

OPALESQUE



Opalesque Round Table Series '10 LONDON

Opalesque 2010 Roundtable Series Sponsor:



Editors' Note

Dear Reader,

The Opalesque 2010 U.K. Roundtable revolved around risk, regulation, opportunities and UCITS. You will hear from some of London's leading hedge fund managers and industry professionals rare insights and details about:

- The extraordinary opportunities available to investors with "patient" capital
- How asset managers successfully rebuilt investors' confidence in the listed hedge fund sector
- As regulators continue to push the industry towards exchange-traded OTC products, what instruments are or become available?
- Why are the exchanges not jumping on CDS clearing? What are the real issues involved?
- Why do industry practitioners think UCITS are a disaster waiting to happen?
- What is the inherent conflict between the manager and the fund investor in a closed-end fund that may also play out in UCITS funds?
- How can investors identify "good" UCITS?
- Insiders' views on Alternative Investment Fund Managers (AIFM) Directive, and how international asset managers can prepare for "Fortress Europe"

Fear of the Regulator

The regulatory changes on the way represent a paradigm shift in the industry, leaving many firms in a position they feel they "almost cannot move for fear of the regulator". The discussed regulatory reforms appear like attempts to "**introduce an air traffic control regime that operates by boroughs or counties**". Hear a candid analysis from **Ian Plenderleith** - now Chairman of BH Macro and a former member of the Bank of England's Monetary Policy Committee - about the "great failing" of the global regulatory framework, and which potential conflicts he identifies that nobody else so far has addressed or offered sensible solutions.

Failures in risk measurement at the root of many risk management problems

The Roundtable also offers surprising insights into the reality of risk measurement and risk management of many hedge funds. While a lot of strategies manage risk and exposures based on "rules of thumb", many funds active in more derivatives-heavy strategies often fail to measure risk appropriately. On top, there is a common mistake amongst portfolio managers to confuse cash usage of a portfolio with risk of a portfolio. The obvious problem is that many funds as a consequence trade strategies based on how much cash they have in the till as opposed to how much capital is at risk.

The 2010 Opalesque U.K. Roundtable was sponsored by NYSE Liffe and took place in their London office on June 29th with the following experts:

- Ana Haurie, **Managing Director, Dexion Capital Group**
- Chris Keen, **Partner, Culross Global Management**
- George Castrounis, **Partner, Maple Leaf Capital**
- Ian Plenderleith, **Chairman, BH Macro**
- Joe Taussig, **Founder, Taussig Capital**
- Olivier Lebleu, **Partner, Montier Partners**
- Louis Gargour, **Founding Partner and CIO, LNG Capital**
- Paul Barbour, **Chief Financial Officer, M2M Management**
- Paul MacGregor, **Director, NYSE Liffe**

We also thank the Opalesque 2010 Roundtable Series Sponsors Custom House Group and Taussig Capital for their support.
Enjoy the read!

Matthias Knab
Director Opalesque Ltd.
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Cover Photo: London Eye from Westminster Bridge. Photo by Palma Mendez.

Participant Profiles



(LEFT TO RIGHT)

Benedicte Gravrand (Opalesque), George Castrounis, Paul Barbour, Chris Keen, Louis Gargour, Matthias Knab, Ian Plenderleith, Ana Haurie, Paul MacGregor, Olivier Lebleu, Joe Taussig

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Introduction

Paul MacGregor NYSE Liffe

My name is Paul MacGregor. I am from NYSE Liffe where I am Director and Head of the Fixed Income Team. Our core products are short-term interest rate Euro and Sterling futures and options, and long-term Gilt futures and options contracts, which on average trade over 2.5 million contracts a day.

As a brief history of the business, the LIFFE market - as it was called then - opened for trading back in 1982 on the newly designed trading floor at the Royal Exchange, next to the Bank of England. After ten years of booming business, the exchange outgrew their premises and moved to a larger building off Cannon Street. In the late 90's, the exchange made a rapid move from floor to screen trading after a young upstart competitor in Frankfurt called Deutsche Terminbörse, now known as Eurex, came along and stole our then flagship contract, the Bund futures, teaching us a very hard lesson. But since then we managed to move electronically very, very quickly, migrating all our products from floor to screen in less than 2 years to our own highly advanced trading system, LIFFE CONNECT®.

We very quickly built a global network, dramatically improving our technology. We were then purchased twice, once in 2001 by the Euronext Group to become part of Euronext and then again by NYSE to form the global stock and derivative exchange group called NYSE Euronext.

Joe Taussig Taussig Capital

My name is Joe Taussig. We partner with hedge fund managers and help them to create banks and insurance companies where the hedge fund managers get to run all of the investable assets. We have raised billions of dollars of permanent capital for our partners. The best known we have done is Greenlight Capital Re with David Einhorn. This vehicle has over one billion dollars in it and trades about 1.3 to 1.5 times over book on NYSE Liffe. I am pleased to be one of the sponsors of the 2010 Opalesque Roundtable Series.

Chris Keen Culross Global Management

My name is Chris Keen, I am one of two partners in Culross Global Management, a London-based fund of funds. In 2010, our broadly diversified flagship fund is in its 11th positive year.

In addition, we also have a more concentrated, smaller manager fund, an arbitrage only product, and a longer lockup product which seeks to take advantage of the fact that liquidity is scarce in this environment. We follow a thematic process, which sets us apart from other fund of funds that may spend time worrying about whether they have categorized the style of the manager they are going to add into their portfolio precisely enough. Our starting point is an analysis of the macro environment which we distill into a number of key 'themes'. These form the basis of our search for managers, as we try to identify people who will do well if our medium term outlook becomes reality. We also think very carefully about the balance of our portfolios, in other words the relationship between the themes and the behavior of the overall portfolio in different scenarios. The firm was founded 15 years ago. In total, we manage assets of about \$550m.

Olivier Lebleu Montier Partners

My name is Olivier Lebleu, I am one of four partners at Montier Partners. We are a multi-family office and invest primarily in hedge funds. We currently manage about \$550 million for 19 families across Europe. We use both separate accounts or the fund of funds format. We also do quite a bit of advisory work for our clients on opportunities in areas like private equity.

We were set-up about 15 years ago by a Frenchman named Dominique Montier, who up until then

had been working in investment banking before setting up this boutique structure. Anecdotally, his last job at the investment bank was as Head of Lehman Brother in Paris, and as his oldest client puts it ever since September 2008, "we now know they never recovered from his departure"...

Ian Plenderleith

BH Macro

My name is Ian Plenderleith, I am the Chairman of BH Macro, which is a stock exchange listed investment company investing solely in the main Brevan Howard hedge fund – the Brevan Howard Master Fund. Our aim is to give the wider range of investors' access to hedge fund investment strategies through the familiar vehicle of a listed company and the regulatory protection that goes with investing in a listed company and the liquidity of the secondary market.

We launched three years ago when we raised an initial billion dollars; at the moment our net asset value is about \$1.8 billion. Brevan Howard as our investment manager achieved net asset value returns of around about 20% a year for each of the last three years, and are slightly up again this year so far. And happily, our share price has pretty well matched the asset value performance. Our share price is usually close to par, sometimes a small premium apart from the short-period when the market as a whole fell out 18 months ago.

We believe we have successfully managed to give a wider range of investors access to the investment strategies of the master fund, which is essentially a macro fund investing in the area of interest rates, exchange rates, bond-yield curves – essentially those parts of the markets that relate to countries' macroeconomic policies. The advantage of listing to investors is that more types of investors can benefit from hedge fund or alternative investment strategies, while the advantage to Brevan Howard is getting quasi-permanent capital, as shareholders who want to liquidate their investment can do so by selling their shares on the market rather than withdraw their capital.

Paul Barbour

M2M Management Limited

My name is Paul Barbour. I am the Chief Financial Officer at M2M Management Limited which was established in 2005 to provide institutional investors with access to the trading returns available in the dry bulk freight market. The Funds we manage, in tandem with our sister management company in Greece, trade freight futures and the physical freight market. This is a niche area where institutional investors generally have found it difficult to access these returns.

