alternative – suggesting that investors expect those assets to provide some diversification. But are those assets not sharing the same risk factor – illiquidity premia? And shouldn't we be wary of a premia which has been **compressing** for the better part of the last ten years?* The message here is simple: If diversifying your portfolio is a priority, some of the diversifying strategies should be liquid (page 9-10).

Another important aspect here is **tail behavior**, so the diversification at the tail rather than diversification in normal market environments. Any tail risk solutions also need to be capital efficient, and require real conviction that the investment's behavior during extreme market outcomes would actually meet portfolio needs. What's complicating things is that **many strategies that can exhibit low correlation to risk assets, but they may not protect during crises** (page 18).

At the same time, investors are not only focused on protecting capital for the sake of smoothing the profile of the returns of their portfolio, but perhaps even more importantly they want to be able to go back and invest in the markets at a time when assets have become more attractive after a pronounced selloff. Any such strategy therefore has to offer **monetization capability** at the right point of time, which again may be achieved with a liquid structure (page 14).

The NY based group of Roundtable participants also discussed:

- Which are the three themes FRM is currently interested in? What is "emerging square"? (page 7)
- What is the main benefit of hyperaligned investment structures? (page 8)
- How is Big Data changing the way commodities funds are run? How can a commodity trade business enjoy longevity? (page 9-10)
- How do we know that 2017 so far has been "100% risk-taking", and what does that mean? (page 12-13)
- **Why do risk mitigating strategies also have to be risk managed?** (page 15)
- What do most people miss about the correlation measure? (page 16-17)
- What happens when quants get too greedy? (page 17)
- Which strategies can capture the tail? (page 17-18) **Why does Lyxor like "humans" in their portfolios?** (page 18)
- **The come back of active trading.** How passive money creates opportunities for active (page 18-22)
- Why do so many alternative strategies have such high cross-correlations? (page 22)
- **What really caused the crash flash of 2010?** (page 23)
- Smart beta and the growth of CTAs. Why passive or smart beta does not imply it's a benchmark (page 25)
- **An overview of the multi-asset, multi-risk premia universe** (page 26)
- Why regulation has made the sourcing of top investment talent easier (page 28)

The following speakers participated at the Opalesque 2017 New York Roundtable, sponsored by Societe Generale Corporate & Investment Banking:

1. Fabien Pavlowsky, **Director – Global Macro & CTA Strategies, Lyxor Asset Management**
2. Osvaldo Canavosio, **Head of Manager Research & Sector Head – Global Macro, Man FRM**
3. Matthew Heap, **Portfolio Manager, Orion Resource Partners**
4. Justin Dew, **Director of Strategic Development / Head of New York Office, Welton Investment Partners**
5. Marc Malek, **Managing Partner & Portfolio Manager, Conquest Capital Group**
6. Jonathan Goldberg, **Founder & Chief Investment Officer, BBL Commodities**
7. John O'Hara, **Head of Prime Brokerage & Clearing Americas and Global Head of FXPB & FX Clearing, Societe Generale Corporate & Investment Banking**
8. Matthew McCarthy, **Director – Capital Introductions, Societe Generale Corporate & Investment Banking**

Enjoy!

Matthias Knab
Knab@Opalesque.com

Participant Profiles



(LEFT TO RIGHT):

Jonathan Goldberg, Marc Malek, Osvaldo Canavosio, Fabien Pavlowsky, John O'Hara, Matthew Heap, Justin Dew, Matthew McCarthy

Introduction

Matthew McCarthy
Societe Generale

Thanks to all at Opalesque for organizing this Roundtable! My name is Matthew McCarthy, I have been with the SG Group for around 13 years. I joined the London team at Fimat in 2004 and later moved to New York in 2008 to help expand the Newedge prime brokerage business.

I am now part of the Capital Introduction team where we are charged with having a strong understanding of all hedge fund strategies as well as maintaining a trusted dialogue with institutional investors.

Through the acquisition of Newedge the bank absorbed a respected and talented team of around 20 Alternative Investment specialists which ignited SG's entry into Capital Introductions along with introducing the ex-Newedge team to a broader product mix such as Equity, Fixed Income and Multi Strategy Funds to complement our 20 year history servicing CTAs and Quants. Within the team we have a group called Alternative Investment Consulting, who among other things are responsible for the SG hedge fund indices and market commentary, which I may refer to today.

John O'Hara
Societe Generale

My name is John O'Hara. I joined Societe Generale in January 2016, primarily to build out the foreign exchange prime brokerage and FX clearing businesses. Since then, I have been asked to head up the prime brokerage and clearing business across asset classes for the Americas which includes equity, fixed income, futures and OTC derivatives clearing, while retaining my FX responsibilities.

I joined the firm from Credit Suisse where I worked for six years, primarily building out that FXPB platform, and with the onset of Dodd-Frank, building out the OTC derivatives clearing functionality and marketing listed derivatives.

As to my background, I began covering primarily hedge funds from credit risk management perspective which has provided me with a good balance from both a risk tolerance and a business momentum perspective, which has served me well in building businesses. Having that background has resulted in a form of gravitas with the clients since they know I have an in-depth understanding as to what their requirements are and how to balance them against their needs as opposed to career credit guys that might not be as commercial since they have only known the business from a particular angle. That might not have that sense of reciprocity in negotiating governing documents.

I have really enjoyed my time thus far at Soc Gen. We are experiencing real momentum behind our business initiatives and we are growing each asset class uniformly. This momentum and diversity is something that I enjoy, and I look forward to working with the people around this table to progress that even further to our mutual benefit.

Marc Malek
Conquest Capital Group

I am Marc Malek, Founder and Portfolio Manager of Conquest Capital Group. Over the years our business at Conquest has developed into two broad categories, our alpha strategies and our alternative beta strategies.

On the alpha side we run two short-term quantitative trading strategies; one with negative correlation and one pure alpha all-weather offering.

And on the alternative beta side we were the **first firm to actually offer an alternative beta CTA product** back in 2004. It got seeded by the endowment of a major Ivy League University after I wrote a paper on the topic in 2002. We still run that product, and we also have an alternative risk factor product.

Matthew Heap
Orion Resource Partners

My name is Matthew Heap. I work for Orion Resource Partners. We are a commodity specialist investment firm focusing on metals and mining. We have two investment vehicles; private equity and the other a hedge fund.

The private equity fund was originally part of the Red Kite Group – the founder: Oskar Lewnoski being one of the three founding partners of Red Kite. Back in 2013 the private equity vehicle spun out, where Orion has subsequently grown to manage over \$3 billion in AUM.

The firm launched the hedge fund at the end of 2015, which I joined to assist setup and launch. Originally I am from the merchant side, from a company called Louis Dreyfus. Our business at Orion covers the full value chain in commodities from shovel in the ground, debt and off-take agreements, physical trading, and proprietary trading in the financial and futures as well.

Fabien Pavlowsky
Lyxor Asset Management

My name is Fabien Pavlowsky. I work for Lyxor Asset Management. We are the asset management arm of Societe Generale and we manage approximately \$145 billion globally. I am based here in New York and I am responsible for product development for Lyxor in North America.

Our business in North America includes customized solutions for investors with a large allocation to alternatives. As a part of that function, we provide advisory services, such as manager selection and portfolio management for our clients. We have one advisory mandate in particular for a large U.S. pension plan that focuses on Global Macro and CTA strategies. Finally, we offer a number of liquid alternative strategies through our Managed Account Platform with our independent risk oversight.

A little bit about me, over the past five years, as the Head of Global Macro and CTA strategies, I focused on allocating to hedge funds in that space. Since 2015, I have been heading the product development for Lyxor. Today, I am also heavily involved in interacting with our institutional and private client base in the U.S. Prior to Lyxor, I gained eight years of experience working for a fund-of-funds, Financial Risk Management ("FRM"), and was responsible for manager selection and portfolio management of Global Macro and CTA funds.

Jonathan Goldberg
BBL Commodities

I am Jon Goldberg and am the CIO of BBL Commodities. We are a commodity focused fund and trade crude oil refined products as well as US natural gas. Prior to that, I was also at a merchant – Glencore – for three years before launching the fund in 2013.

Justin Dew
Welton Investment Partners

I am Justin Dew. I started out on the allocator side of the hedge fund world and joined Welton Investment Partners nine years ago. Welton is a scientifically-oriented, research-driven investment management shop and headquartered in California as well as New York. I run the New York business.

The business is generally a split between some more traditional CTA-oriented type portfolios, as well as a higher frequency global equities business that's run from here, as well as some fixed income arbitrage strategies run out of a small office in Chicago. We manage around one billion for primarily institutional investors domestically and abroad.

Oswaldo Canavosio
Man FRM

I am Oswaldo Canavosio, Head of Research at Man FRM based in our New York office. FRM is a unit of Man Group. At FRM we manage approximately \$16 billion and focus on providing flexible portfolio solutions to clients on their allocations to hedge funds, building portfolios, and helping them select hedge fund managers.

I grew up in Argentina and moved to the US more than a decade ago. My background is as a trader in emerging markets fixed income and FX. When I moved to the US, I entered the alternative investments business and have spent the last ten years working on hedge fund manager selection, allocation and portfolio management.

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Oswaldo Canavosio: We are currently very interested in three broad themes: The first theme is Emerging Markets, the second is Fixed Income Relative Value and the third one is Quant strategies.

