OPALESQUE

Opalesque Round Table Series '11

NEW YORK

Opalesque 2011 Roundtable Series Sponsor:

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Editor's Note

Dear Reader,

Welcome to our fourth annual Opalesque New York Roundtable! The year so far has been a challenge for investors worldwide, but some **astute hedge fund managers participating at our Roundtable were still able to deliver positive returns to their investors.** For example, many relative value Mortgage Backed Securities (MBS) strategies delivered double digits returns to investors YTD. Veteran hedge fund manager Bill Collins overweighed Credit Opportunities at 75% and was able to keep his event-driven fund in positive territory as well.

The Pendulum Swings Back: "Size kills, and absolute size kills absolutely"

Hedge fund administrators report that the large majority of assets flowing into hedge funds are still allocated to the very large funds. Emerging managers launching new funds face more and higher hurdles than before, but that does not deter them to set up shop – service providers tell us they have a **substantial pipeline of managers hoping to launch in the next 6 to 10 months.**

Historically, emerging managers tend to outperform the larger funds - there are various studies about that, and a lot of good, logical reasons. Read in this Roundtable why industry observers believe the pendulum may soon swing back favoring smaller managers, and why investors may soon ask questions like **"why am I invested in this big guy who is not quite performing like he used to?"**

The Roundtable also includes an **in-depth analysis of the current debt crisis and a painful, but clear perspective where things are heading in Europe and the U.S.**

The Opalesque New York Roundtable was sponsored by Custom House Group and Taussig Capital on September 14th at the Opalesque office in Manhattan with:

1. **Andy Ball,** Portfolio Manager, West Side Advisors
2. **Bill Collins,** Founder, Brencourt Advisors
3. **David Freelove,** Managing Director, Del Mar Asset Management
4. **Joe Taussig,** Taussig Capital
5. **Katiana Guzman MacNabb,** Co-CIO, The Caravel Fund (International) Ltd.
6. **Scott Price,** Custom House Group

In addition, read about:

- **The new reality of hedge fund investors: how investor expectations adjust to reality**
- **What is "shadow accounting", and how does it happen in the hedge fund world?**
- **What drives the current M&A cycle, and how long will it continue?**
- **What investors require from new or emerging managers**
- **Why the smart money is going now into Emerging and Frontier markets**
- **Why "we are flexible" may be the old hedge fund paradigm as investors demand higher degrees of specialization in products and strategies**
- **Opportunities and challenges of the $12 trillion U.S. mortgage market and why investors should we aware of the differences in mortgage backed securities investments**

Enjoy "listening in" to the Opalesque 2011 New York Roundtable!

Matthias Knab
Director Opalesque Ltd.

Knab@opalesque.com

Cover Photo: Nwe York

Participant Profiles

(LEFT TO RIGHT)

Matthias Knab, David Freelove, Joe Taussig, Scott Price, Andy Ball, Katiana Guzman MacNabb, Bill Collins.

Introduction

David Freelove
Del Mar Asset Management

I am the Founder and CEO of Del Mar Asset Management. We manage about $850 million. We are an event driven investment advisor with expertise in corporate action credit, special situations equity and derivatives. We have been around for six-and-a-half years and are generating returns that have a very low correlation to major market indices.

Joe Taussig
Taussig Capital AG

We partner with hedge fund managers to create insurance companies and banks where the manager runs all of the investible assets of the entity as permanent capital. These companies are similar to Greenlight Capital Re, which is publicly traded, and Third Point Re, which was announced last week.

Scott Price
Custom House Global Fund Services

I am the Vice President of Custom House Global Fund Services where I head the Chicago operation. We are a full service fund administration firm and administrate about $53 billion dollars of assets, representing about 600 funds and about 240 investment managers globally.

Andy Ball
West Side Advisors

I am a portfolio manager at West Side Advisors which employs a relative value Mortgage Backed Securities (MBS) strategy. Gary Lieberman founded West Side in 1997 and today we manage approximately $350 million in Agency MBS - primarily mortgage derivatives, such as Interest Only (IO), Inverse IO (IIO) and Principal Only (PO) securities. We look for inefficiently priced securities in the Agency MBS market that are poised for capital appreciation, while earning interest income. We strive to hedge out interest rate and prepayment risk and work to produce consistent returns. David mentioned correlation; we also seek to produce non-correlated returns to the equity and other fixed income markets.

Katiana Guzman MacNabb
Caravel Management

I am the co-CIO of Caravel Management. We are long-only equity investors focused on emerging and frontier non-BRIC countries, managing $200 million.The company was founded by James Harmon, who used to be Chairman of Schroder Wertheim and also Chairman of the EXIM Bank of the US. We believe in the tremendous potential growth in emerging markets, particularly the frontier markets.

Bill Collins
Brencourt Advisors

I am the Founder and CEO of event-driven manager Brencourt Advisors. We started Brencourt in 2001 and prior to that I was at Furman Selz where I started and ran an event focused fund, Taurus Capital from 1993 until the end of 2000.