Our flagship Fund was launched in 2006 and has about \$400 million assets under management. At the moment we are also currently looking to raise capital to buy dry bulk vessels in a private equity style limited partnership structured fund. This Fund will acquire dry bulk vessels as we approach the low point in the asset cycle, lock in attractive medium term yields and then sell the vessels opportunistically for a significant capital gain, as and when demand recovers and the supply of new vessels is likely to have dissipated. We believe the timing is good for this investment strategy.

George Castrounis

Maple Leaf Capital

My name is George Castrounis. I am a partner at Maple Leaf Capital which started in 2002 as predominantly a volatility fund. We were one of very few funds that traded volatility as a core strategy. Our flagship fund is the Macro Vol fund, which marries macro and volatility trading. You could also call it a multi-strategy fund, because macro and vol have many synergies that translate into different types of strategies which in the end are a combination of the two disciplines.

We manage about \$300 million and have started to migrate or restructure from our current multi-strategy fund to effectively a multi-fund set up. Meaning, instead of running the one fund with multiple strategies we will be running many funds with single strategies, which follows what investors prefer in the current environment. They want to have strategies that are more focused and transparent in their investment structure. We will break out a macro fund, a quantitative vol fund and a high frequency stat-arb fund, which are the three cornerstones of what we have been doing for some time. Maple Leaf has offices in Hong Kong, London, Cayman, and are opening one in the US next year - I actually spend most of my time in Hong Kong.

Ana Haurie
Dexion Capital Group

My name is Ana Haurie, I am the Managing Director of the Dexion Capital Group. We have been in existence for 10 years, launching in 2000. Dexion Capital is an alternative investments specialist, engaged in three distinct areas. First of all, we have four London listed closed-end

investment companies, which are Dexion branded companies, but where the actual investment advisory function is outsourced to third party fund of hedge funds managers. Between these four companies, we have about £1.1 billion under management. The largest of our funds is called Dexion Absolute Limited, a multi strategy fund which in the fund of hedge funds sector is considered the bellwether with a track record going back to 2002. The investment adviser for this fund is Aurora Investment Management LLC, based in Chicago.

The other three funds complement it in terms of their investment styles. Our next fund is a commodity and environmental fund of hedge funds, Dexion Commodities Limited, managed by Man Investments.

The third fund is a trading fund of hedge funds, Dexion Trading Limited (this fund is a feeder fund into Permal Macro Holdings Ltd) and is managed by Permal Investment Management Services Limited, based in New York. Lastly we offer an equity long-short vehicle, Dexion Equity Alternative Limited, managed by K2 Advisors LLC, in Connecticut.

As an organisation Dexion Capital has been instrumental in reinvigorating and reinventing the listed hedge fund sector. When we came to market in 2002 with Dexion Absolute, we introduced a lot more transparency and implemented additional structural shareholder protections for hedge fund investors. We believe we have enabled shareholders to have a real voice as opposed to allowing many decisions to be left only to the discretion of a Board of Directors.

The second area in the alternatives sector that we are involved with is our distribution and marketing business. Here we market and raise capital for open-ended funds, UCITS, and obviously the closed-end sector. We also have a market making service that specializes in the London listed hedge fund sector providing liquidity to investors in these products.

Thirdly we have Dexion Capital (Guernsey) Ltd. which is the offshore investment manager for the four listed funds and which also offers, under the trading name of Dextra, a range of regulatory support and company administrative services aimed at supporting company secretaries and their boards.

Louis Gargour
LNG Capital

My name is Louis Gargour. I am the founding partner and CIO of LNG Capital. LNG is an alternative European credit manager. I founded the firm in 2006 with my team from RAB Capital. Our objective in spinning out has been to create a highly focused, fixed income boutique, with investment professionals having vast experience and top pedigrees in order to deliver low volatility, risk-adjusted superior returns to the firm's clients.

I have over 20 years experience in the credit space, having held senior positions at Goldman Sachs, J.P. Morgan, and Solomon Brothers, prior to being in charge of RAB Capital's fixed income division. The team's unique selling proposition is that we focus on European credit, and manage our portfolios in a nimble, dynamic and thematic way. Depending on the market cycle and opportunities we constantly adapt our strategy to maximize returns. In terms of return characteristics, our track record annualizes at 18% over the past 9 years with 6.9% volatility, achieving a long-term Sharpe ratio of 2.14.

We are currently repositioning the firm, and increasing resources in key areas such as marketing, operations, risk management and systems. We have consistently made excellent returns for our investors, which we currently are running in managed account format, however due to strong underlying demand, we are planning on launching an offshore fund, as well as potentially a UCITS version, in the third quarter of this year.

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REUTERS	0#G:	0#H:	0#FLG:

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Matthias Knab

What is the outlook for our fund and strategies? What is happening right now in your company, in your funds, in your investment arena?

Louis Gargour

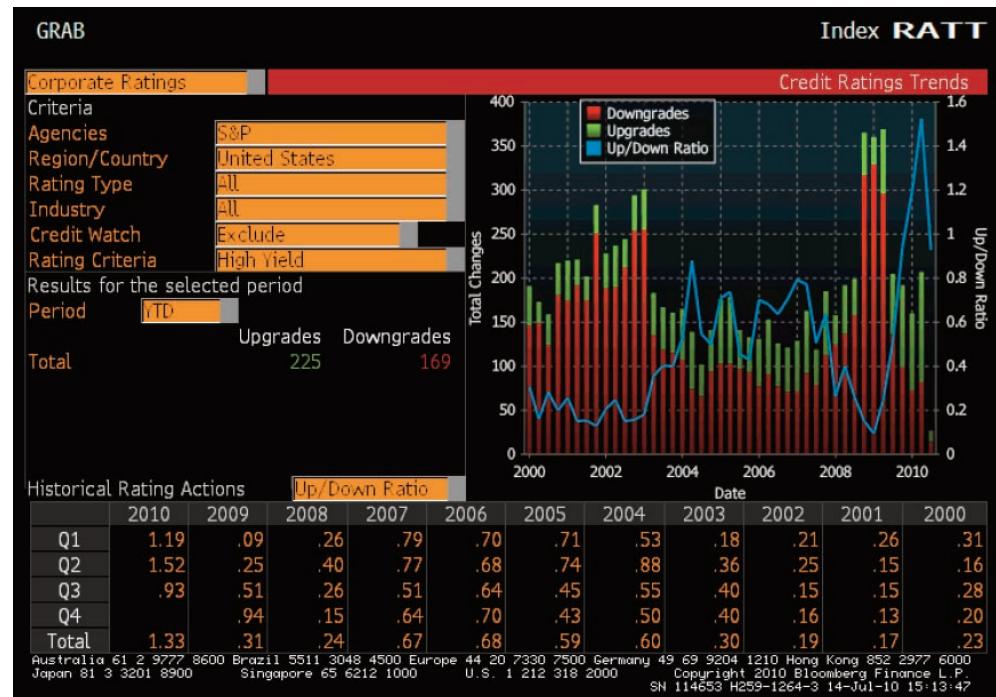
We see European credit as continuing to be an interesting asset class, but feel that it requires an actively managed approach. The simple strategy of buying as a whole is no longer valid in this complex world. Credit trends are still positive, however returns can be significantly enhanced by a nimble, dynamic, actively managed approach.

We see a number of opportunities in European credit across in relative value, event driven, and later in distressed. We are entering a period where managers who are nimble, focused, and experienced can make supernormal returns.

The key factors that we believe will drive returns are:

1. The dislocation and opportunities caused as a result of the Greek crisis
2. An improving credit cycle, with upgrades outstripping downgrades
3. Underperformance of equity markets relative to bond markets
4. Very low levels of dividend yields, making fixed income more attractive
5. Improving corporate balance sheets across northern Europe, presenting long opportunities
6. Deteriorating balance sheets across southern Europe, presenting short opportunities

As you can see from the chart below, the upgrade to downgrade ratio has moved into significantly positive territory recently. This is a very strong indicator of a robust and improving asset class, with the occasional short opportunity for companies that cannot refinance, or have overleveraged unsustainable balance sheets.