Let me start with emerging markets (EM). I don't see emerging markets so much as an asset class, but rather as a subset of idiosyncratic markets, with historically uncorrelated sources of returns which provide a distinctive opportunity set for hedge funds to operate in.

I therefore view emerging markets as a potential *multi-dimensional opportunity*. Some of these dimensions are *countries, asset classes, strategies and managers*. There are a multitude of countries within emerging markets that each have their own stories, some of them quite idiosyncratic and uncorrelated to each other. Then there's the added dimension of asset class when you can trade equities, fixed income and fx in those different countries. Thirdly, you can also trade these different countries and asset classes with different strategies. This could be a macro strategy, an event-driven strategy or a quant approach. And then the final dimension is that in all those buckets you can access a number of managers to implement the strategy. This multi-dimensional menu can potentially generate a rich and differentiated opportunity set. What I find compelling is the *degree of diversification given all the variables that come together in emerging markets*, combined with the fact that they are generally less efficient than developed markets, and so there are potentially more opportunities for managers to monetize their talent. *Hedge fund manager skills can be easier to monetize in emerging markets* than in developed markets and we believe we have seen evidence of that in return streams and in staying power.

We like some *locally-based managers* in EM that seek to exploit opportunities using their local network. Having a local presence can provide a potential edge. In other cases managers can operate successfully from outside of EM being one step removed and having a broader perspective

And finally, what I think is an interesting element to the emerging markets theme is what I like to call **emerging squared** which means *emerging managers in emerging markets – emerging in both dimensions*. I think there's a tremendous amount of local trading talent in emerging markets, primarily on the macro side. A lot of these countries live through macro volatility on a daily basis, so it's in the DNA of a lot of the young traders in emerging markets to navigate through high volatility and risk. We believe these emerging managers in emerging markets represent a rich pool of talent to follow, and that can be an interesting potential opportunity as well.

Now let me cover the second theme: **Fixed Income Relative Value**. This theme may be a bit underfollowed and perhaps less present in portfolios lately. I believe there is both structurally and cyclically an interesting opportunity in fixed income relative value.

Structurally because hedge funds can essentially replace banks and take some of the space that banks left behind by providing liquidity to the market.

The more cyclical aspect is linked to the central bank monetary policy normalization which is starting to happen and has the potential to continue in our view. This may generate some dislocations that are cyclically attractive at this point in time and we think may continue to be attractive.

The third theme we find interesting is **quant strategies**. This theme is widely followed and I think there are two sides of it that are quite interesting: one is the explosion in data availability combined with computing power. The availability of data and computing power have increased dramatically, making some of the well-known systematic strategies now more

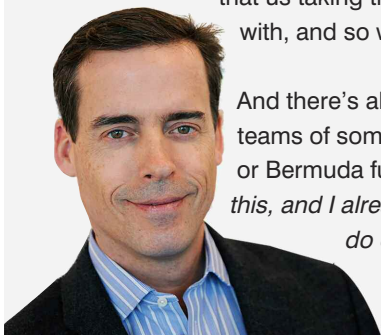


attractive, more affordable and more effective on execution in my view. The second one concerns the niche new ways to implement quantitative trading methods in markets, which I feel can be quite compelling primarily because they can potentially exhibit attractive diversification properties from a portfolio perspective.

Justin Dew: In addition to the strategies Osvaldo mentioned that are kind of top of mind, I would just touch on one other that we are currently in consideration of, and that is taking the kind of **classic event-driven credit strategies** and attempting to systematize much of what those types of PMs do. It is our goal to take the positives that come with the quantitative investment space, cheaper, faster, better, et cetera, and apply them to a particular market or strategy that hasn't been really addressed using those techniques in the past. So that's something that we are working on that we think are pretty cool.

But I will just step back for a second. On the investor side, some of the observations that we have had over the course of the past couple of years and really meaningfully over the course of the past six months has been really the **strong lack of strong interest in the traditional kind of Cayman, Bermuda-based fund structure** where it's Two and Twenty and the monthly liquidity with 30 days notice and whatever various terms might be applied.

What we are seeing is really two things: One, a strong interest in **hyperaligned investment structures**, so not necessarily cheaper, but much more aligned toward the outcome where the investor is being paid first. We actually embrace that. We think that us taking the volatility and performance risk over the long-term is something we are very comfortable with, and so we are agreeing with and embracing this particular development in the market.



And there's also great demand and interest in highly customized fund of ones. You can see marketing teams of some very large US primarily based investment managers talking all day long about the Cayman or Bermuda fund structures, but investors kind of say, *"Oh, that's great, but I don't want that. What I want is this, and I already got that somewhere else. So, to get my investment, could you take this and that away and do only the things that I want?"*

Jonathan Goldberg: So one question was how do you deal with the current markets? At BBL we always look at two types of trades; one are sort of short-term opportunistic based on events and the other one is based on more structural, longer term thematic views in oil and/or gas.

Short-term is pretty obvious for anyone in the United States: two pretty massive hurricanes, Harvey and Irma, have heavily disrupted US oil and refining infrastructure during the 2017 hurricane season – not quite Katrina levels in terms of initial magnitude, but in terms of duration.

There was some initial obvious excitement in the front end of the gasoline curve, but we think the market is under appreciating how long that's going to last. And oil markets had been fairly range-bound and they actually still are fairly range-bound from a price perspective for the first six or seven months, which has been frustrating for managers.

But what has not been range-bound at least recently, which is good for managers, are relationships in the curve, particularly in the front – so between gas oil and crude, and between gasoline and crude. We expect those relationships to be very volatile in the short-term, which we like.



Longer term, oil is getting more interesting. I think there was a view at the beginning of the year that the market would just be stuck forever, and probably stuck with a downward trajectory. We think ultimately oil prices are going to go lower, but that lower trend is not happening for several years. The various trends are going to take a while. And there has been some, I wouldn't say halting, but the slow down in the rate of growth in US shale recently and that has pretty profound impacts for 2018.

From a business or fund perspective, another trend many investors and fund managers talk about these days is data – **big data** and things like satellite imagery. We certainly are seeing our share of new information sources coming into the market, some of which is good for the market and some I think is bad for the market. We certainly know that historically oil data is not very reliable and there is a difficulty in checking the data versus other data sets. This means that anything else. So there is no arbiter of what's right sometimes.

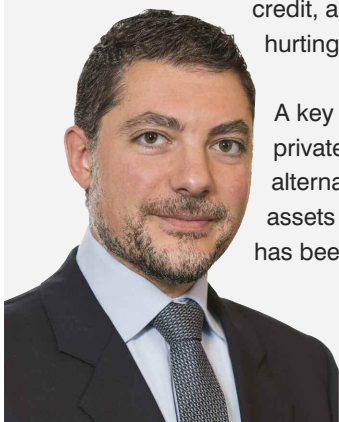
For example, there are data services that are providing imagery of satellites and tanks in China, but there is no way to know whether that data provided you with an accurate observation. But let me add here that other markets are much more advanced than oil. For example in natural gas the data is more reliable as the data sources are US based and consistent. That allows us to use a sort of big data advantage.

So just about six months or so ago, we have just doubled the size of natural gas. On a fundamental basis, **five key inputs come into the gas market every day**; weather, demand, pipeline flows, imports and exports. At BBL we have a *fundamentally-based daily trading model*, so not price signal-based, but based on those five fundamental triggers. They are either bullish or bearish, so simply buy or sell, with stop losses and profit taking, a pretty straightforward model. But so far we found that expanding our data has been a good way to streamline things that we were doing or looking at anyway, but do it a little bit more rigorously.

Fabien Pavlowsky: Regarding Matthias' question about the interests and themes on the side of the investors, at Lyxor we are fortunate enough to have a large institutional investor base that provides insights into their perception on the current market environment, as well as their concerns. At the same time, based on our daily interactions with numerous managers and our internal research team, we are able to source and analyze strategies which can be deployed to address current market issues and clients' needs. Being able to liaise between the two gives Lyxor the competitive edge to build optimal solutions for our clients.

One of the most recurring themes with our clients today is diversification. What we mean by diversification is *adding uncorrelated sources of returns to the portfolio that may potentially protect the portfolio during prolonged equity sell-offs or market duress*.

It's not difficult to pinpoint the reasons why those discussions take place: on one hand, politics, geopolitics, end of QE, China credit, and others trigger fear among investors. On the other hand, low rates and equity valuations are hurting the prospects for reasonable future rates of returns.



A key observation at Lyxor is that **many investors have large allocations to illiquid assets** in the private equity, real estate, private debt, or infrastructure sectors. Those assets are often classified as alternative – suggesting that investors expect those assets to provide some diversification. But are those assets not sharing the same risk factor – illiquidity premia? And shouldn't we be wary of a premia which has been compressing for the better part of the last 10 years?

Our message here is simple: *if diversifying your portfolio is a priority to you, some of the diversifying strategies should be liquid*. In a world and a market facing so many uncertainties,

being able to change course or simply monetize a successful investment in a rapidly changing market environment should be seen as a desirable feature by any asset allocator.

In short, diversification needs must also have a liquid component. Lyxor actively engages with prospects and clients about liquid diversifying solutions which can include, but not necessarily be limited to hedge funds.