Brencourt manages three core event-driven strategies: Credit Opportunities, Equity Special Situations, and Merger Arbitrage. Each core strategy team works to identify definable and investable corporate events that are expected to occur in 12 months or less. This shared focus allows for the cross fertilization of ideas as well as the opportunistic allocation of capital from a strategy that has an opportunity set that is contracting to one that is expanding or stable. Our goals are to achieve absolute returns with lower volatility and lower correlation to the broad based market averages. We tend to outperform in flat to down markets and slightly underperform in big up markets. so naturally we spend a lot of time thinking about risk management and capital preservation.

Matthias Knab **2011 has been a challenge so far. The markets are choppy and volatility is high. Where do you see opportunities for your fund or for your investors?**

Andy Ball 2011 has been an interesting year for mortgage strategies in general. Our current strategy benefits from low short-term interest rates, as well as low levels of mortgage refinancing activity. Tight lending standards during the past three years have resulted in very low levels of refinancing, especially compared to what we saw in 2002 and 2003 which was the last major refinance wave.

This has produced a significant opportunity to purchase IO and IIO securities, which benefit from these circumstances. In addition, we are able to trade in and out of these securities as interest rates fluctuate and refinancing expectations change. The nice thing about Agency securities is that you are primarily dealing with interest rate risk, not credit risk, as the securities are backed by the full faith and credit of the underlying Government Sponsored Enterprise (GSE or Agency). In the case of Ginnie Mae securities, this is directly the Federal Government. In the case of Fannie Mae and Freddie Mac, the government has injected billions of dollars into both institutions and has firmly stood behind the credit of the securities issue. While credit is not a primary risk, we can actually hedge the interest rate and prepayment risk, that is, the risk that interest rates fall and more people are able to refinance their existing mortgages at lower rates. A few possible ways in which we hedge this risk is by purchasing 10-year Treasury securities, 10-year swaps or mortgage pass-through securities to actually hedge against a decline in interest rates.

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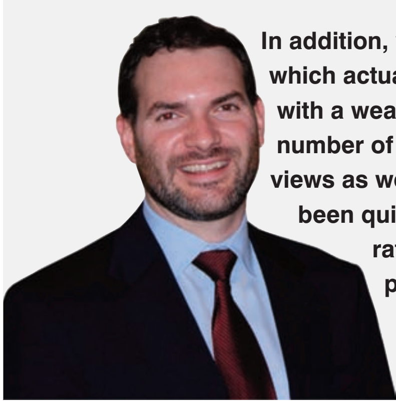

In addition, you can buy what's called Principal Only (PO) securities in the structured CMO market which actually benefit when prepayments pick-up. The Agency MBS market presents investors with a wealth of potential different trades and truly represents its own strategy. There are a number of different structured mortgage products that allow investors to express different macro views as well as views on the likelihood that refinancing activity increases. So while markets have been quite volatile and interest rates have declined significantly, the CMO market and interest rate markets present us with opportunities to hedge many of the imbedded risks of our product.

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One of the most difficult things this year has been the potential for government intervention with proposals to change the rules of refinancing, allowing more people to refinance at lower interest rates.

The government has considered implementing additional programs or changes to current programs to help borrowers refinance, allowing them to access lower interest rates. Unfortunately for borrowers, there are many operational and political reasons why there should not be large-scale changes to existing programs. In essence, while looser credit standards would help many borrowers refinance, this would reinstitute some of the worse underwriting guidelines and loose credit standards of the mortgage boom. The credit pendulum has swung too far in one direction and will slowly reverse itself but mortgage originators have been very cautious about taking on credit risk.

Currently, there are two government programs that have been in existence for the last two years. One is HAMP, which helps delinquent borrowers modify their mortgage. The other is HARP which actually helps borrowers who are current on their payments but underwater (appraised value of the home is less than what is owed on the mortgage). While these programs have helped some homeowners avoid foreclosure and others refinance their mortgages, they have not been as successful as the government wanted. The government may alter these programs to make them more successful and reduce frictions for underwater borrowers allowing them to refinance. However, I think the lack of success of the current programs show the limitations of the government's ability to impose programs and solutions on the private sector. We believe any new programs will face many of the same limitations as the current programs.

Matthias Knab **Can you give us more background on the sector of hedge funds that engage in the mortgage space?**

Andy Ball Certainly. The mortgage market itself is roughly $12 trillion in size. Roughly $5 trillion of that is in Agency wrapped Mortgage Backed Securities (MBS). The Agencies include Freddie Mac, Fannie Mae and Ginnie Mae. The Agency structured products market (CMO or Collateralized Mortgage Obligations) is roughly $2 trillion in size and has operated since the mid-80s. As far as structured products are concerned, they are quite mature. $2 trillion of the mortgage market is securitized in non-Agency or private label securities while the balance ($5 trillion) exists as loans on bank balance sheets.