We think that the dislocation in the European markets, as caused by the sovereign dislocation of Greece, Spain and Portugal, has thrown up a range of opportunities in the corporate sector to take advantage of relative mispricings, which are in fact sovereign in nature, but which are not default based. We believe that the dispersion and yields present as a result of these sovereign dislocations will result in significant opportunities for mean reversion and compression pair trades. We have

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Louis Gargour



been managing money for a while and have seen this part of the credit cycle before – we believe we are now in the sweet spot of upgrades versus downgrades, and of spreads going tighter over time.

We have had a very good 2010; we are up approximately 45% so far. We had a good 2009 when we were up approximately 80%; and a respectable 2008, down only approximately 8%. Backed by our strong track record over the past nine years, we are currently preparing for a new fund launch. We have built a strong team with robust infrastructure, dedicated risk management, and an investment management process that is tried and tested over time, and feel that the opportunity is ripe for offering the strategy externally.

We currently manage assets for one institutional client, however we have seen strong demand for an actively managed offshore product, as well as a hedged UCITS product, in addition to several requests for white label products from institutional investors. So we are seeing a variety of exciting opportunities and very much look forward to the next six months in terms of increasing our offering of products.

George Castrounis: The changes in the investment environment create new opportunities and force existing firms to react to capitalize on those changes. Furthermore, investor demands change, an example of which I had mentioned previously being their appetite for more transparency and more liquidity.

On the flipside, service providers, namely administrators and prime brokers, have changed massively. In general, administrators cannot respond at the pace with which products become more sophisticated. They also take a step back from being accommodative to strategies that have more non-standard risk - exotic credit trades for example - after having gone through some pitfalls in the last few years... Most importantly, at least related to what we do, prime brokers have changed considerably with respect to derivatives, in that many no longer effectively margin option trades with their hedges.

Some strategies or instruments are less viable in the new environment. For example, strategies with long dated OTC products. The prime brokers' whole approach of VAR-based margining no longer extends diversification benefit. Illiquid, long-dated, exotic assets are no longer liked by investors, administrators and prime brokers. And the fact of the matter is that they are no longer in favour with banks either, since it is difficult for them to lay off their risk, which gets translated into wide bid-offer spreads. So the opportunity in those assets basically dissipates in this environment.

What has improved though is the liquidity on the exchanges. It has increased quite dramatically. Quantitative strategies, particularly those executed algorithmically, benefit hugely from that.

George Castrounis



Since the year 2000 we have witnessed a continuous growth of exchange-based quantitative strategies. And because of bond credit instability, market participants have doubled their use of listed instruments as an alternative in recent years.

With respect to volatility strategies, we are now in a period where we finally have a core dataset in all asset classes that is long enough and stretches through enough cycles for firms like ours to properly back-test volatility strategies. Before that, say in the 90s and early 2000s, we may have been a few smart guys making money trading vol – which could never really be replicated and back tested, but it worked. However, now you can really refine your trading. On top of the data improvements, the whole technology advancement in the last decade with respect to quantitative and algorithmic trading has finally come to volatility trading as well - to the point where I now consider us a quantitative trading house.

While from a technical point of view these changes are quite dramatic, they also appease all concerns with liquidity. As all instruments are exchange based, administrators have the easiest job in the world because they are just looking at securities and quotations. Investors get the liquidity they want and more importantly the volatility trading firms themselves can vastly expand because now strategies can be diversified considerably with algorithms beyond the scope of what was being done manually.

Another development for vol trading firms is the change of our counterparties. Traditionally, the counterparties for volatility trading used to be banks, but given the migration of option trading to exchanges, counterparties are increasingly retail clients and non-volatility competent investors that trade options. Historically, strategies to capitalize on this were too manually intensive but since they are now automated, it allows us to extract more volume and value from non-competent vol trading participants, namely end users trading options.

Paul MacGregor

As George pointed out, it looks like the regulators are continuing to push the industry towards exchange-traded OTC products, and we have noticed certain trends developing from the hedge fund industry over the past say 18 months. As we have moved into the zero rates environment, we could witness a much greater participation in interest rate options on the NYSE Liffe market, particularly in Euribor and Short Sterling options. Market participants have started to play applied volatility in the zero rate environment, and those products are very, very liquid now, trading about a million contracts a day.

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In the interest rate futures, which are more of the core traditional markets and attract a lot of algorithmic trading, the volumes are up significantly as traders move into the back months, trying to grasp the changing shape of the yield curve. They obviously know the front of the curve is very, very flat, and therefore we have seen a much greater move into green month futures for example, and even blues and golds in Euribor.

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Most recently we launched Short and Medium Gilt futures to cater to what we perceive to be a huge amount of debt issuance that the U.K. government is undertaking over the next few years. I would also ask you to keep an eye on other products which will probably grow in the short to medium term, such as the Swapnote futures, particularly if people are forced to do a lot more exchange based trading, and also Eonia swap index futures, which is obviously an OIS based product. Also, you could see another blowout between OIS rates and term lending occurring in the medium term.

Ian Plenderleith

The trends George points out are extremely interesting, particularly in light of the pretty rocky experiences the industry went through during the last two or three years. As BH Macro essentially invests in a single macro fund, the question we are looking at first is if there is still a legitimate case for alternative investment strategies? Will hedge funds be able to generate the kind of returns like in the past, given that quite a number of them have run into serious difficulty over the last year or so?

Of course, there are lots of different types of hedge fund strategies, which make it quite impossible to generalize about the area as a whole. But surely for those that have a legitimate investment strategy – one that makes sense, that is different from the conventional strategies, and is supported by good reasons and good justification – the opportunities, as well as their case for a longer-term presence in the investment scene, will continue. However, others who may not be based on a new idea or strong case, or who do not follow a coherent strategy will quite naturally fall by the wayside. One of the things we could witness is the winnowing out of those weaker performers or weaker strategies along with a concentration on the more effective firms and those with better-constructed strategies.

Within this scenario, the place for macro funds and their prospects remain strong. The last two or three years has been a terrific period for macro funds: declining interest rates, flat yield curve, terrific volatility and a great uncertainty related to risk differentials. This is a very fertile ground for macro funds that need to try and sit down and work out in a rather fundamental way where they think a particular asset should be priced in relation to the economic situation; where they think the market might be mispricing them, and then construct strategies to take advantage of that mispricing within a reasonable time scale. While in general this strategy has never been easy, for the last two or three years there have been far more opportunities than in the earlier parts of the decade.

So the question remains what are the opportunities ahead? My view is there are fairly substantial opportunities ahead. We may have come out of the recession, but the recovery is pretty slow, faltering and uncertain. We face a world in which the great financial crisis has hopefully passed, however a lot of financial institutions are left pretty wounded and certainly people's risk appetite is left pretty small. There are great uncertainties about how quickly and to what extent the major economies will recover, and how quickly the governments who need to do so will take steps to reduce their fiscal deficits, bring budgets back into order and how quickly the central banks will remove the enormous monetary stimulus that was created in the major countries. And all of that without stopping and thinking, we will continue to deal with unexpected shocks that can hit us from many sides, either political, or military, or economic, or institutional sector related.

The uncertainties will continue, to present good opportunities for achieving superior returns, particularly for a firm with sound analytical capabilities within macroeconomics, trading skills to take the right positions and the appropriate risk management.

A last question I want to address is if there is a future for listed funds like my own - BH Macro. I agree very much with Ana that the listed sector has shown it has a vital part to play. We make

alternative investment strategies available to a wider range of investors, including many institutions who feel more comfortable buying a listed share – a process they are familiar with, with the protection of the listing rules and with the liquidity of being able to sell them in the secondary market if they want - then they would be inclined to make direct placements with the individual hedge funds.

Chris Keen

From our point of view as a fund of funds, the changing behavior and structure of markets that George was talking about offers a terrific set of opportunities for people that have the increasingly rare combination of capital and skill to be able to take advantage of them.