Alongside the discussions on the topic of diversification, we frequently address the cost of deploying these strategies. Obviously, hedge fund fees have been in the spotlight, but I feel that fees are not the only concern for investors today. Investors want to be better aligned with their managers and want to invest in cost-efficient structures to limit the amount of capital required to achieve their objective.

Not surprisingly, **managed accounts** take the center stage in many of those discussions, either to provide the necessary transparency to operate a multi-asset global portfolio or to customize the investment vehicle to fit client needs. These needs can include a customized fee structure, a specific set of processes designed to address ESG requirements, or an increase in volatility targets to achieve better cash efficiency.

Matthew Heap: When we're looking at investment opportunities, for us as a commodity specialist one of the most exciting parts about this sector is that there is underlying trade that has to occur, rain or shine. Producer and consumer business require the raw materials to operate, so for us as commodity investors, that's something that we can always rely on. And with global GDP being positive, naturally that underlying business is growing year on year.

So we found that *if you can structure commodity trade strategies around the underlying business, that's where you have longevity* in your business and the opportunities you can find. Also, after the close to seven year bear cycle there has been a reduction of specialists in the commodity space to the point that specialists are actually now lacking in the sector.

Looking at the markets in more detail, we find that there's an interesting mix or **clash of the long-term cycle versus the short-term cycle in commodities**. On the long-term cycle you are faced with the changes and challenges of demographics, spending habits, technology, deflation the dollar cycle and global growth on the macro side. And then on the short-term side where things such as supply side issues, financial dislocation, localized fundamental technicalities start to come into play. The hedge fund vehicle can extract value from these short term anomalies in the financial markets utilizing a liquid strategy, whereas the longer term thematic ideas can be expressed through the private equity vehicle.

I agree that diversification is certainly an important topic, but as a matter of fact it's also a hard sell in the hedge fund universe at the moment with the S&P being the best performing investment. It's very easy being overweight US equities, particularly large cap, and so for many investors the S&P has as a matter of fact been the better trade. Whether this is the case on a risk/adjusted return basis is a different discussion. *This market dynamic generally encourages crowded and concentrated trades, which works until they don't.*

Other big shifts in the market are the rise of the Chinese speculator and the rise of the Chinese hedge. I am not sure if that's a challenge or opportunity. Within our market the Shanghai Futures Exchange is extreme liquid and actively traded, and the arbitrage opportunities that we see are certainly starting to become more impactful for the ex-China world market.

To follow up on Jonathan's comment on data, we are now trading in a world where everybody knows everything in commodities. However, in our world you really have two sides of the market, there's the financial markets and the physical market. *The financial markets are*



become more transparent and efficient whereas the physical commodities markets are still opaque. This information isn't available on a Bloomberg terminal, it's where the specialists have an edge and can provide some alpha.

Matthias Knab

You mentioned the rise of these the Chinese speculator and Chinese hedge, could you please elaborate a bit on how they influence your market?



Matthew Heap: As we know there has been incredible wealth created in China. You see that in the institutional and also on the private level. Gambling is officially illegal under Chinese law, but financial markets act as the quasi casino. It always amazes me walking around the Shanghai underground system and see the average person on the street looking at the stock price or the commodities market on their mobile phone. It's very engrained into the society and a little adds up to a lot.

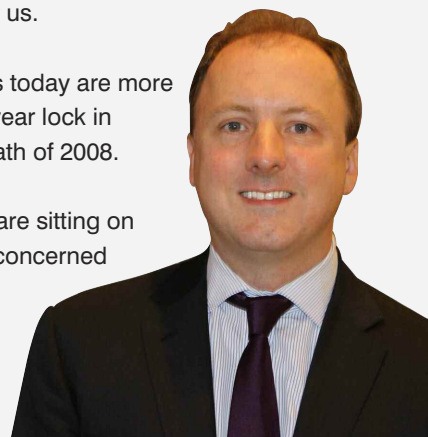
The access to trade is very prevalent. It's very easy to set up an account and start trading. These are all fully margined positions and there is little credit in the system on the retail level, but their risk appetite is quite phenomenal, and the aggregate volumes are phenomenal as well. What we also witness is that commodities is relatable to the world around them and a clear appetite to trade.

Matthew McCarthy: From our viewpoint at Societe Generale Capital Introductions, I'd say that some things have changed and some things have remained the same. Investors still want to talk to and discover managers who can deliver uncorrelated returns by extracting alpha from the market in a demonstrable, repeatable way. There's particular interest in **relative value** strategies and generally for managers who achieve tight draw-downs through their risk management. Investors are also interested when say a star performer within a large organization sets up his or her own business. Given the interest in diversification, and the challenge to become really diversified we are seeing interest in managers accessing **esoteric markets**, which ties in with investors whom want to talk to us about anything that is capacity constrained so they can gain access to the most desirable strategies.

Where we see changes is when it comes to how investors access these strategies, as Justin also said, we see more customization, more funds of one, more founder's share classes, SMAs are a hot topic for us.

The other change is the fees they are prepared to pay, and in an interesting twist investors today are more prepared to **compromise on liquidity** than they used to be in the past, agreeing a three-year lock in exchange for reduced fees for example – the exact opposite of what we saw in the aftermath of 2008.

As we are on the road meeting larger institutions, we often hear the same story; that they are sitting on billions of dollars of long equities (which has served them well), but are now increasingly concerned about a correction in traditional assets, and they are therefore looking for strategies to mitigate risk. One such strategy that has attracted a lot of attention is **CTAs**, which they know did well in 2008, but they are *not exactly sure why and whether that performance*



would persist in another crisis. How would these strategies perform in different interest rate or inflationary environments are typical questions we hear.

So a lot of what we do is educational, the market commentaries we produce aim to respond analytically to interesting investor questions we field and we are happy to assist allocators build the case for alternatives internally and even to help them present to their boards.

Marc Malek: Let me address some of challenges we see, how we are trying to respond to them, and then some opportunities. I think the elephant in the room of challenges is the **central banks' activities**. It's amazing by every measure that we have looked at. We have gone back 100 years and looked at data, and it's broken every record since then. Over the last seven, eight, nine years, central banks have bought about \$15 trillion of risk assets, and that has to show up somewhere.

We know that monetary policy operates with about a two-year lag. We know that this was the engine that was causing a lot of the drop in volatility, whether it was through low interest rates or increased liquidity. Quantitative easing accelerated around 2010-11, so assuming a two-year lag, we saw the sweet spot of its impact around 2013-2015, but these things have been, at least in the US, turned off a couple of years ago.

We see talk in Europe about unwinding some of their purchases. It's always very difficult to call an end to these cycles, but it seems reasonable to say we are probably closer to the end of it than we are to the middle of it.

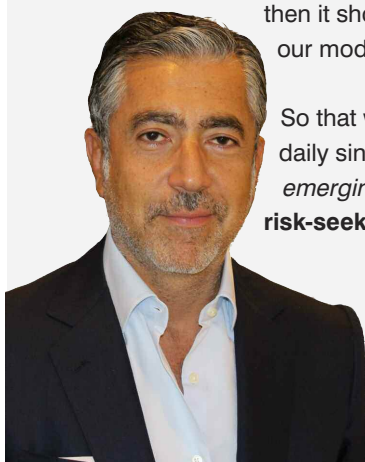
Now, one of the ways that we try to deal with these extremes in the regimes that we have seen is to go back to **fundamental quantitative design**. Meaning one way to think of the return of any quantitative portfolio, if you think of the sort of portfolio, you think of the return of a quantitative model as a representative of the overall portfolio.

But you can think of the returns on that quant model as the sum of two things; that stream of the return that is directly attributed to the model itself, how well you have built it, whether it's optimized, not optimized, things that really are affected by the model, and the effect of the environment on the model.

Because as we know, models don't run in the vacuum, the environment really has a very important effect on them. So we had an idea a bunch of years back that if we are able to properly model the environment and then prove that the way we have modeled this environment actually has a fairly statistical significant effect on the market and also on our models in particular, then it should give us an additional edge in our asset allocation within our portfolio to be able to deploy our models more effectively.

So that work led to the creation of the **Conquest Risk Index**, which has been published on Bloomberg daily since 2005, and has five different components. It looks at five pockets of risk: *liquidity, credit, emerging markets, foreign exchange and equities*, and gives you a daily reading on whether we are **risk-seeking or risk-averse**. So, a few interesting things about the risk index:

If you look at the sorted 30-year distribution, *the world spends about 70% of the time risk-seeking with low vol and tighter spreads and spends about 30% of the time risk-averse, high vol, with wider spreads*.



When you look at the 30-year distribution, there is a fair amount of **mean reversion**. So any time we trade significantly either above or below the 70/30, something happens to kind of snap us back into it.

If you take your observation lens and go from 30 years down to let's say two to three years, then you notice a fairly high-level of autocorrelation in the data, which really is pretty cool, because it makes it tradable. Now you can actually do something with this.

So again, when we're looking at the environment up to 2009, we are talking 70/30 risk-taking. So *since 2009 until now, that 70/30 distribution risk-taking versus risk aversion is running closer to 85/15 or even 90/10*. Now, needless to say that any trading strategy, any quant strategy, any CTA strategy is very, very affected by that ratio. The closer you are to 70/30, the better you will do; the further you are from there, the worse you are going to do.