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The primary risks in many Agency securities is interest rate and prepayment risk. In the private label (non-Agency) market, credit is an additional risk and in many instances is the primary risk. Hedge funds in the MBS space often invest in both Agency and non-Agency securities. Because we believe the risks are quite different, we only invest in the Agency side giving our investors a more targeted investment and risk allocation, we are one of the few hedge funds in the mortgage space to do so. I think it's important for investors to understand the differences in MBS investments and allocate appropriately.

Andy Ball

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As I previously pointed out, one of the main risks in Agency MBS is prepayment (refinance) risk. The last big refinance wave we saw was 2002 and 2003 when credit was widely available and home prices were headed higher. However, during the last three years, following the contraction in lending, many borrowers are underwater on their mortgage and unable to refinance at lower rates.

More specifically, in 2009 the market expected refinancings to be substantively higher than they actually were and securities re-priced higher to reflect the adjusted forecasts. However, this is not necessarily a buy and hold strategy and investors can hedge against a pick-up in refinancing behavior or a dip in interest rates. We believe modeling refinancing probabilities and hedging against an increase is one of our competitive advantages over others in the MBS space.

Matthias Knab **Scott, which developments and trends do you see from your perspective as a fund administrator?**

Scott Price We have seen substantial inflows into the larger funds we administrate. Unfortunately, for our emerging managers, things have become much more difficult in the current climate. Emerging managers are under intense pressure to launch as soon as possible to ensure they capitalize on whatever investment commitments that initially spurred them to start a fund. However, with the focus on compliance and due diligence in the current environment, establishing a fund can take much longer than they expect. Unfortunately, many managers find that the investments they were initially promised have dried up by the time the fund has been established. That's why Custom House focuses on helping emerging managers. We have a lot of experience establishing funds and can help emerging managers get their funds established as quickly and as painlessly as possible.

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Scott Price

Intuitively, it makes sense that the majority of inflows are coming into our larger and more established funds. I believe that many institutional investors feel that there is safety in numbers. Is that true? Maybe, but recent history has provided some evidence to the contrary.

Matthias Knab **But the emerging managers keep coming, right?**

Scott Price Absolutely, the emerging managers keep coming - we have many funds in the pipeline hoping to launch in the next 6-10 months. As far as the strategies go, we have seen a good mix. We have seen increasing activity in property, land, and other such Private Equity vehicles.

We also see an active interest from our investors to negotiate and improve liquidity terms. This obviously depends on the underlying strategy but the take away is that investors are increasing their demands on managers. Many of these demands could be costly for a manager and I think this is a contributing factor when we talk about the struggles of emerging managers. I can speak from experience that daily valuations are costly and smaller managers may have trouble footing the bill.

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Another area where we as a firm are seeing increased activity is regarding our shadow accounting service. Shadow Accounting is typically requested by either self-administered funds or for funds that have smaller name administrators. The back office function, either the administrator or internal valuation team, could be doing a perfectly great job with the NAV, however, investors could be uncomfortable with the valuation process. What Custom House does in these scenarios is to produce a second book and records which serves as a check against the valuation produced internally or by another administrator. This provides investors with additional level of comfort without having to change a valuation process that is working fine. It is also more cost effective than a full administration service. The demand for this service just reinforces that the increased investor demands and the level of due diligence that investors require on investment managers have become a lot more extensive than ever before.

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We also offer a lot of compliance support to our clients to help them to address and prepare for the big unknown of the coming regulations that are coming through in different parts of the world. We invested internally to build this expertise and technology solutions in-house to support our clients. Before 2010, there was limited demand in these areas but now these services are expected from a top tier administrator.

Coming back to the inflows, we are seeing massive inflows into our top 25 largest clients but unfortunately the emerging managers are probably a bit pushed to the sideline because of that.

Andy Ball What reverses that trend? I mean, what makes people gravitate back towards smaller managers? How important is performance now to the investors versus other metrics like size and name recognition?

Scott Price

It is strange to say but, performance has become almost a secondary consideration for investors. Think about what it takes to run a successful asset management firm today. A lot of the demands and challenges a start-up has to deal with today are rather outside of the scope of a successful trader. A new manager coming into the market today has to deal with things that probably three years ago he would never have had to deal with. Today investors expect him to have a very clear marketing pitch, a very detailed business plan, compliance functions etc. I would say that only those emerging managers that can address and communicate these issues to investors are the ones that are successful.

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Scott Price

Joe Taussig

I believe it will rotate. The emerging managers historically have always outperformed the big guys. There are various studies about that and a lot of good logical reasons. During a financial crisis, nobody invests in anything, but when they start to allocate again, people tend to go with the big, recognized names because it is like in the days when people bought computers, nobody got fired for buying IBM. As long as every name was recognized, that made it easy for the people overseeing the investment and allocation process. But down the road, the emerging managers will likely outperform and then people may start wondering and ask questions like "why do I have this big guy who is not quite performing like he used to?" To paraphrase Lord Acton, "Size kills, and absolute size kills absolutely".