We have moved seamlessly from an environment where markets were supervised by people who thought that keeping their hands off the day-to-day activities of those markets was a good idea, into an environment where every day brings a new policy intervention, a new regulatory intervention, a new source of confusion about the way markets are going to function tomorrow. At the same time, the amount of capital available to many market participants has shrunk. And on top of that, we have gone through significant market interruptions where the machinery does not seem to have worked very well, let me point to the flash crash in early May as the most obvious example.

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On the supply side, the need has grown for capital to be deployed to intermediate a tide of government debt coming on to financial markets. The U.S. mortgage market is still digesting the problems of the last couple of years, a capital intensive process. There is the prospect of increased activity in mergers and merger arbitrage arising as a result. And the credit market, like many others, is taking its time to normalize, producing relative value opportunities along the path. Therefore, we see lot of opportunity in the various subdivisions of what you might broadly define as arbitrage.

I agree with Ian that the environment for macro managers is pretty promising. It was great to see the coordinated nature of the government intervention after the financial crisis. But it was inevitable that the after effects would not be coordinated or even in their impact. The name of the theme in our portfolio, which relates to this is “Relative Sovereign Opportunities”. This is our way of trying to encapsulate the interesting nature of the environment for macro managers as the GDP/interest rate, credit/equity market implications of the huge monetary and fiscal stimulus play through the system. We think that process has some considerable distance to go.

For people who have patient capital, this is an exceptionally interesting time. There is understandable anxiety around providing liquidity to markets and a great many investors who still need to sell assets for non-economic reasons.

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For people who have patient capital, this is an exceptionally interesting time. There is understandable anxiety around providing liquidity to markets and a great many investors who still need to sell assets for non-economic reasons. Generically, this makes for opportunities that are pretty attractive for investors. We are in a constant quest for investors who agree with us about these opportunities. Luckily, we have found a few, and remain open for more.

Paul Barbour

As freight traders we rely on volatility to help generate investor returns and we are confident that this will remain and increase in the medium term. Underlying factors such as Indian port expansions, new mines opening globally, piracy, the new quarterly priced iron ore contracts and the continuing Chinese tactic of applying the brakes then the accelerator pedal to their commodity orders all support a volatile freight market.

A positive result of the credit crunch is that all freight derivatives are now exchange cleared, reducing the credit risk significantly which is very positive.

Further, the continuing lack of finance available to ship owners is depressing vessel prices relative to freight income rates, so asset backed strategies can lock in excellent medium-term yields that should be attractive to investors with longer-term horizons.

Olivier Lebleu

In our view, a couple of questions have been thrown up in the last six months or so. One is what to do with credit. Credit has done well, very well. In retrospect, for us, all of the funds that restricted our liquidity and ultimately our investor's liquidity in 2008 were credit funds. Except for one of them, we did not mind being restricted, because we wanted to stay invested in those funds, we understood the reasons and we were rewarded for – Chris, I will use your term - our patience.

Credit has done well, very well. In retrospect, for us, all of the funds that restricted our liquidity and ultimately our investor's liquidity in 2008 were credit funds. Except for one of them, we did not mind being restricted, because we wanted to stay invested in those funds, we understood the reasons and we were rewarded for – Chris, I will use your term - our patience.

However at the moment in credit and mortgage backed strategies, things are less clear to us.

Also in macro strategies, the picture is not that clear either. A lot of macro managers have been caught offside in the recent months, even though you would have thought they would not have been. Maybe not Brevan Howard or a small number of other funds that were different, but generally I don't think macro has rewarded investors as well as they thought they would be rewarded in the last few months or the last few weeks.

Olivier Lebleu



However at the moment in credit and mortgage backed strategies, things are less clear to us. In late 2008/early 2009, it was an easier decision for us as a team that it was good to be patient, because at that time markets had cratered and basically at some point you would benefit from a directional bounce back, if you could be patient.

Also in macro strategies, the picture is not that clear either. A lot of macro managers have been caught offside in the recent months, even though you would have thought they would not have

been. Maybe not Brevan Howard or a small number of other funds that were different, but generally I don't think macro has rewarded investors as well as they thought they would be rewarded in the last few months or the last few weeks.

Mathias Knab **And why is that?**

Olivier Lebleu

I am going to use these terms loosely because it is probably not applicable to all, but there were a lot of carry trades back on, especially vis-à-vis emerging market currencies. There were probably a lot of people who are not as aware of the relative value issues, and my guess is generally there was a lot of raising net exposures into a market that was, as we now know, approaching its top.

Louis Gargour

My view is that the market has significantly changed since 2008. The strategies that relied on leverage and liquidity, which include long only, real estate, mortgage backed securities and commodities have obviously underperformed and in some cases the managers have been forced to shut down or liquidate.

The new paradigm is that long/short strategies, which remain nimble, do not require leverage and are able to exploit mispricing, market volatility, as well as directional trends, together with running successfully a number of short positions, have outperformed and will continue to do so.

Macro, which honestly is a difficult and complex asset class, is about spotting trends and exploiting medium-, short-, and long-term opportunities. In this changed world, these trends have become more difficult to identify and more violent in their swings. As a result there has been a significant differentiation in the return characteristics of macro managers.

Olivier Lebleu

Correct, and I would add through our own experience that there were managers who basically stayed bearish and those who progressively let themselves be seduced into getting more bullish.

Historically, we never invested a lot in macro funds, principally because it is generally very difficult to understand what they do consistently, and as I mentioned the recent experience does not exactly encourage us. What to do about credit and what to do with macro are two issues for us right now.

Ana Haurie

For the last two years at Dexion Capital we have focused on rebuilding investors' confidence in the listed hedge fund sector. A while back you could read comments in the media claiming that the listed sector was dead and gone forever etc. We are dealing with an investor base predominantly from the private bank and private wealth management side, who at that time suffered a double hit. There was not only the significant loss in NAV terms on their hedge fund and fund of funds investments, but an additional loss through a depressed share price, which almost doubled the magnitude of their losses. At that time, the listed funds did not prove themselves to be absolute return vehicles, and they demonstrated equity like volatility.

Coming out of this and rebuilding the investors' confidence has been a slow and painful process; but has certainly been worthwhile. The way that we tackled it was to communicate and communicate, and frankly we still could not communicate enough. Even at times when there was real chaos in the markets, some of which were closed and not even the hedge fund managers knew what was coming next, we sat down with investors who were very disappointed, but we had decided to be as transparent and as open as possible.

We believe that our efforts have been successful - having just completed a fundraising for BlueCrest AllBlue fund on 17 June 2010 which raised £350 million. Proof, I think, that investor confidence has returned to the listed hedge funds' universe. Proof that the structure continues to work, and that investors who understand the structure still have appetite for the funds.

I want to share some reflections on the UCITS boom. Investors' desire for liquidity has contributed to this huge demand for UCITS funds, and I think the challenge that we all have is how to identify

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products that really work well in a UCITS structure. I believe we should avoid making too much effort and too many changes in order to force-fit a fund or a strategy into the UCITS wrapper, just for the sake of increased distribution opportunities. Identifying a good product that is suitable for the UCITS structure is certainly a challenge. Dexion Capital wants to bring products to investors where the structure matches the underlying liquidity of the vehicle – the approach should be “horses for courses”, and not a “one size fits all”.

We have just conducted a survey here in the U.K. to help us identify the product and hedge fund strategies in demand, etc. We found that investors are asking for tail risk or typical hedge type or uncorrelated strategies, macro and so on, but there is also demand for other asset classes like environmental and water, commodities and infrastructure, those newer themes. The survey showed that there is still appetite for illiquid assets, and investors who are used to investing in private equity are still comfortable doing so.

The last challenge that I think we are all facing in different ways is the hugely significant change in the regulatory regime. I think that in terms of the regulatory regimes and the world that we are moving into, we are definitely in a paradigm shift (an expression I seldom use). It seems that a financial firm almost cannot move for fear of the regulator. When you listen to the FSA saying, “credible deterrence”, and “intrusive regulation”, and “look we have just fined a large US bank £33 million for self-reporting a mistake that they made”, then I strongly believe that it is going to be a challenge for all of us.