So 2016 ended up being 88% risk-taking and only 12% risk-averse, with only two pockets of risk-aversion, essentially the January Fed market hiccup window and then Brexit. And we thought that was like, okay, well: now you are really sort of in an extreme. **2017 has been 100% risk-taking.**

So I mean, one of the ways we have dealt with changes in vol – I mean to us this is non-sustainable – but *by having this risk index and the ability to develop strategies that are either dedicated to risk-seeking behaviors or risk-averse behavior gives us an additional tool in shifting our risk* between what works in what environments. So we try to look as much as possible like a typical hedge fund when hedge funds are making money and the opposite of hedge funds when hedge funds are losing money.

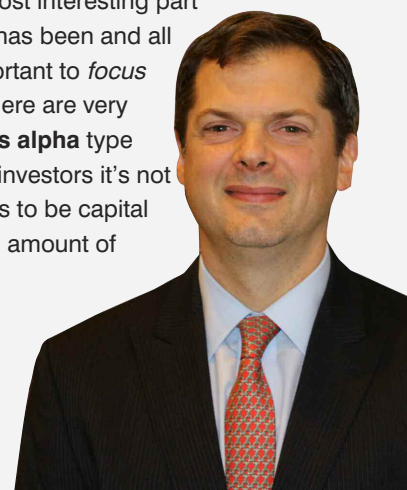
In a year like 2016, for example, in one of our funds we were able to keep a 75% downside correlation to the S&P, and finished the year up 7-8%, in the year where the S&P was up 12%.

On the business side, we offered a UCITS version of one of our funds earlier this year. We launched in March with about €15 million in the UCITS vehicle and now it's close to a hundred. So we are excited meeting this good demand and good reception from European investors.

Oswaldo Canavosio: I wanted to go back to it and highlight diversification. I think it's a very important point, and I wanted to make a distinction and get a bit more granular on it.

We see a lot of interest from clients in diversification and **crisis protection**, and I think the most interesting part about it is the emphasis on *tail risk*. Given how extended this economic and market regime has been and all the consequences this is having on the markets, as Marc said before, I believe it's very important to *focus on diversification at the tail rather than diversification in normal market environments*. And there are very interesting ways to address that problem. For example, we have been working a lot on **crisis alpha** type strategies that can be achieved with liquid instruments. What I'd like to add is that for many investors it's not only about the ability to express a crisis alpha strategy in liquid form, this solution also needs to be capital efficient because you want to be able to implement it without having to deploy an enormous amount of capital.

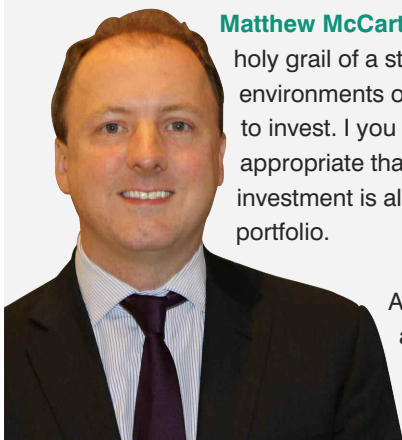
Therefore, both **capital efficiency and liquidity** are very important in these solutions. The third element is that you also need some conviction that the investment's behavior during extreme market outcomes would meet your portfolio needs. That's of course an interesting



exercise because we haven't seen episodes of sharp market stress recently and therefore we have to do enough research to build conviction that the trade has the potential to exhibit the desired profile when the time comes.

What's also interesting is that we see investors not only focused on protecting capital for the sake of smoothing the profile of the returns of their portfolio, but perhaps even more importantly they want to be able to go back and invest in the markets at a time when assets have become more attractive after a pronounced selloff.

From that perspective, the ability to provide liquidity at the right time in the markets is very important precisely because it provides the investor more optionality at a critical time. Any such strategy therefore has to offer *monetization capability at the right point of time*, which may be achieved with a liquid structure. If the protection aspect is achieved, you can monetize it and go back to the market to deploy capital at a more attractive point in the pricing cycle.



Matthew McCarthy: We spend a lot of time with investors on tail risk, some of whom are searching for the holy grail of a strategy which provides that crash protection in a crisis and also avoids the theta bleed during environments of low volatility like we are currently experiencing. Another important point is the vehicle used to invest. If you intend to crystallize profits after a sharp shock, a separately managed account may be more appropriate than a fund vehicle where you could be locked in while the market recovers. How you size the investment is also something which may take some time and analysis to provide the best protection for your portfolio.

Also the time period covering the crystallization of the manager's incentive fees should be also considered to ensure interests and timings are aligned between investor and manager.

Justin Dew: At Welton we've received the benefit of some of these capital flows that relate to this crisis risk offset and similar type portfolios, and I do have a general concern that the people or institutions that are purchasing these may not exactly know what it is that they're getting.

I'd be curious to know from people in the room that structure these solutions for large institutional clients. Do you get the sense that they acknowledge or understand that the investments that they're making are **not a guaranteed hedge?** *That these things may exhibit the likelihood and statistical probability of performing in periods of difficulty, but there will be periods where that may not be the case?*

Again, my concern would be that the end investor in some cases may not have that expectation and that understanding...





Osvaldo Canavosio: You are right, having exactly this understanding is very important, and I would say that from our interaction with clients they do understand that point. There's definitely an ongoing process of communication and education, with emphasis on thinking about these strategies as facing a tradeoff between potential reliability and expected return.

If you want something that historically has more reliable characteristics, you've got to pay for it in the form of negative expected returns. For example, you can buy a put option on S&P. You'll then have very high reliability, but at the same time your expected return on that is going to be negative. From there you can move towards less reliability with the potential for better expected returns. Our focus when working with clients on these type of portfolio solutions is to find with them *the appropriate point in that continuum of reliability and potential return*, that is the key.

Fabien Pavlowsky: Of course, the challenge here is that it is difficult to quantify the efficacy of those risk mitigating strategies. Why is that? Because those strategies have two inherently distinct objectives:

- (1) Protection during difficult times and
- (2) Reasonable positive performance during normal market conditions.

Understand that there is a compromise to be made between those two objectives. Striking the right balance between the need to protect and the need to perform is what we are trying to solve.

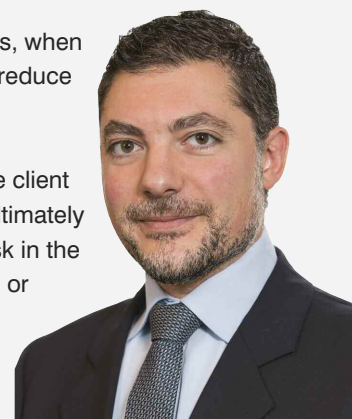
We spend a lot of time educating clients about the strategies and the structures we employ for those types of solutions. A pillar of our investment framework is to understand when a particular strategy or a particular manager is no longer behaving within the range of our expectations and requires us to take action. In order to do that, we developed a series of quantitative metrics designed to help us set expectations prior to investing. We found that communicating with our clients about those expectations is very beneficial. For instance, think about the following question:

"The S&P was down 10% this week, is it normal that my CTA portfolio is also down because it was supposed to provide protection?"

In that case, we measured the CTA performance historically for every consecutive 5 day loss in the S&P between -5% and -10% and established the distribution of returns of the CTA. From that we are able to assess whether seeing negative performance for the CTA over the past years is likely to be rare or not. This is very simple yet powerful.

We also use the same framework to alter the allocation to managers or strategies – in other words, when we observe a behavior outside of our expectations, we take defensive action in the portfolio and reduce our allocation. We strongly believe that **risk mitigating strategies have to be risk managed.**

Finally, we believe that when the strategies are deployed using managed accounts, it enables the client to have transparency into the underlying positions and monitor the behavior of the fund, which ultimately provides these clients with a layer of comfort. The fact that Lyxor also independently manages risk in the portfolio ensures that we truly mitigate the risks traditionally associated with excessive risk taking or style drift.



Marc Malek: This is an area actually we studied quite a bit. I think there is a *dangerous misconception amongst a lot of the clients that CTA strategies are long volatility strategies*. Of course maybe 90% of CTA strategies are based on long term trend following, and the assumption is that long term trend following is a long volatility strategy, which is not the case. There is nothing wrong with not being a long vol strategy but it's really a matter of expectation at that point.

If a client is buying a long term trend follower thinking that that long term trend follower is going to act like a S&P put, they could, with a 50/50 probability be in for a very bad surprise. I actually wrote a paper in the mid-2000s proving how long term trend following is not a long vol strategy. However, that doesn't mean it's not a good diversifier to a multi-strategy portfolio.

But what's much more interesting than that is a paper we wrote a couple of years after that which was published by Risk Books. There we were able to prove that *as you come down the trend following timeframe from where the whole world is – which as I think of it is kind of a 60-day breakout type strategy – down to sub one month closer to maybe around two days, at the onset of risk adverse event, the correlation between pure long vol strategies such as long the VIX for example, and very short term trend following strategies spikes to one*, and stays very highly elevated until the effect of that risk aversion starts dissipating and going away, at which point the correlation starts dissipating or going away.

What this means is that a very short term trend following strategy gives you very interesting hybrid characteristics that can be relied on to be used as a portfolio protection. Now that we have those tools and can quantify them, the question is how would you want to protect the portfolio? So if I get a pension plan that is coming to us and says, "We have a hedge fund portfolio that is invested in long/short equity and converts and I want something that hedges," well, I can try to put a hedge against the convertibles and a hedge against the long/short, but that's a losing proposition assuming that everybody has some alpha and we don't know nearly enough about that as much as these other managers do.