I am kind of curious though, are many of these launches people leaving the traditional banks because they are required to shut down their prop trading due to Basel III and all that?

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Joe Taussig

Scott Price

That is correct, some people spin out of banks but still, at this point, the majority of the managers that we speak with are actually coming out of large hedge funds. They have decided to go on their own and not be a part of the larger fund any more. These are second or sometimes even third generation hedge fund managers. Custom House has a real commitment to the smaller managers, it is to a certain extent our bread and butter. Our firm was set up in 1989, and the firms who are today our largest clients - like Winton and Bridgewater - all started with us when they weren't the size they are today, so we really know this space and demands.

David Freelove

Looking at opportunities over the last couple of months, we have experienced, like everybody else, unprecedented volatility. But I think what is unique is the extent of volatility on the upside. If we look at 100 years of data, you have not seen anywhere near the number of up days that we have had in the last six weeks or so. That has driven correlations into the 90s when even back to 2008, correlation was only realized in the 69 or 70 range. That is a sort of bad news.

The good news is if you have done your work and you are prepared, the markets do create temporary dislocations on the pricing side, for a variety of reasons. For example, an investor may have to get out of a position which can really magnify those price swings. A lot of hedge funds are stepping into the market at such points because if you know what you are buying and if you are ready and prepared, you can purchase something at very attractive levels. That is how we have positioned ourselves at our fund, but it requires a lot of focus, a lot of attention to detail and being nimble, and that is not always that easy.

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David Freelove

Katiana Guzman MacNabb

It is interesting what David just mentioned about the dislocation on the fundamental side. If you look at the emerging and frontier markets where we are active, economic growth will likely be sustained at about 6% for next two or three years, and for the most part these countries have low debt to GDP.

Ironically, they went through the crisis 20 years ago and many of those countries were lectured by most of the developed countries about maintaining low debt. They have learnt their lessons, and now we have the inverse situation, it is really ironic. We see huge opportunity in emerging markets on valuations, because more than any others they retained the ability to stimulate their economies. The can still cut interest rates, they have the ability to fund infrastructure projects, their reserves are at all time highs, and many have been working on diversifying their economies, boosting domestic consumption and not being completely dependent on exports to any one country/region.

Everyone worries about China and their export story, but we also see how they push their domestic demand. Countries that traditionally used to be seen as completely export dominated, such as Mexico, are doing more internal investments. Of course, a lot still depends on what happens in the US., but in general these countries continue to develop their internal consumers and towards a greater diversification of their export base.

I think the flight from emerging markets is not so much a concern about Emerging Market fundamentals, as just taking all risk off the table and increasing cash levels. Once we have some stabilization around the global macro issues in Europe and the U.S., Emerging Markets are in the best position to benefit in the next two years and I believe money will be directed into those markets first.

Frontier markets are completely uncorrelated to what is going on elsewhere. The dynamics in places like Kenya or Rwanda is more about what they are doing with their internal policies and investments over the next five or ten years.

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Katiana Guzman MacNabb

Matthias Knab **In which frontier countries have you made investments and which countries are on your watch list, can you give us the details?**

Katiana Guzman MacNabb We are invested throughout Africa in Rwanda, Kenya, Nigeria, Botswana, Zambia, Nigeria and Zimbabwe. In Asia we are in Vietnam, Bangladesh, Pakistan, and Peru and Columbia in Latin America.

We have Mongolia on our watch list and we also observe developments in Iraq, but it is very unstable at this point. There is huge potential in some of the African countries if they ever open up like Ethiopia or Angola, but they are really more of a private equity environment right now.

Sri Lanka is interesting, but it is expensive. There are always political concerns in the Middle East, but there is a lot of growth potential. One place people sort of dismissed because they consider too wealthy is Saudi Arabia, but Saudi Arabia has a very young population - 50% is less than 20-years-old. The next stage of development for Saudi Arabia is developing its internal economy, and not being completely dependent on oil. It is actually quite a deep market and quite interesting, people do not pay enough attention to it.

Long only is a tough strategy to pull off this year in our strategy. Emerging markets are off 14% YTD. It is a very difficult strategy to hedge. Long/short strategies can work principally for the larger markets, but for now most of the smaller emerging and frontier markets do not allow you to short their stocks, this remains a problem. To a certain extent hedging can be done on the currency side.

Bill Collins

We are in the event-driven sector and are pleased to be able to report slightly positive performance year–to-date despite what has been a very challenging year for the event-driven space.

Looking at 2011, our disciplined approach to risk management and opportunistic approach to core strategy allocation have been key to our modest success. Historically, our portfolio might have 10-30% in Merger Arbitrage, 20-40% in Equity Special Situations, and 30-50% in Credit Opportunities. Unlike the majority of event managers, in 2011 we overweighted Credit Opportunities at 75%, held Merger Arbitrage steady at 10-15%, and earlier in the year had about 10-12% in Equity Special Situations but took that down to less than 5% at the end of June due to our concerns about global events, particularly those unfolding in Europe.