Matthias Knab

Who else? How do and will the changing regulations affect your business?

Louis Gargour

As a market practitioner, I have significant reservations concerning regulatory changes being proposed.

Certain key themes begin to come out: One, certain instruments cannot be traded to the short side, this includes German equities bank stocks and other specific restrictions on how one ought to position a portfolio. Fundamentally, I believe that liquid functioning markets with no restrictions offer investors in the long-term the best opportunity for unfettered returns. Restricting short selling is simply restricting the ability of an investor who has identified a weak balance sheet, a compromised business plan, or other factors from exiting from his analysis. I do believe certain circuit breakers need to be in place in order to avoid dislocated markets and the commensurate systemic risk associated with a liquid nonfunctioning markets.

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My second concern about the regulatory trend has to do with the scrutiny surrounding sovereign CDS. We have systemically hedged our portfolio this entire year against a Greek default, a depreciating euro, and dislocation in the Portuguese and Spanish markets. We have hedged these factors not because we are long Spanish and Greek bonds, but because these events have impacted credit and equities generally across Europe. For the regulator to say that he believes credit default swaps on Greek debt should be restricted is equivalent to the regulator saying that we should be long all the other asset classes without being able to hedge our external extraneous systemic risk.

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I therefore feel very strongly that the regulators need to very carefully examine restricting trading in asset classes especially those like credit default swaps, which are specifically designed to help investors reduce or hedge risk

Paul MacGregor

One common positive trend, at least from our perspective, is that regulators across the globe appear to think that "exchanges are good", and want to drive more OTC business toward them.

Louis Gargour

In fact sovereign CDS clearing.

Paul MacGregor

Exactly, that is a very interesting point. As you remember, CDS was the first asset class where the regulators focused and mandated central clearing. As an exchange we looked very closely at offering our own CDS clearing, however we found that as soon as you move out of the realm of indices into single names and sovereigns, CDS become extremely difficult to price and to risk manage, and therefore extremely difficult to effectively centrally clear.

Your evaluation of these products is always going to be dislocated. For most cases there will be a sort of bipolar view about the actual correct value of this particular asset. There are very, very few people in the world who can actually agree on how to unravel a CDS default situation.

NYSE Liffe looked very closely at CDS, including the economics of actually offering a central CDS clearing service, and we stepped back. We decided that, as an exchange, clearing CDS is actually a business we are not going to be in. There will be potentially other asset classes that the regulators may start looking at to establish central clearing, which equally can't be standardized in very simple ways. This will probably have a drying up effect on the liquidity.

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Obviously, the largest market by far traded OTC is the interest rate swap market. We are already in active conversations with a lot of our clients at the banks who are now saying our swap futures contracts do look like a potential solution. Banks are actually having a look at whether they should be trading these now, because they know the regulators are going to come to them by the end of 2011 and say, "You've got to put as much business through clearing as you possibly can."

Paul MacGregor

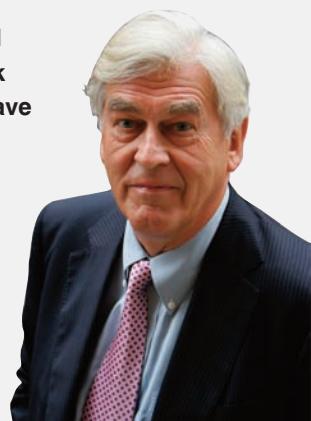
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Hedge funds really need high liquidity on these contracts, and liquidity is not something that just appears when you list an exchange-based contract. It takes years and years to build the confidence, to have a back-tested history, particularly in a futures contract where people need to have the confidence it is behaving in the correct way that it should relative to its underlying. Customers need to see open interest moving in a positive direction before they get involved.

Going forward I believe that exchanges will be obligated by regulators to list all sorts of asset types to move into this new regulatory environment, but it is not guaranteed that we can deliver the liquidity the market is going to demand from day one. The market will need to have quite a bit of patience there, I think.

Ian Plenderleith: At this point in our discussion, maybe I should add here that in my earlier life I was indeed a central banker. My focus was monetary policy and trying to help the markets work properly. I believe regulators are motivated by three main concerns out of the great crisis we have just have gone through.

Let us first remember that this has been the biggest financial shakeout in modern history. Whatever you think the reasons and whoever you think is to blame or not, the markets and the whole system was undoubtedly in a huge upheaval. It is therefore, not too surprising seeing a concerned regulator trying to respond and figuring out how to avoid that thing happening again.



I think there are two or three conclusions they have drawn. One is that many financial institutions, not just banks, have too little capital for the risks they were taking. Therefore, in different areas financial institutions will probably need to comply with higher capital requirements.

Secondly, almost everybody in the system had too little liquidity. This is, in my view, a great failing of the way the system has developed in the last ten or twenty years: there has been excessive reliance on liability management; the assumption that you can put on assets and somewhere you will find a way of funding them, hopefully, at a profit. This is fine in the modern world of liquid, interconnected, international markets. However in some cases the reliance was excessive and ignored the fact that it is quite a good idea to have a bit of liquidity or reserve lines etc. just in case for some reason you cannot get in to the market as you are normally used to, or the market suddenly is not at the right price, or indeed as happened, is not there at all, like what happened with the money market seizing up. There are great lessons about too little liquidity, both in the system and in individual institutions.

The third aspect is that in many areas the market failed to price risk properly. A number of risk analysis systems and processes did not focus on all of the risks inherent in some of these instruments we invented, and we failed to put the right kind of price on that risk.

Now, those are all probably normal human failings and partly they are just a product of the world getting too overheated from time to time. I believe the core arguments running through the regulatory debate are that firstly banks or indeed everybody will need to hold more capital particularly against the riskier parts of their business. Secondly, everybody will need to hold more liquidity in the system - so they have got a cushion if things suddenly hit the rocks - and thirdly that people who engage in sophisticated risk activity better improve their skills in managing the risk and pricing it, and have capital and liquidity in reserve against it in case they have mispriced it.

The reform process may not be comfortable, and it may mean that financial services businesses will be less profitable because they are more costly due to higher capital requirements, but nonetheless in these aspects the system can be put right and life will go on. However below those issues I believe there are two additional, huge areas of questions where I simply do not know what the answer is, and I do not think anybody does.

One is the recognition that even if individual institutions are behaving reasonably prudent or they will be forced to behave reasonably prudently by the regulators, the system itself can generate excess to the point where it can blow up and threaten the stability of the remaining perfectly innocent institutions. That is clearly what we have seen happening in the last few years, it's called systemic risk.

It has become conventional wisdom that we are not very good at controlling systemic risk, partly because we can never be sure when things get to the critical point where they blow. But equally we now know that we don't quite know how to stop the crash when things are about to blow up. I am reminded of the Icelandic volcanoes: we know that at some point in time they are going to blow up, but we don't know when and there is not a lot we can do to stop them when they do.

Therefore, the conventional procedure seems to be to all get together and clean up the mess afterwards. I believe that now there is a recognition that we probably can get a reasonable idea when one of these volcanoes is about to blow or get to that threatening point. We also agree that we need to try to have some sort of system to intervene in order to dampen it down. But the question is really - what is the instrument? It is actually quite difficult to dampen down excess in the financial system.

The only way that I can think of is by a combination of a higher capital - requiring people to hold higher capital when you think that the system itself is getting over exuberant - and probably some form of direct control. Here the regulator would need to be able to say to people: "well, you may not lend more than an increase of 10% of the mortgage market, or you may not lend more than the certain lend of your mortgage book or you may not lend more than a certain loan to value ratio." But it's quite hard to see that how that type of administrative control could be applied.

The second great problem area we have to deal with is that we ended up with financial institutions that are clearly too big to be allowed to fail, because they would set off such a panic that would bring down other institutions. We have seen that very vividly in this crisis both in terms of the institutions that had to be supported by the taxpayer, and the consequences in the case of Lehman on the other side that was not supported. This is a completely intolerable situation: to have institutions who are working hard to make money for their shareholders on the basis of an implicit guarantee by the taxpayer for which they are not charged, and that is why we've got these ideas of narrow bank and so forth. But how you deal with that, and how you get away from the situation in which these large institutions couldn't fail without causing contagion around the system is very difficult.