So one way I started thinking about this and then found that it kind of made sense and actually works pretty well, is that I think of **hedge fund strategies in general as being long the risky asset and short the less risky asset**. So if you take a dummy portfolio of let's say an FX manager, a long/short equity, converts and fixed income. Well, the FX guy is kind of going long the high yielding currencies and shorting the low yielding currencies. Your fixed income guy is buying again the high yielding securities and shorts the low yielding securities. The equity guy, with a long bias, is long in a high beta structure. And all of these strategies, if you run them relative to their hedge fund indices, you'll find they will give you 70% to 80% correlation.

But let's take this now one step further. If we look at a portfolio of a fund of funds manager, often people think it's quite diversified. Except if suddenly risk aversion went up and all of the underlyings are starting to lose money at the same time. Well, the reason why that happens is actually quite simple, and it's got to do with correlation. **Correlation** is of course one of those statistical measures that we all love to hate. You hear a lot that correlation is unstable, it doesn't work, but *actually correlation is really very stable but most of the time it's used the wrong way*. Meaning, when you look at a correlation across a data series that is going say 10 years, over those 10 years you'll be going through periods of risk seeking and risk aversion.

One thing we can prove is that *correlation is very stable intra-regime but unstable across regime*. So correlation of two strategies in risk-seeking periods is very different than the correlation of those two strategies in risk-averse periods. When you then look at correlation across environments that are crossing risk-seeking, risk-aversion, risk-seeking, risk-aversion, you get a lot of garbage, but if you isolate for the regime itself and look at correlation then, it becomes really stable.



Coming back to the fund of funds or any large investor's portfolios, your five different managers look uncorrelated because in risk-seeking periods, and obviously what they are doing, is very different in their respective asset classes and all of that. But the oxygen for all their strategies is **liquidity**. As long as there is plenty of liquidity, the convert guy can buy the high yielding convert and sell the low yielding convert and make an alpha return that is separated from the FX guy who buys New Zealand versus Yen from the long/short equity guy that's doing it between the Russell and the NASDAQ. But then *what happens when risk-aversion goes up is that the first victim of risk-aversion is liquidity*.

Suddenly, this one risk factor that you couldn't see before in risk-seeking periods suddenly acts as a weight down and they all are losing money at the same time causing those red numbers everywhere. So for us, *rather than worrying about what each one of these guys are doing, if instead I have a way to ensure that I can make money when liquidity becomes a premium, then I can synthetically structure a strategy that will act almost like a perfect hedge, even though it's not doing anything related to the underlying market or any underlying position of those managers.*

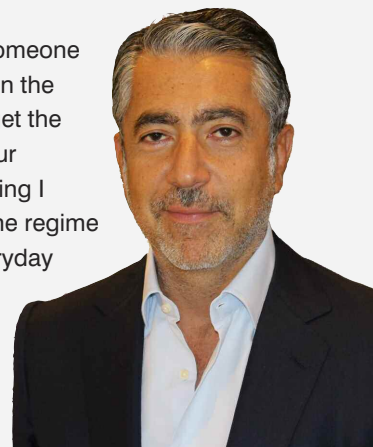
Justin Dew

I would agree, but I think in all fairness I think that predicting those regime shifts and capitalizing on them in the way you've described is extremely difficult.

Marc Malek: I agree, Justin, and I'd say that we're not smart enough to predict a regime shifting, and frankly, I think it's almost pointless to predict regime shifts. However, what we found is that there is *auto correlation on short windows of a risk environment*. So when we're looking at two to three years, there's a high level of auto correlation in the data.

What that really tells you is that once you're in a certain regime, the probability is you're going to continue stay in it, rather than reverse. And we also know that periods of transition from one regime to the other can be fairly choppy. But once you flip, you stick, so it gives you some flexibility to add a smoothing function to kind of smooth out the choppiness in this transition. And once you're in a certain regime then at least you're likely to stay in it, and this then also allows you to benefit from the different asset allocation that you can do.

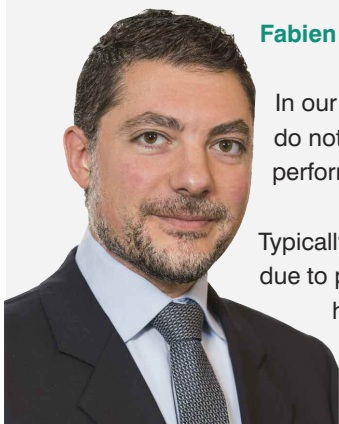
Of course, none of this is perfect and we kind of like to learn along the way. And honestly, as someone who has been in this space for decades now, I find that *quants can sometimes get too greedy* in the sense that you want to extract the most amount of information from the data, and then you forget the golden principle that by trying to extract the most amount of information you're also limiting your degrees of freedom to such a point that whatever you're extracting is just crap. So with everything I talked about, it's not that say we're at 100% in risk seeking and then turn off everything when the regime shifts. We don't do 90 degree turns, but we're constantly on the margin adjusting things. If everyday we wake up and incrementally do one or two decisions better than everybody else and each one can give us a small edge, then over a long period of time hopefully it will make a difference.



Fabien Pavlowsky: I agree that regime shifts and crises are hard to predict.

In our approach to diversify, or protect for that matter, we combine a number of different strategies and do not rely solely on one single strategy to provide a target return during market stress and stable performance during normal market conditions.

Typically, **managed futures** is going to play a role which we are confident will capture the tail. However, due to prolonged drawdown periods, one could say that the cost of carry of a managed futures strategy is high. **Discretionary global macro** strategies can complement managed futures because macro managers are expected to better navigate inflection points, or market reversals which are often



difficult periods for managed futures strategies, particularly trend-following. We also like the idea that when it comes to crises protection, it is important to be diversified. *Combining a systematic, machine-driven strategy, and a discretionary human-based strategy has some merit.*

When you build these types of strategies, you spend a lot of time making sure that your assumptions are correct. In that case, one of the main question is: Can I reliably depend on managed futures to deliver during a crisis period? I believe the answer is yes. There are fundamental reasons to believe that the drivers of returns of trend-following will not disappear, especially during market duress. That being said, crises always have a way of surprising you. *There is a risk that systematic strategies which have been designed, calibrated, and backtested on past history may miss the turn if something new comes up. That's why we like humans in our portfolio too.*

Oswaldo Canavosio: There are **many strategies that can exhibit low correlation to risk assets, but they may not protect during crises.** They can actually hurt during a crisis even if they have close to zero historical correlation during normal times. This has played out in the past, particularly with those strategies that depend on market liquidity – we've already mentioned the critical role of liquidity.

We look therefore for diversification with a focus on behavior at the tails of the probability distribution. An additional point that's very important in this type of strategy is the dynamic nature of the strategies we are using. We are looking for positive skew at the end of the day, and there are adaptive dynamic strategies that may exhibit behavior that's non-linear and offer the potential to generate an attractive profile at crisis times.



Matthias Knab

One ongoing trend is the record flows into passive strategies over the last couple of years. However, according to the latest Morningstar data, active management is having a field day: While in 2016 only 26% of active U.S. stock funds beat their composite passive benchmarks, over the 12 months through July 2017, however, 49% outperformed. Long/short equity hedge funds are also enjoying an excellent year. And these results are net of all fees and transaction costs.

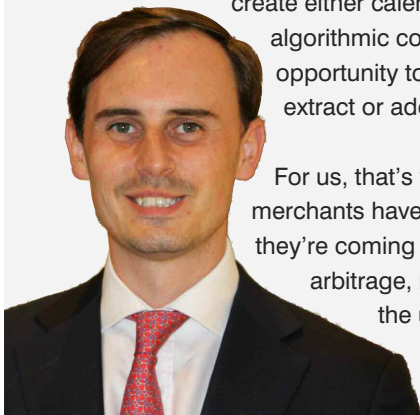
One of the reasons that stock picking is making more of a difference for investors now is that correlation between stocks has collapsed. In the S&P 500, for example, correlation has gone from almost 70% at the beginning of 2016 to less than 30% today. Despite market-level volatility being very low, we are seeing rather high single-stock volatility and significant sector rotations. What are your observations?

Matthew Heap: I think active managers always have their space in the market. For me the human brain is still better than a model in most situations. Of course the quantitative models have their role and each strategy has their relevance, but crucially the human brain can react to change and diagnose a situation. So as I think Marc has said, once the regime changes it generally sticks, but the difficult part is understanding why and when it's changing.

As an active traders – we're discretionary traders running absolute return vehicles – and in the commodity space particularly, inefficiency is our friend, and arbitrage is for us one of the most powerful commodity concepts.

We've actually been in this strange situation where *we very much enjoyed the rise of the CTAs, passive and algorithmic strategies, largely because they create dislocations in the physical market*. I already mentioned that the underlying business that's being conducted in the commodities market is growing by and large year on year, but it's only growing by global GDP, whereas the shifts of the algorithmic community can vastly outweigh the size of the underlying commodity markets, for example.