We focus on North America and Western Europe. Our view on the current events is of course influenced from having managed capital through many cycles in the past and having gone through too many Black Swans over the years – you know, those once in a lifetime opportunities that seemed to happen every five or six years. We believe the current environment can be compared to maybe the late 70s where we had a lot of structural change following the oil shocks that significantly affected Western economies and markets over the following decade. What I mean by that is I believe today we are going through a structural change, not cyclical issues. The last time we went through this, it took the U.S. about ten years to come out of it. This structural change is being driven by deleveraging.

When Canada hit the wall on their debt situation a couple of decades ago, it took them about ten years to get their economy and their debt situation right. Now they are considered a healthy economy. New Zealand went through a similar process and it took them ten years as well to come out of it. We believe we are in maybe year three of a ten-year process for Western Europe and North America, and that the main theme is deleveraging.

One of the problems is that many U.S. companies expanded capacity during the 2004-07 period, most of that was debt financed in anticipation of 4-5% GDP growth. As a result, several companies and industries have too much capacity and that leads to capital structures that need to be rationalized which suggests the event space will be active and opportunity rich over the next five years as mergers, asset sales, debt for equity swaps and other restructurings take place. At Brencourt, we are working to approach this structural shift with an arbitrage mentality rather than a directional approach that relies on binary outcomes. I think most people would agree it is highly unlikely for the West to achieve 4-5% GDP growth over the next five years. So we will not be able to simply grow our way out.

Again, we think it's too difficult to take a directional approach in this environment. When securities move 5% intraday like we've seen over the last three months, it is very hard to be a directional investor making one way bets. That said, this same volatility presents a good deal of opportunity in the form of asymmetric investment opportunities. An example would be setting up a capital structure trade in our credit portfolio where if we are completely wrong we break-even, and if we are right we can make maybe mid-teens returns.

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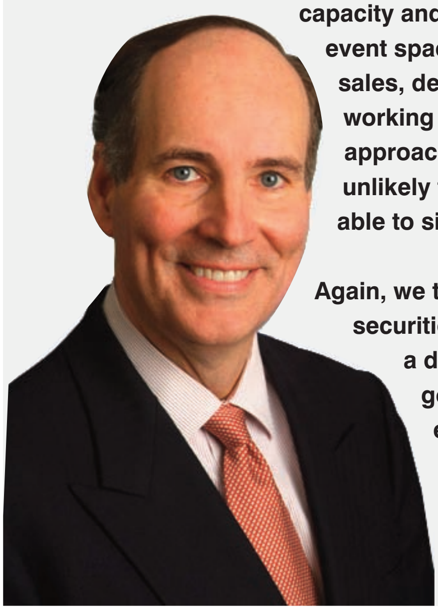
Looking at 2011, our disciplined approach to risk management and opportunistic approach to core strategy allocation have been key to our modest success. Historically, our portfolio might have 10-30% in Merger Arbitrage, 20-40% in Equity Special Situations, and 30-50% in Credit Opportunities. Unlike the majority of event managers, in 2011 we overweighted Credit Opportunities at 75%, held Merger Arbitrage steady at 10-15%, and earlier in the year had about 10-12% in Equity Special Situations but took that down to less than 5% at the end of June due to our concerns about global events, particularly those unfolding in Europe.

We focus on North America and Western Europe. Our view on the current events is of course influenced from having managed capital through many cycles in the past and having gone through too many Black Swans over the years – you know, those once in a lifetime opportunities that seemed to happen every five or six years. We believe the current environment can be compared to maybe the late 70s where we had a lot of structural change following the oil shocks that significantly affected Western economies and markets over the following decade. What I mean by that is I believe today we are going through a structural change, not cyclical issues. The last time we went through this, it took the U.S. about ten years to come out of it. This structural change is being driven by deleveraging.

When Canada hit the wall on their debt situation a couple of decades ago, it took them about ten years to get their economy and their debt situation right. Now they are considered a healthy economy. New Zealand went through a similar process and it took them ten years as well to come out of it. We believe we are in maybe year three of a ten-year process for Western Europe and North America, and that the main theme is deleveraging.

One of the problems is that many U.S. companies expanded capacity during the 2004-07 period, most of that was debt financed in anticipation of 4-5% GDP growth. As a result, several companies and industries have too much capacity and that leads to capital structures that need to be rationalized which suggests the event space will be active and opportunity rich over the next five years as mergers, asset sales, debt for equity swaps and other restructurings take place. At Brencourt, we are working to approach this structural shift with an arbitrage mentality rather than a directional approach that relies on binary outcomes. I think most people would agree it is highly unlikely for the West to achieve 4-5% GDP growth over the next five years. So we will not be able to simply grow our way out.