Of course we can split them up into bits as some people say, but I can't help feeling this represents rather a luddite approach, and I would prefer not having to go back to that kind of 18th century banking structure. I think there are synergies in big financial groups, but you do need to have some way in which you can have a situation in which the taxpayer is not going to be forced to bail out institutions in future, but again, I don't know how that is going to be achieved.

Chris Keen

We are in an era where policymakers will target the control of asset markets to avoid the kind of excesses that are perceived to have caused trouble in the last couple of years. We now clearly recognize the role of the consumer in GDP growth or lack of GDP growth, and the role of asset markets and particularly real-estate markets in dictating what happens to consumer behavior.

The 1970s was an era in which policymakers were most worried about inflation and learned how to control it, and the 1920s was an era in which policymakers were most worried about unemployment and social welfare and learned how to deal with that. This is an era in which economists are busy trying to figure out how to avoid asset bubbles causing dangerous consumer behavior. In the process, they will need to answer Ian's questions on regulation.

The problem is that so far there is very little sign of any attempt to coordinate the response, even to the immediate regulatory problems. Banking is a global industry. In the past we saw institutions shopping regulatory regimes in order to find the most helpful environment for minimizing the capital requirements on their business. In many instances, this wasn't the best interest of the system.



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The reforms that are being discussed at the moment, ranging from The Volcker Rule to the reintroduction of Glass-Steagall to taxes in different jurisdictions at different levels on different things, look to me like trying to introduce an air traffic control regime that operates by boroughs or counties. Parochialism is dangerous. This is a global industry, you cannot expect a sensible outcome unless there is a greater degree of coordination.

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Olivier Lebleu

A couple of points on regulation. One is that maybe more as a result of market forces than through regulation - time will tell - all of the attempts that have been made at liquidity transformation through things like fund of funds will get found out as often inefficient and unstable, if they haven't already been found out already, and need restructuring to be more in line with their underlying investments.

In my view, at least more discerning investors will require that if they are asked to invest in structures where you should have locked up capital, that you state that upfront and you lock it up appropriately, in line with the underlying parameters of the investment and liabilities. Conversely, if you do not need stable capital as much, then investors will ask that you create more liquidity and that you guarantee it.

I am sort of reminded of what happened in the U.S. with the money market fund industry, which is a huge industry, half of the U.S. mutual funds in assets under management as it is effectively a substitute for bank deposits. They basically transform one year commercial paper into daily liquidity mutual funds with a stable NAV through amortized cost. When in September '08 one fund that held Lehman was going to go to I think \$0.96 on the dollar instead of \$1 and the whole system had a run... The United States authorities are now looking at how to make sure this liquidity transformation exercise is backed up by assets that actually make sense to be transformed into daily NAV mutual fund.

I think investors in fund of funds are going through the same process, whether through a listed vehicle or an unlisted vehicle. I believe we need categories of funds that match liquidity profiles better, otherwise the industry won't survive, particularly the multi-strategy fund of funds. They can't survive as a mishmash of a bit of everything, holding things that are very tough to liquidate together along with very liquid assets, it just doesn't make sense at times of market stress in particular.

My second point on regulation is that unfortunately the marketing answer from the industry says, "don't worry we've got a better solution, it's called UCITS." I think UCITS are a disaster waiting to happen.

In a previous job I used to be responsible for a large American fund manager's European operations. We had a \$10 billion UCITS structure at Luxemburg. Each and every single one of those funds invested in listed equities but could gate, and would have gated if there had been a run on the fund. So this idea that UCITS are going to save the hedge fund investor from liquidity problems is - and I hope I'm wrong on this, but I think it's the next scandal waiting to explode, and I don't know if the industry will be forgiven for that that one.

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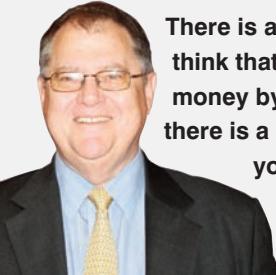
Joe Taussig

A quick reflection regarding closed-end funds and UCITS. When I graduated from business school 38 years ago, my first investment banking deal was the largest closed-end fund in the history of the United States at the time. And I remember going on that roadshow at the time I was studying for my securities exam which said thou shall not lie, cheat or steal. There was this old-timer saying

"you know these things always trade at a discount NAV, why is it going to be different this time?" I said "it'll be different this time" - it wasn't.

I felt like I had just misled the investor community. Subsequently I started analyzing closed-end funds and came to the conclusion, Ian's experience notwithstanding, that it is virtually impossible for them ever to trade at a premium to book value. Most likely they will always trade at a discount. A question is of course how they can, as a mutual fund equivalent, ever trade at a premium? I suspect there is a surplus demand in the case of Brevan Howard, which is a manager in demand where those little investors can't go directly.

So arguably a fund can trade periodically at a premium. I have been part of a group that has basically taken over all the Swiss closed-end funds and opened them up. We ousted Citibank as the manager of one, liquidated all the funds inside and went and bought some companies and distributed the shares of those companies to the shareholders, and did quite well by the shareholders.



There is an inherent conflict between the manager and the fund investor in a closed-end fund, and I think that there are going to be some similar problems in the UCITS area. The managers make the money by having assets under management. The last thing they want to do is buy back shares if there is a discount, and that's really what they should do, but eventually if you buy everything back, you are not in business anymore. And I think that's a real problem.

Joe Taussig

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Ana Haurie

Just anecdotally, but for the BlueCrest AllBlue C Class that we just closed last week, throughout the whole capital raising the ordinary shares were trading at 3% to 4% premium.

Joe Taussig

Coming back to UCITS, I think they will not be the Holy Grail for the hedge fund industry. It's really a distribution business. If you look at mutual funds, the star managers are rarely ever in a mutual fund, they have all gravitated to the hedge fund industry.

Coming back to UCITS, I think they will not be the Holy Grail for the hedge fund industry. It's really a distribution business. If you look at mutual funds, the star managers are rarely ever in a mutual fund, they have all gravitated to the hedge fund industry.

But the mutual fund complexes are just marketing machines. They can just basically distribute like there was no tomorrow. I learned from Fidelity in the 1970s that mutual funds were sold, not bought. IFAs can sell anything. They can sell air conditioning in the Arctic, hanger heater in the Amazon, as long as there is enough commission in it.

Up until now, the hedge fund managers don't have that same machinery. However, UCITS creating expectations that you going to hedge fund like returns in a UCITS package may turn out to be tricky. I think it's been shown in the managed account platforms like Lyxor that if a manager is looking over his shoulder constantly at liquidity, he will not put his best ideas in play.

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Our core business is teaming up with hedge fund managers to create reinsurance companies and banks as permanent capital vehicles, where the manager gets to invest all the assets. We are in business with over two dozen managers, this is very permanent capital for their business. It's basically what Buffett did 40 years ago, he laid it out for everyone. These guys put their best ideas that have any kind of long-term aspect in the insurance company and not in their funds, because they have always got the redemption problem hanging over their head, and UCITS exacerbates that.

George Castrounis: Ian has elaborated on the regulatory issues from a macro perspective, let me add my own experience here, a kind of micro perspective from a hedge fund manager and our business. How are regulations affecting me? Well, as a U.K.-based manager, what you read in the press and in the public discussion is, for lack of a better word, entirely overrated. I think every time somebody asks me about any concerns of how the regulators are going to affect business, I usually tell them that all they have been reading relates to U.S. hedge funds, since in the U.K. the FSA is already there.

The FSA is already as harsh as the SEC wants to be years from now, so if you are a London-based manager, you are already dealing with all those requirements that are making headlines in the press. If you're set up appropriately, with the right compliance, functions and right regulatory response vehicles etc., and manage your trading risk appropriately, then it's not such a big deal.