So we have these sudden shifts from a short market to a long market or from a low open interest to a high open interest and that creates huge dislocations in the financial market, which aren't represented in the physical market. These things then create either calendar spread opportunities or interexchange opportunities. That's one thing that the algorithmic community hasn't quite grasped yet, and where particularly active traders with the opportunity to trade the physical market, which again is outside of the realm of the financial markets, can extract or add value.



For us, that's where the active trader active in commodities is still successful. For example, a number of merchants have been around for over 100 years, and some of those strategies have longevity. Typically, they're coming back to the core of a hedge fund strategy, which is a hedged fund, so it's long/short, arbitrage, relative-value and calendar spreads, strategies that have an offset and asymmetric return to the upside.

Jonathan Goldberg: As a commodity trader I think Matthew's comments are spot on. I agree that whether you call it passive money, algorithmic trading, quantitative money, trend following money, whatever, there's by far more money coming into the market from those sides than a growth in oil and oil demand. So at BBL we are increasing the number of lots traded and open interest at a rate that's greater than how oil demand is changing every year.

I do think that cautiously creates opportunities for us. What we found at least for the last seven or eight months is, when there are events such as the hurricanes that are extreme and the commodity, physical markets have to do something and react, combined with the activities of algorithmic trading flows, buying or selling based on whatever the trend, there can be **massive opportunities** in the market.

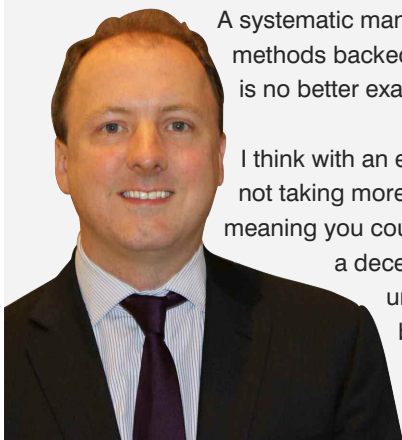
When for instance Europe is short on diesel, they import diesel from the United States. There aren't any gulf coast refineries to export diesel to Europe, and if there is a physical event that must happen to attract barrels to go there, that can be a great opportunity taking sort of the other side of what the trend following traders are doing. I think that play is bigger now than it's ever been because there are more people putting on positions for reasons that aren't quite clear. I believe active commodity traders can make a lot of money in such situations, I think more than they have ever been able to make.

I think what we are learning and trying to be cautious with is that, when the market is not clearly out of whack – and we've seen this in the commodity market, especially oil market this year – when it's not clearly out of whack, it's pretty easy to get run over by the flow. For example, say in the oil curve, the crude curve is in a contango, the front of the curve is cheaper than the back of the curve. If it's not one of those extreme events, you're not building inventories too rapidly, it really doesn't matter at what point it could be minus 10, it could be minus 15, it could be minus 20. If you're just chasing the money flow, it's very difficult to make money. What we



are looking to do is just to be super-opportunistic and really pounce when there's an opportunity like the one we had recently, and to avoid the noise, otherwise you just can't stand.

Matthew McCarthy: Just to comment on that, I think there is much more acceptance from investors of a rules based approach to investing, so they are becoming more comfortable with so called black box strategies but they need to know what is in the box and how it will work in different environments, and I think managers are more and more likely to help investors both understand that and be armed to explain it in turn to their investment committees.



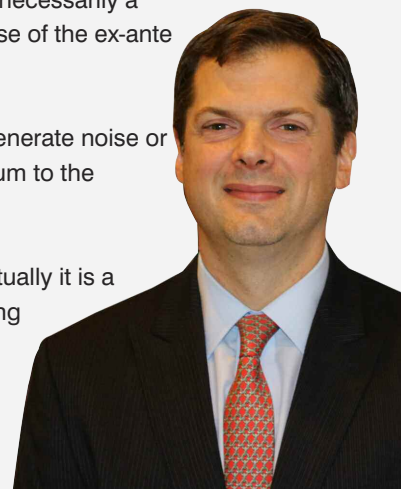
A systematic manager can actually be much more open than one might think in terms of insights into their methods backed up by daily return data and risk metrics. Everybody wants a disciplined manager and there is no better example than a rules based system.

I think with an event like Brexit for example, there was some disappointment with discretionary managers for not taking more advantage of what was a binary outcome with a skewed risk-reward for the leave vote, meaning you could have risked a little premium for an outsized return. The systematic managers actually had a decent Brexit, though many were likely short sterling going into that event as sterling was already under some pressure. Looking at our discretionary and systematic macro indexes they have both annualized 7% and change since 2000, so the jury is still out in some respects.

Oswaldo Canavosio: On the passive versus active discussion, I guess my economist training leads me to look at it as a **stock versus a flow problem**. I think conceptually the stock of passive money being higher is not necessarily a problem. In fact, it could potentially generate more opportunities for alpha generation because of the ex-ante sub-optimal behavior of passive money by definition. That's from the stock perspective.

Now, the flow analysis is very different. If there's a flow of money going into passive, it can generate noise or some obstacles for strategies that are positioned from an alpha perspective, giving momentum to the passive position, and that may work against the alpha seeking strategy.

I have to say that the data we have seen is not conclusive on this point, but I believe conceptually it is a valid framework, that once the flows become less dominant, the stock of passive money being higher is actually not a problem. It may in fact be a benefit to hedge funds and to alpha seeking strategies.





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Fabien Pavlowsky: I feel like we tend to reduce the **active vs. passive** debate to equity mutual funds or long/short equity hedge funds vs. S&P. The reality is that passive investments are permeating through most of the other asset classes. Over the past few years, even certain hedge fund strategies have been systematized, indexed, and sold as low cost “passive strategies”.

I certainly welcome these developments because it gives us an opportunity to better understand and benchmark our active managers. Today, I am much better equipped to assess whether a manager is producing alpha above and beyond a cheaper, more liquid version of the strategy. Based on this, I can decide whether or not to invest and pay the higher fees.

That being said, I feel that the flows and the current stock of those passive strategies can no longer be ignored by active managers, and like everything else in the market where there is risk, there is also opportunity.

Matthew’s and Jonathan’s comments about how the algos are sometimes distorting the commodity markets and offering great trading opportunities are spot on. *I believe you can certainly make the same statement about other markets.*

In equities for instance, many passive U.S. investors fell in love with the so-called “low volatility indices” because of their recent outperformance vs. the cap-weighted indices and the perception that buying a low volatility index is a defensive way to gain equity beta. At the beginning of 2017, those investors were inherently buying stocks at a higher P/E than the average P/E of the index because of the demand for those low-beta stocks. This obviously creates opportunity for active managers.



In the macro space, to give another example, we see more discussions about the impact of the so-called multi-asset “volatility sensitive” passive strategies. Call them **risk parity** or CTAs, but their flows, which were by and large absent from flow analyses 10-15 years ago, are now being recognized as an input to reckon with in the market. Those flows have been quoted as being responsible for dramatically impacting the price action of very large and deep equity or fixed income markets like the 10 year treasuries. Remember the taper tantrum of 2013?

Now, I believe that an active investor needs to understand these flows, if not to profit from them, but to protect his or her active views in the portfolio at the bare minimum.

Marc Malek: I want to say something a bit controversial for a hedge fund manager, but I think the next biggest idea in asset management is going to be the creation of **Vanguard of hedge funds**. I think we’ve kind of deluded ourselves for too long in thinking that there is so much alpha in all these sleeves of the hedge fund strategies.

By definition “alpha” is doing things different. Anyone of us can go and buy any hedge fund database and I urge you to do a simple exercise I did 15 years ago. At the time I did it with the Tremont database. So you take any hedge fund database and you divide it by long/short equity, converts, CTA, all these categories, and then run the *cross-correlation of all the managers to each other*. If those managers truly have alpha, then if you plot their cross-correlation it should be very dispersed because alpha by definition is unique. You can’t have two people having the same alpha. However, when you run this analysis, you see that the *managers are not dispersed at all, they are actually all concentrated somewhere very close in the middle, which really tells you that in each one of those categories there’s a very high level of common beta*, which is something that they are all doing and which is exactly the same thing that everyone is capturing.

CTAs had the cross-correlation of about 75%, and that led me to write the paper about CTA



beta, and by now we've seen that this sector is really commoditized and you can actually do a much better job offering just simple low fee trend following product than the a high fee one. Then converts came next, long/short equity was right there, and at the time I did this, which was in the early 2000s, the lowest amount of cross-correlation was discretionary global macro, which kind of makes sense. I don't know if you really get the same cross-correlations today, if you run it.

So I agree with Fabien that it would be a very positive thing to have more of these beta products. And by the way, we are doing them a **dis-service by calling them the “dumb beta” or an “inactive beta”** or something because actually you're doing the same thing that others are doing. For example, in our alternative beta CTA products, we have 20 different trend following timeframes that actually probably trade more actively than any other traditional CTA.

But anyway, it will be a great service for those who have alpha, to actually have a beta to compare it to. Right now, one of the biggest problems we have is that *there is no real beta*. We know the definition of alpha, right? You know how to calculate alpha off a mutual fund manager because you know what the benchmark is. Well, when hedge funds came about, there was no real benchmark. So hedge funds came up with a really smart way of looking at alpha of hedge funds: Since we don't really have a benchmark, why don't we calculate our alpha relative to each other, which is great for relative performance but has nothing to do with alpha, because now suddenly you have the fee structure, the numerator and the denominator, so it cancels itself out.