Again, we think it's too difficult to take a directional approach in this environment. When securities move 5% intraday like we've seen over the last three months, it is very hard to be a directional investor making one way bets. That said, this same volatility presents a good deal of opportunity in the form of asymmetric investment opportunities. An example would be setting up a capital structure trade in our credit portfolio where if we are completely wrong we break-even, and if we are right we can make maybe mid-teens returns.

Bill Collins

Those are the kinds of things that we are looking for and in the current environment we are finding them most often in in the mid and small cap space or for large caps maybe in the high yield end, but it is becoming more crowded there. We believe too many people are chasing yield in that space and some of the bigger capitalizations are priced too rich. We think as you go through this restructuring over the next 5-10 years, the smaller and mid-capitalization space will likely continue to be a source of attractive opportunities and that these opportunities will exist in both credit and equity.

We are in the middle of an M&A cycle right now, and that M&A cycle has two themes. One is rationalization of businesses where there is too much capacity: for example hotels, retailers, utilities, cell phone operators, airlines, hotels, mid-sized banks, mid-sized insurance companies, home builders. Excess capacity will be taken out through M&A.

The second big driver is big businesses will buy smaller ones. The large firms have already done their cost cutting and rationalized their businesses. In a 1-2% GDP world, where is top line revenue going to come from? I believe the large businesses are going to buy it, and they have a distinct advantage today as Fortune 100 or Fortune 200 companies can go to the market and issue 5-7 year debt at 1-2%.

I sit on the board of a few mid-size private companies. During the last couple of years, they have not had access to high-yield markets and, as a result, must go borrow money from the banks. But the banks charge higher rates and usually want security on your assets. It is very hard to be competitive in a 1% GDP world if you are forced to grow your business while borrowing at 6% secured and your larger competitors are borrowing at 1% unsecured.

The option for many of these companies is going to be a sell, rather than try to build. With 5% or 4% GDP growth, maybe those firms can grow their way out, but in the kind of world that we think we are going to face, I believe selling will be the preferred option, so we should see a robust M&A cycle.

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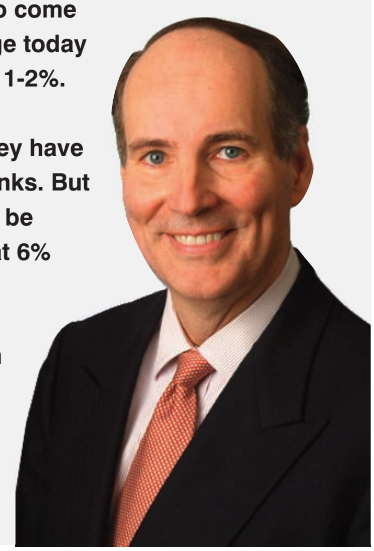

The opportunity set associated with Equity Special Situations space is starting to expand as companies have begun breaking themselves up in order to realize the sum of the parts valuation. Also, shareholder activism, where activist investors push for the similar outcomes is starting to pick up. Despite the increase in event friendly activity, we remain underweight the space because it's difficult for this strategy to realize its investment goals in the current volatility. If you want to hedge some of that market exposure, that hedging becomes 1) very expensive and 2) the correlations aren't as dependable as they are during periods of stability. The issue of how markets behave during periods of instability is exactly why we are currently overweight Credit Opportunities which relies on its ability to extract value from opportunities that volatility creates within the capital structures of various companies.

A good example is a an opportunistic trade we did in August when we had the first round of worries about the French Banks, and specifically about Société Générale having liquidity difficulty. Société Générale senior debt traded from par to 85, these were senior bank notes with short maturities. We bought the senior debt at $0.85 on the dollar and bought out of the money puts on the equity that would have brought our cost down to about 50 in the event of a bankruptcy. My own view was that even if Société Générale got cut off from financing, you would get a French solution - the French government would likely come in, put in equity and establish credit lines. It didn't seem likely to us that France would let Société Générale go under.

That disconnect between where credit has been trading and where equity has been trading allowed us to set-up a trade where we felt hedged to the downside in a very disastrous scenario and with an attractive upside opportunity. Within two days after having put that trade on, the French government came out and said they stand behind French banks, Société Générale said they had adequate funding, and the bonds traded from 85 back to 94, 95. We sold our bonds and kept the puts.

This week we reloaded on the same trade. We are still long the puts and the bonds traded back down to 85. I suspect that at some point the volatility may give us a chance to trade on that multiple times. Again, we are working to maintain an arbitrage approach in this environment. It's simply too difficult to make directional bets based on binary outcomes in the current environment.

Société Générale is not a good example of this but the majority of the arbitrage opportunities we like are coming from small and mid-cap names. Bottom line: there is a lot of financing that needs to get done and a lot of debt that is going to have to be rolled in the next two years. When the sun is out like it was earlier in the year, everybody was able to refinance. Right now that window is closed. I don't know what that window will be six months from now, but I like having a hedged trade that allows me to take advantage of the volatility along the way.