Ian mentioned the significance of risk and that people who take on larger financial bets should really be a sound risk manager as well. To me, that is exactly the crux of the problem: is your fund actually managing risk effectively?

The first thing to do is actually measure risk appropriately, as opposed to just try to risk manage. What I mean is that if your fund basically has the right VAR and stress test tools and appropriate internal risk measurement functions in place, then you shouldn't be running into any problems, because your target of a annual performance return volatility of 7, or of 10, or of 12, is going to be much more strict than your prime broker's margin requirements or the regulator's restrictions.

But the deeper problem is that fund companies do not have a well-developed risk measurement function in the first place, at least in my area of expertise. Historically, derivatives were always traded in banks. If you assume that most hedge fund traders grew up in a bank and traded at a bank, the issue that arises is that for the whole part of their careers, when they are learning or growing or managing money on the prop side, they never really had to exercise a risk measurement role; that was done by the risk managers (as opposed to traders) at the bank. Risk managers would then give traders a trading limit and traders would use that trading limit accordingly, kind of like a credit card limit. They knew they could max it out, and in fact were encouraged to max it out, because management could always pull it back and adjust it as certain strategies succeeded and other failed.

So that is a real issue, since investors assume a competent trader has



measurement skills, but they often don't because they never had to develop or use them. It's kind of funny - you can take a person who can have an extremely successful career at a bank trading derivatives, and if you would ask him "in order to put on a \$100,000 volatility position on the yen, what kind of capital do you think that requires?" Or, "what kind of capital base do you think you should have to support trades of that size?" And nine times out of ten they don't know.

This situation, more apparent after horrible performance for some funds in the last few years as a direct result of poor internal risk measurement, has now forced the regulator to have the prime brokers (i.e. banks) essentially take on that risk measurement function by imposing stricter capital requirements and, thus, margining rules.

The root of the risk measurement problem is that there is, amazingly, a common mistake amongst portfolio managers to confuse cash usage of a portfolio with risk of a portfolio. Therefore many fund managers believe they are fully invested and operating at an acceptable risk only when they exhaust their unencumbered cash. Cash usage has nothing to do with the measurement of risk of a portfolio. There are many cash intensive strategies with no risk or if anything they have a long or upside risk. Conversely, a fund that has exhausted all its available cash can be running risks that are many multiples of what has been described to investors, as we have seen in the last few years – Peloton Partners is a great example, founded by two successful Goldman partners who then ironically blamed Wall Street's lending drought for their fund's demise.

You see the implications here? The problem becomes that many funds trade strategies based on how much cash they have in the till as opposed to how much capital is at risk. Prime brokers are concerned about setting margin levels related to how much money can be lost in a few days before they take possession of trades and close them out themselves, which results in a much smaller margin requirement than if they looked at how much money can be lost in those same trades in a month or a year.

If fund managers use those prime broker margin requirements as a guideline for risk, then they have effectively sized their investments for a potential drawdown of the entirety of their capital base in a downside scenario of a few days. And the ironic thing is that now regulators are raising capital requirements at banks having recognized the lax risk measurement tools at many funds (or lack thereof) and their erroneous use of prime broker margin requirements as a risk measure, and therefore prime brokers decrease lending as a result -- since the funds fail to have an effective risk measurement role, they are forcing the banks to provide that function with stricter guidelines. It's kind of full circle again, traders focus on risk management and banks on risk measurement. And that is precisely from a micro perspective how the mechanism has to work. Regulators basically have to instill sound risk management approaches in funds by force, simply because it has never been properly done before. As I said, a lot of fund managers have never had to do it themselves throughout their careers.

It's a sad case that nine times out of ten the one of two major skills required to be an effective and successful fund manager usually comes with zero experience, and people rely on those folks.

A lot of strategies and thus fund managers get away with it because there is a lot of "rules of thumb" around them – long/short is a great example. I haven't met many long/short managers with a good concept of VAR or of risk or of correlation of trades within their portfolio. They usually seem to be putting on the same positions six times in six different ways. So they don't have a great understanding of their portfolio risk quantitatively, but it's a strategy where there are enough rules of thumb that managers get instilled through both working at other funds and more relevantly within the margin framework of prime brokers, since they've learned their lessons with respect to those strategies, and they have been around the longest. So also here in effect a sound risk management approach is force-fed.

Overall, I think there is nothing wrong with regulators forcing funds to manage risk effectively and in a disciplined and responsible way. It should be entirely encouraged and enforced.

Paul Barbour

When Ian talked about the future of financial regulation, it's interesting how much of it was aimed towards the banking sector and the need to improve the capital adequacy rules. I believe the interesting thing to look at from our standpoint is how the fund management sector will be affected going forward by the need to reform adequate capital in all leveraged financial businesses.

About a decade ago, we were visited by officials from one of the major international regulators. I discussed the LTCM crisis with them and the chances of a similar event being repeated. They responded that they were relatively relaxed about the potential for contagion being triggered by the hedge fund sector, because the financial risks were now so well diversified throughout the global economy. I think most people now would consider that degree of comfort in the system to be misplaced. I would rather say that going forward the hedge fund sector will be pulled into the global regulatory oversight trend.

For example, the AIFM regulations can be seen as an effort to have funds domiciled in Europe. This will open the door to the onshore regulators seeking to delve further into the balance sheet for the funds themselves and have more control over what's held on the balance sheets and the capital supporting them.

Ana Haurie

I actually think that regulation is having a significant impact on our business. I understand the points that you are making about risk management and I also agree with the capital adequacy points. But what worries me is what Chris had described so adequately as the borough approach to regulation. It is a patchwork.

The directive also shows a huge amount of ignorance about hedge funds and whether they cause systemic risk. We should ask the questions - if it really is about systemic risk, why is private equity and real estate caught in the scope of the directive? I am also worried that with each version (whether it goes to the Parliament or the Council) seems to get worse and worse. There is absolutely no certainty at the moment as to the detail of the outcome, but the ultimate outcome of that directive certainly will have a major impact on the whole alternatives funds industry, not just hedge funds, and we will all have to consider new rules around depositors and strict liabilities.

I think these issues are not really about reporting and transparency. We all agree, I believe, that reporting and transparency are sensible measures, which could be done at the G20 level in a globally coordinated way. Then on top there is uncertainty with third country managers. Are we going to end up in a protectionist environment? How is the U.S. SEC going to react and respond? Will more countries be like Germany and come in with their own restrictions at the domestic level, for example suddenly imposing a ban on short sellers?

Now we've got the Dodd-Frank Bill about to become law, which will change the face of U.S. financial services further.

How will all these extra territorial issues further develop, like the U.S. with their Foreign Account Tax Compliance Act (FATCA) saying that if you get any revenues from the U.S., you have to report them, if not we are going to impose a 30% withholding tax on you, and so on.



Dexion Capital is regulated by the U.K. FSA, and even here on our home turf regulators are becoming so much more intrusive. If you want to bring on a control function or a non-executive on to the Board, these people will now be interviewed by the FSA for three hours. A large amount of my time is being spent on internal operational regulatory issues and the decision-making is being paralyzed at times, when we encounter a "grey" area. I see the problem coming as the FSA moves away from principles to rules based, more intrusive regulation.

Ana Haurie

On the one hand we have to deal with AIFMD, of which I think many aspects are very bad. I believe the motivation behind that directive is mainly political. The directive also shows a huge amount of ignorance about hedge funds and whether they cause systemic risk. We should ask the questions - if it really is about systemic risk, why is private equity and real estate caught in the scope of the directive? I am also worried that with each version (whether it goes to the Parliament or the Council) seems to get worse and worse. There is absolutely no certainty at the moment as to

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So how am I growing my business? I have to invest and build out my business in compliance, accounting, and finance. It is not just the capital costs that we have already touched on - it has become very expensive to do business.

Louis Gargour

I believe that the regulators are acting post event. If one looks at the mortgage-backed market pre-crisis, they assumed that subprime default rate was between 5-6%, while the observed subprime default rate across the USA was in fact 18%.