But you cannot really look at the alpha of one long/short manager against a group of other long/short manager, because this guy is not charging 2 and 20 and all of them are charging 2 and 20, so you cannot be looking at alpha independent of the fee structure which is completely crazy because that is the biggest drag on alpha.

Another area where I think investors do themselves a dis-service is by **lumping all quants together as the same thing**. I mean there are probably more categories of quant than there are categories of non-quant investment, and just to kind of label everything as quant leads to missing a lot of it.

One of the biggest risks that we have as traders or portfolio manager is the increase in **high frequency trading**, and not because of that increase itself but because of the percentage of daily market making that is done by these high frequency funds.

Prior to 2008, high frequency funds were doing some market making, and when 2008 happened, a lot of them got taken out but also many of them came to realize that their models worked really well in low vol environments, and not so well in high vol environments. So, in their reincarnation post 2008, they all put volatility filters into it. As long as vol is low, they will make great markets and have a very suppressing effect on volatility. *But the minute an exogenous event causes this vol to go beyond a threshold they think it should be, they all turn off the liquidity at the same time and cause massive market dislocation.*

Exhibit A in this behavior is the **flash-crash of 2010**. I'm sorry, it wasn't that Indian gentleman from Hounslow that caused the flash-crash. It was a lot of the high frequency funds turning off their machines at the same time.

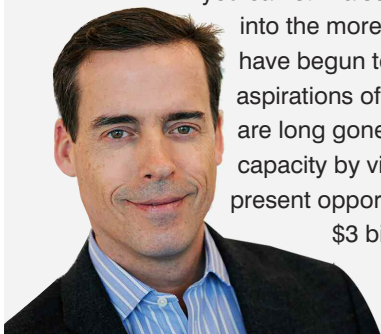
How do we deal with this at Conquest? Mathematically it reminds me of trading exotic options on Asian currencies back in the 90s where if you actually calculate the standard deviation of the vol of the currency it was likely zero because they were all controlled currencies. But they all had tremendous risk in them which is evaluation, political risk, everything, and the same risks now exist in the market. *The vol of vol, if you calculate it through the standard deviation of the volatility, is not indicative of the real vol that is implied in the market.*

So, for us, we started adding adjustment factors to our volatility calculation and we've actually seen a net positive fact in the way our models react to it.

Justin Dew: I would like to discuss a bit along the topic of beta because in a prior life, my team at S&P were the ones who designed the various S&P hedge fund indices including all the constituent indices of the master hedge fund index. And to some extent, I would agree with what Marc was saying, and to some extent I would disagree.

You pointed out accurately that many CTAs have very little distribution and very high clustering. I think that the effect in the market has been really price, right? Everybody is charging less for trend following portfolios, but that also creates some opportunity for firms like yours and ours to take advantage of the lesser commoditized strategies within the context of CTAs, for instance. And I'm sure you're doing that and we're doing that too, in order to maintain margins and grow.

In other investment strategies, to use converts as an example, if you're not a volatility or credit trader in converts, then maybe you can still raise assets at a higher margin. I think there's **less clustering** in some of those strategies if you get into the more esoteric, more capacity constrained strategies. And a lot of us, I'm sure you and us certainly, have begun to get more and more exposure into those areas of opportunity, because the days of having aspirations of being a \$50 billion manager and maintaining a 2 and 20 fees or something even close to that are long gone. The only way to continue to demand reasonable margins in the market is to lower your capacity by virtue of embracing and addressing those strategies which are not as clustered, which still present opportunities to create uncorrelated return streams. And by design, that means you're going to be a \$3 billion shop or a \$5 billion shop.



Marc Malek

And charge less.

Justin Dew

And likely charge less than 2 and 20. It's clearly the case that the market wants fees to be more aligned with investor's outcomes than they have been in the past.

Oswaldo Canavosio: It's a natural evolution of a dynamic and reactive management industry that some sources of return will be considered alpha before they are progressively recognized as beta to identifiable market factors. Basically, **the unexplained becomes explained** and you can access those potential sources of return easier and more effectively, and that's a good thing for investors, there shouldn't be any issues with that. I don't see this as much of a problem.

The unexplainable being explained and alpha ceasing to be classified as such, is really *more of a labeling issue than an actual problem for investors. They are getting the same thing, but more easily and affordable.*

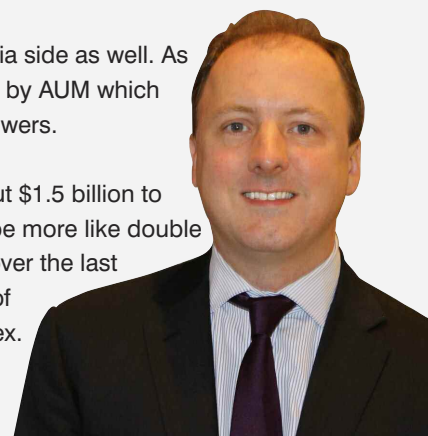
I would also add that there are other reasons to be a bit concerned about the lack of hedge fund alpha that have more to do with what was discussed earlier, the low volatility regime and dominant central bank action in the markets.





Justin Dew: In my view **smart beta** has some positive effects for the industry, specifically in the trading domain, in addition to the benefits it brings to the investor in terms of low price. Clearly, the money flows into these smart beta products are causing *opportunities from a flow perspective*.

So, if you see \$10 billion coming out of the US smart beta growth portfolio and flowing into an EM growth portfolio, the asymmetry of the impact on those markets is significant. It doesn't even move the US market, but massively moves the EM market. You can take advantage of that as an active investor and so that's obviously an opportunity.



Matthew McCarthy: It is very interesting to see flows into trend followers on the risk premia side as well. As most people know, we at SocGen run the CTA index which is made up of the top 20 CTAs by AUM which are also open for investment along with the Trend index which is the largest ten trend-followers.

What's interesting is that while in 2016 a trend-following strategy would have needed about \$1.5 billion to get on that list, I think when we reconstitute the index at the end of this year, it's going to be more like double that, north of \$3 billion, so we've seen a lot of **inflows** come into those kind of strategies over the last two years. And it's an interesting point for the index committee whether we will see more of these low cost trend or risk premia products creep into what was historically an alpha index.

Justin Dew

Do you include the smart beta portfolio products in your CTA index?

Matthew McCarthy

Currently the majority of constituents are alpha driven programs. Do check our website and you will see the constituents and returns, we also have a neat trend dashboard which shows how our in-house trend indicator is currently positioned across its investable universe. It gives a nice insight into where trend-followers are likely to be positioned and where P&L is being made albeit in a naïve setting.

Justin Dew

That's fascinating. I would love to be in that index committee..



Fabien Pavlowsky: One of the issues we often see is that **investors hear things like passive or smart beta and then they think benchmark** as if that would all be the same.

This can be explained by an example I recently gave in a lecture at Columbia University. I compared the S&P market cap weighted index and S&P equally weighted index. The difference in performance between the two indices over a six month period ranged from -15% to +20% since 2000. This is large considering we are talking about the same index – so imagine when you decide to compute the alpha of a U.S. large cap mutual fund. Your result will yield widely different figures depending on the index used.

In this example, I only tinkered with one degree of freedom within a relatively simple index, but think about the number of degrees of freedom present in some of the alternative risk premia, such as diversified trend-following, diversified cross-asset carry, or some of the equity market neutral programs.

My point is that *implementation matters!* Just because it is called passive or smart beta, does not mean you can disregard the tools and assumptions used in the strategy because they are important.

I invite you to read our paper that Lyxor researched and published, called “A primer on Alternative Risk Premia”. This can be downloaded on the SSRN website for free.

Matthew McCarthy: Sure and it ties in nicely with the risk premia comments made earlier. Our team has done some work on the **multi-asset, multi-risk premia** universe, and we identified a universe of programs with around \$35 billion AUM. 80% of those strategies are management fee only; charging about 93 basis points as the average.

We found that despite risk premia factors being quite well-known and the markets they trade fairly limited, to the point that was made by Fabien earlier the surprising thing was actually the *non-correlation of these returns, the average pairwise correlation was 0.23*.

So what does the performance look like in aggregate? Well it looks most highly correlated with our Quant Macro index (0.75), our Trend index (0.75) and our CTA index (0.74), and that's somewhat due we think to those managers taking meaningful risk exposure in momentum trades as well as interest rate carry in currencies and fixed income.

The peer group generally shows positive, albeit low, uncorrelated returns with low volatility.



Matthias Knab

We talked about the deeper trends in our industry and how important it is to really understand them well. Innovation is an important aspect, business models and client preferences change, and the industry has to be both adaptive and proactive. Let's look at innovation, specific new products or changes at your respective companies now.

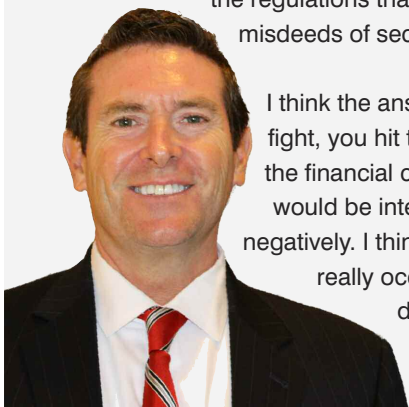
John O' Hara: SocGen Prime is actively filling the void created by those providers that have resized their offerings or have shifted their focus, either for strategic reasons or because regulatory changes have made maintaining league table standings more challenging. We recognized that the time was right for a credible provider to step up and gain market share as a consequence of that retrenchment.