Matthias Knab **Now, you have referred to the structural changes that must happen in the Western world, and you mentioned a couple of countries that already successfully restructured in the past, but it took them ten years. From your experience and your analysis, can you foresee a certain sequence of events for the Western countries as they will go through their structural changes now?**

Bill Collins I am not smart enough to tell you how that is going to precisely play out, but I do think that it is a challenge for democracies to "take away the candy". In a democracy you have a tendency to elect candidates who promise to give the voters the most benefits and defer the bill to pay for those benefits to their successors. It appears that process has reached its limits. We are probably facing a period when some leader or candidate will have to stand in front of electorates and say that we have to reduce or take things away from you rather than giving things to you.

We have spent the last 30+ years promising and committing ourselves to giving more candy than we can afford. That day of reckoning has now come. If you look back to the 70s, we had a series of one-term presidents and one-term governors because there is a tendency where people vote for the other guy when they don't like what is going on. Today we are seeing that play out in Europe, and we might see the same in the U.S.

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Bill Collins

Angela Merkel's party has lost every state election in the last 18 months. Every incumbent government that I am aware of in Europe in the last 18 months has been voted out of office. Whether they were from the left or the right is irrelevant. People are voting for the other guy, because they are frustrated, they feel no one is offering a plan, and so they vote for the other guy and hope something will change for the better. In the end I believe it will be very hard for elected official to be honest about how the

last 25 years have been about maxing out the credit card, that we have flat to declining income but still have to service the debt and pay down principle.

Ultimately, that means we will spend less on discretionary items, which will be a drag on GDP which will result in lower tax revenues. As the populations in Europe and North America age, how will we meet obligations that are not funded or provided for in the budget? At some point someone will need to step forward and deliver the bad news but so far nobody has been willing to commit what many probably view as the equivalent of political suicide.

I started my career at Lehman Brothers. Pete Peterson was the Chairman of the Board at Lehman at that time, and after he left and went to Blackstone, he wrote a book in the 90s called 'Gray Dawn.' In the book he said that basically the trajectory we are on is unsustainable and will hit the wall sometime between 2010 and 2020, because that is when the baby boomers are going to be retiring, and unless we alter our Medicare and Social Security Systems we are going to go bust.

The math is the math - he wrote it in the 90s and we are there now, but we elect people who promise to give us candy and while we all agree that we have to give up something, we all believe we should give up Joe's candy but not mine, and until that changes the markets are now saying we are no longer going to let you kick the can down the road. This is having repercussions in terms of corporate board rooms, in terms of how you look at investing, how you finance your business etc. How can you properly plan for a business long term when everyone opts for the most conservative short-term strategies that ultimately do not lend themselves to employment and investment growth, all those other things that make economies grow?

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So I believe we will go through a tough period. We are focusing on companies that are undergoing stress; we do financial analysis to model how that stress will play out. In 30 years of managing money, the one thing that has been a constant in my career is that corporate change will always be there. It maybe not always good corporate change, in fact it can and is often harmful corporate change, but it occurs. I believe academic studies say that two out of three mergers are judged to be unsuccessful five years post the event, but nevertheless everybody believes they will be in that one-third category.

The average CEO's life as a CEO is somewhere between four and five years. No one wants to be a CEO that says "in my four years we did absolutely nothing, I didn't have any hits, no runs, no errors". Rather, everybody wants to swing the bat, and the outcomes can be good, they can be bad, but everybody wants to swing the bat and make their mark, and it is exactly that type of behavior that gives way to opportunity for our event-driven strategy.

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Katiana Guzman MacNabb One of the things you mention on the structural changes is a ten year period of de-leveraging, and you also briefly mentioned the possibility of a haircut. I agree, we have seen repeatedly that in order for growth to recover faster, that haircutting of debt is necessary. You can take the Argentine example, or Asia, the Asian debt crises and taking a haircut on debt allowed it to recover sooner – and compare that to Mexico which paid all its creditors back but then had ten years of subpar growth as a result because of their interest and principle obligations. Would it be healthier in your opinion that haircut be taken sooner rather than later in certain parts of Europe and perhaps in certain sectors in the U.S.?

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Katiana Guzman MacNabb

Bill Collins I certainly think the sooner you take the haircut, the better. What is the healthiest economy in Europe today, anybody know?

Joe Taussig Switzerland.

Bill Collins Yes, but I was thinking of what Iceland has done in contrast to Ireland.

Katiana Guzman MacNabb In terms of what?

Bill Collins In terms of growth. Iceland bit the bullet, let their banks go under and is growing again. The key for Iceland was that they were not in the E.U. or the Euro zone. They could depreciate their currency, they could say "take the banks, we will crash and then rebuild." Exactly to your point when Argentina defaulted, the pundits said it would be ten years before Argentina would be able to tap the capital markets again, but the truth was that Argentina was able to borrow again in three years.