The entire subprime crisis was based on two factors. One, an abundance of capital and overleverage; and two significantly less aggressive default expectations and models of default expectations than reality has shown empirically.

Therefore the regulator might use two methods to avoid problems in the future

1. Limit leverage,
2. Increase provisions margins and oblige more stringent stress tests

If one looks at the European and US regulators, they have reduced access to leverage by obliging banks balance sheets to be rebuilt, they have regulated tier 1 capital ratios, and they have made capital available to the banks, but with the caveat that lending needs to be prudent or else. In fact the ultimate regulatory footprint is found in the U.K. and in the U.S., where several large bank institutions were nationalized in the case of RBS, or semi-nationalized the case of Citibank and Lloyd's.

The second method by which regulators can exert control is the requirement of stress tests. Interestingly, this is precisely what we are seeing happen in Europe this month.

Unfortunately, the regulators did not do their jobs at the time of excessive leverage and increased risk of systemic melt down.

Therefore, the real question regarding supervision and regulation is what are they are going to do going forward to avoid the next bubble, which is invariably going to come. As always, greed will create the next bubble. My view is that with risk-free investment returns as low as they are now, investors will begin to seek higher returns and commensurate higher risk, and once these returns have begun to come down as a result of demand and supply, they will begin to leverage the higher

returning asset classes in order to increase returns. This of course re-creates the bubble theory of leverage and risk where leverage increases, and perceived risk diminishes.

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Louis Gargour



Matthias Knab

We mentioned several times the risk in UCITS. We said they are a time bomb, UCITS could be the next scandal. How do deal with this? Is there a way to deal with this upfront?

Louis Gargour

UCITS is offering a unique opportunity for investors to buy alternative managers and alternative strategies in a regulated easily distributable and retail-sized product offering. I think the danger is that not all UCITS are created equal, so homework on the manager, strategy, infrastructure risk management and investment management process must still take place. UCITS is not a filter for bad managers, UCITS is a vehicle by which good managers and alternative strategies can be more widely distributed.

Ana Haurie

Certainly a lot of investors who like UCITS feel they have a regulatory stamp of approval and are therefore safe. UCITS have come as a reaction to the crisis, but I share Olivier's concern that when the time comes, they will also gate and suspend.

Joe Taussig

What drives these regulatory moves is that the regulators can't just say "we're going to eliminate the hedge fund industry", but they can say "we are going to make the hedge fund industry behave

in certain ways: The UCITS is the tried and true way for investors to be protected in the process, and so we are going to set the framework up so if you want to play in Europe, you are going to play through UCITS."

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I would say this is a sad development. Interestingly, most of my partners are Americans, and I think they haven't a clue about what is coming here. The Americans used to mine for assets of Europe constantly with impunity. This is going to change dramatically. They are going to have other structures going forward, which affect them operationally as well. I don't think that at this point they are mentally equipped or prepared to think about all the requirements and implications. It is going to be a real shock to them.

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Olivier Lebleu

One thing we can do to make sure the introduction of more alternative strategies within UCITS does not go wrong would be a buyer's strike. As a Frenchman I can talk about strikes, we are good at that. We can refuse to buy them. This could be the number one or maybe a more or less appropriate way to demonstrate to those hedge fund managers who manage both their traditional funds in whatever format and jurisdiction, as well as a UCITS fund, that they understand our preferences.

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The second thing is to make sure that hedge fund buyers generally perform the kind of due diligence that they should be doing. One aspect that we worry about is exactly Joe's point. I would strongly recommend that investors or buyers look through the current format of how UCITS are pitched, which is "show me the benefits", and instead check on the investor disadvantages. Let me decide whether or not the investor disadvantages are worth something to me. And if they are, what's the price of that? Because let's not forget that these UCITS are not coming at a bargain, they are not a cheaper version of something else.

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strongly recommend that investors or buyers look through the current format of how UCITS are pitched, which is “show me the benefits”, and instead check on the investor disadvantages. Let me decide whether or not the investor disadvantages are worth something to me. And if they are, what’s the price of that? Because let’s not forget that these UCITS are not coming at a bargain, they are not a cheaper version of something else. As often in such cases, the product is usually a mutated version of something that already exists, but certainly not that much cheaper.

With UCITS, Europe has now an equivalent of the U.S. Investment Advisers Act of 1940. If a product is UCITS, it will go into private banking channels, direct banking channels, et cetera. If it’s not UCITS, then it doesn’t. So they are retail in the sense of where it goes in distribution channels, but not necessarily in terms of design of the investment instruments.

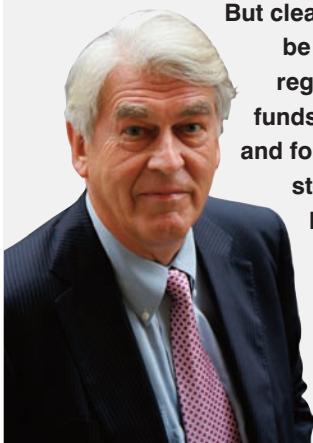
Matthias Knab**Is there a way to identify a good UCITS? What should people look out for if they study this universe of UCITS out there?****Chris Keen**

A lot depends on what you are comparing the UCITS with. If you are comparing them against a mutual fund, then UCITS have a kind of hedge fund flavor, which may be seen as an improvement. I’m not a UCITS or mutual fund expert, but I can understand how a long only mutual fund investor, particularly coming through bad experiences in the last few years, might look over the wall and compare his results with what was going on in hedge funds. While things here are not brilliant in all respects, hedge fund performance might well look like a better proposition than the typical long only mutual fund. Unfortunately, for the hedge fund manager, it is difficult to explain to that potential customer the distinction between what is going on in his hedge fund versus the watered down more limited UCITS compliant alternative.

We operate in a regulatory environment where it’s not straightforward for many hedge fund managers to communicate with the wider investing public, notwithstanding the fact that there are some excellent examples represented here today of closed-ended products that set out to convey that message.

Ian Plenderleith: I think it's not just a question of UCITS, in terms of whether there will be some disaster down the road and what the kind of remedy is. The bigger question, which Chris effectively put his finger on, relates to the interest within the retail market to get some of the investment return benefits of wholesale market type instruments.

In the modern world, we are perfectly capable of packaging wholesale type investments in a way that make them available to the retail investor. That seems to be a highly desirable thing and it gives a broader range of people a better chance of earning a decent return on their savings.

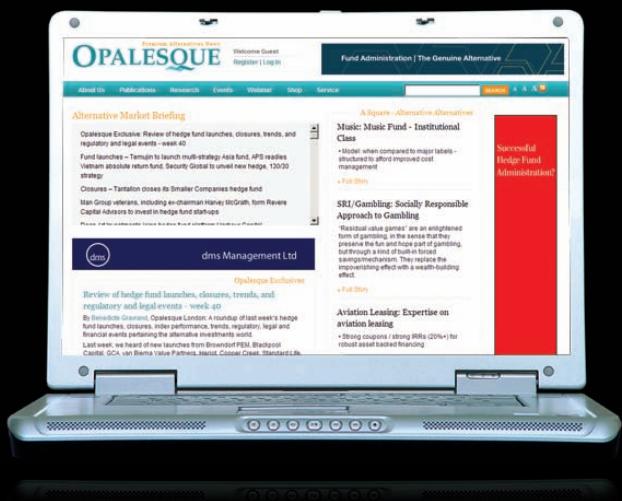
But clearly, now an investor has to understand the risks. There are number of ways in which this can be done. Just because one route or another proved to run into difficulties, I hope very much that regulators won't make it impossible for us to run our funds. If regulators took the view that hedge funds must be regulated out of existence that would be a very negative reaction. Part of the remedy and for a proper development of our industry going forward is that we have to be prepared to tell the story about the merits of alternative investments, concepts like long-short or leverage, and the higher returns one can hope to earn at lower volatility, together with a detailed risk disclosure and explanations.

It is really up to us to tell the story and educate the world that alternatives are a different form of investment, with their own merits and that under certain circumstances they can be a better way of investing than through standard conventional equities for example.

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