What we've been doing – and I know a lot of firms talk about this, but upon closer inspection, very few actually do it – is that we're investing in each of the business lines within Prime to ensure that we can connect with our clients on many fronts. Additionally, we have housed each asset class under one organizational structure so that we can employ a truly holistic pricing regime. This includes promoting equity PB, fixed income PB (including the use of balance sheet and repo activity) and FXPB and OTC Derivatives Clearing which many firms have pulled back from considerably. So although Futures remains a center of the plate offering for us, we have numerous solutions with which our customers can avail themselves.

One of the main benefits for our clients is that they can derive material benefit in the form of margin relief through **cross asset class netting**. We have always been proficient at allowing positional offset and using various var based and linear cross asset class margining methodologies. This has helped us to pro-actively adapt to changing markets and hopefully assist our clients in their own differentiation efforts.

For the folks around this table, I was wondering about your thoughts on how your firms and your businesses have been impacted by **regulation**, negatively or positively? For example, there has certainly been a disintermediation from Volcker, etc. where your firms can step in and become a liquidity provider or provide some of those trading services that traditionally were done by the banks and the large brokers.

I remember when Dodd Frank was first enacted, I was tasked with selling solutions to the hedge fund community. In one case I was in a large meeting in a boardroom of a very large New York-based hedge fund which in a way turned out to be a pretty aggressive meeting to the extent that they were saying, "You know, you have a lot of nerve coming here trying to capitalize on the regulations that have been enacted as a result of missteps by banks and insurance companies. It was the misdeeds of sectors of your industry for which hedge funds are now paying the price".



I think the answer, rightly or wrongly, was that in a barroom brawl, you don't hit the guy who started the fight, you hit the guy you always wanted to hit. I think that's what the regulators did at the time and saw the financial crisis as an opportunity to get in and attain a greater oversight of the hedge fund space. I would be interested to know how the people around this table view regulation, again both positively and negatively. I think the expectations around the Trump administration pulling back from regulation hasn't really occurred, so I'd be interested to know how this group is dealing with regulation, again, to your detriment or benefit.

Marc Malek: We're probably the least impacted because we only trade futures and FX, and the CFTC and NFA always kind of regulated us, but the change is very noticeable from any liquidity that has to do with a bank balance sheet. So, if we're trading on the exchange then no one really cares. Except that sometimes, some of the brokers want to charge exchange margin-plus, but I think there is a reason why there is an exchange margin, it's not "exchange-plus".

That has of course consequences when margin to equity is measured, when for example on the same product that we run in the form of different managed accounts for different owners, the outcome here will look very differently depending on who's the owner of that managed account. If owner A is a very important client and can have exchange margin, and owner B is not as important and gets one-and-a-half of the exchange margin, the results will look very different.

And secondly, if we step away from the exchange and go to say FX, that became really a disaster because we literally went from an environment pre '08 where every single major bank was after you to get your FX business, while now we suddenly have to use our futures business as the carrot to get someone do our FX business. So, today you have to beg for that liquidity or go to



futures on the exchange, which is kind of a very different route.

It's the much discussed pendulum effect, and we've all been around Wall Street long enough to kind of seeing the overcorrection in either way.

And hopefully we will at some point see an overall correction on the restrictions of the much tighter regulation we have now, and ideally this will adjust things then a little bit.

Justin Dew: I'll not comment on whether the onslaught of regulations have been good or bad, but I will say that it has been costly. The regulatory environment or specifically how we are addressing regulatory requirements has consistently been near the top of our expense list – short of research, which is probably number two in terms of what we have to spend money on.

Unlike Mark, we are regulated by the SEC as well because we have a fairly large equity business, and yes, it's cumbersome. That being said, my primary role at Welton is to **source the top investment talent** that I can to build out new teams, to build out new portfolios and businesses and to add to our multi-strat as many high Sharpe-Ratio strategies as I can possibly find.

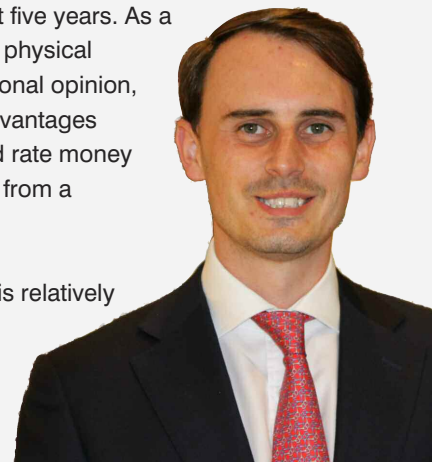


Regulation has made that part easier because traders and PMs spinning out from various shops and big and small firms anywhere in the world are simply realizing that their probability of success has gone from somewhere in the range of 10% to 15% down to 3% to 5%. That has been helpful because I can go to them and pitch them a similar business to what they would have done had they created it themselves but without all the headaches around the overhead of building a business and the huge cost of compliance.

Matthew Heap: Correct, the cost of entry for a new hedge fund has gone up dramatically from regulation and from a number of issues. We'll be two years old this November, and the breakeven AUM one needs to meet regulatory burden, higher top tier legal, accounting and administrators has been somewhat astounding to me. This is in the face of investors pressuring margins. It's my natural believe as a trader, that high margin businesses are pressured by predators or arbitrated out to medium to low margin businesses: its evolution and creates barriers to entry that consolidates the space until the business cycle seeks differentiation and change, whereby the cycle repeats.

The regulations in the commodities market have seen an overwhelming change in the last five years. As a consequence of Dodd-Frank and various other regulations, the banks stepped back from physical investments and are forced to liquidate a number of physical trading activities. In my personal opinion, this is actually quite a welcome change as a bank has a number of natural competitive advantages which the buy side doesn't have access to: The access to interest-free money or Fed fund rate money for example, the access to seeing client flow and trading it. This is very difficult to achieve from a proprietary seat.

My next point here also touches on innovation. I had mentioned that our business model is relatively unique being on the physical side as well, so it's very much a corporate style investment thesis, and therefore we need a number of corporate style products. In a way we are moving down a path that hasn't been trodden before, there are high natural barriers to



entry, a number of hurdles and a lot of persuasion along the way. But that can also create genuine alpha. Coming back to Osvaldo's expression of the unexplainable becoming explained, when you're the first mover, you're still in that territory of the unexplained, but nonetheless, there are a number of challenges.

The way we started and built the business plan, new products and services, was to look at the market holistically. Our whole firm is purely metals and mining, and so we map out metals and mining from shovel in the ground to one minute-day trade. Within this holistic approach, there are three metals exchanges, and I had already mentioned one being the Shanghai Exchange. You can only have access to the Shanghai Exchange if you have a Chinese entity and a Chinese vehicle. We've have embarked on this mission to create this Wholly Foreign-Owned Enterprise (WFOE).

That again, is a corporate style product because it requires genuine Capex into the country and then you have a number of issues, for example, extracting your investment onshore against capital restrictions from China.

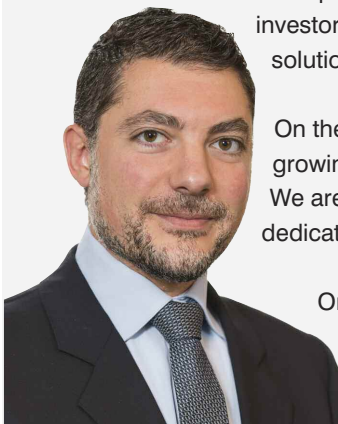
Fabien Pavlowsky: I completely agree, innovation is key! We all saw how the pace of innovation has increased dramatically.

At Lyxor, we innovate to continuously enrich our product range across the full investable spectrum - from passive and ETF to active alternative management and hedge funds. We also work hard to bring new and innovative ways to deliver tailor-made solutions to clients by leveraging our technology and managed account expertise.

For example, on the active side, we have been expanding our **alternative UCITS** fund range for European investors, including adding new strategies like risk premia as well as fixed income focused multi-manager solutions. The UCITS platform has successfully grown more than 60% over the last two years.

On the passive side, Lyxor has recently launched the world's first ETF to offer investors access to the fast growing **green bond** market, in response to the increasing regulatory requirements for ESG investing. We are also in the process of launching our first Global Gender Equality ETF that demonstrates our dedication to innovation in that sector.

On the solution side, our work ranges from advisory, asset liability management, all the way to OCIO business covering alternative and traditional strategies.



Osvaldo Canavosio: I agree that customization and flexibility have become key elements in the alternatives investment space. We at Man FRM seek to deliver them through our managed account platform. This trend is indeed happening on both the manager and the allocator fronts, both sides are working towards customization and flexibility and towards client portfolio solutions.

If you look back ten years ago, clients were generally presented the typical flagship product offering. It was largely a one-fits-all type of approach. Now, providers of customized client portfolio solutions like Man FRM can **unbundle and customize return streams** from managers through managed accounts for our clients. While before the focus was more on what could be offered, now the focus is definitely on what's needed by the client, and there's a better ability to help satisfy it with flexibility on the provision of the solution.





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Opalesque.TV video which got 104 views over 2016 Christmas:

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