Ireland should have dropped out and walked away from their banks instead of saying the government would stand behind it. It will take them a generation to pay off the debt from the recklessness of their banks. The great challenge for Europe is that there are no easy choices. I think it was Churchill who said, "Leadership is deciding among lousy alternatives, if it's an easy choice it's not leadership."

Europe is in a bind. Germany is the biggest beneficiary of the Euro, because as an export economy, they benefit from the weakness of their neighbors in the Euro zone. If Germany left the Euro, their new German marks would trade up significantly and make their exports less attractive, slowing German GDP. That said, there are rules and regulations in place to protect the Euro and these were not enforced. Greece even hired some American bankers to find ways to skirt those rules, and so countries particularly on the peripheral are in situations that are now unsustainable.

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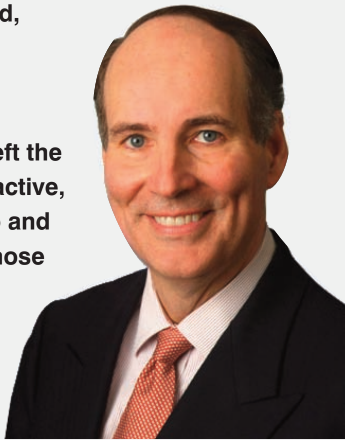

The most famous book of last year was "This Time Is Different" and Reinhart and Rogoff said that when you get to the point of 90% debt to GDP, you got about a 1% drag on GDP. We are going be at 150% in some of the peripheral countries. Most of them will be over 100%, Italy is at 120% now. The U.S. will push it off as long as we can, but with the economy slowing down in the second half of this year and the proposed increase of the stimulus spending, we could be approaching a $2 trillion deficit next year if there is another liquidity crisis coming from Europe. When do markets start to push back and when will the Federal Reserve be unable to carry the burden alone?

So the short answer is the sooner you take haircuts, the sooner businesses can start to make decisions about their future. While business may not like the rules, they know them and as a result are able to model a budget. Right now, all those things are proving difficult to define and businesses are having a hard time planning for the future. As a result, we are seeing many businesses manage for the next 3-6 months instead of the next 3-6 years.

Andy Ball

Bill spoke before about the bifurcation in corporate credit. Some corporations with the ability to access credit markets will likely survive the downturn while others will not. His firm puts on trades to benefit from this while choosing to be more market agnostic in terms of directionality. While we operate in a different sector entirely, we essentially have the same trade on. However, our strategy is expressed with views on individual borrowers and housing not corporate credit. Individual borrowers have been de-leveraging since the crisis began and credit has been tightening.

What has emerged is a strong bifurcation in the lending market where someone with a 760 FICO score is considered good credit and therefore, can go get a loan these days. However, someone with a lower score of 700 FICO really has difficulty accessing lending markets. They have difficulty both refinancing or qualifying for a new loan. We also tend to be more directionally market agnostic but choose to take advantage of mis-pricings of the embedded prepay option that people have in their mortgage in order to generate alpha. We do this by purchasing a structured Mortgage Backed Security where the underlying borrowers have slightly worse credit characteristics. We purchase only the underlying IO cash flow stream from these borrowers monthly payments. When these borrowers are unable or unwilling to refinance (access credit markets) the IO stream of payments extends longer than otherwise expected and the return for these securities is enhanced.

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While credit characteristics is an important part of our modeling and decision making, other variables including how much economic incentive the borrower has to refinance, where they live, their loan size and others, are determinants of security valuation.

In more general terms, I agree with Bill in that I think deleveraging will occur slowly over the next several years. It is not just going to happen at the corporate level or governmental level but also at an individual household level. This deleveraging could keep consumer spending capped which, if it occurs, would continue to depress economic growth. In this scenario the Fed will likely keep rates low for some time to help offset the effects of a lack in aggregate demand. This helps our current strategy in that the coupon on many of our securities (Inverse IOs) resets with the inverse of short-term interest rates. When these rates fall, the coupon on an Inverse IO bond resets higher.

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Bill Collins

This has been talked about in the press. Do you see the government doing anything to allow homeowners who cannot qualify now, get help to refinance say 6% mortgages and refinance at say 4%?

Andy Ball

President Obama recently said in his address before congress that the government wants to help people who are current on their mortgage to be able to access the credit markets and lower interest rates. We think there will be small incremental changes in current refinance programs to reduce frictions for some borrowers to refinance. Proponents of a large government induced refinance wave are under the false assumption that this is a costless stimulus. They think because Freddie and Fannie already own (securitize) the loan, they can go and refinance the borrower and there would be no additional credit risk.

The problem is, this scenario is really not costless. And there are several operational issues with instituting such a program. At the end of the day, somebody has to pay for refinancing expenses such as title searches and appraisals. There has been talk that expenses could be folded into the loan. However, I don't think any bank wants to amortize the cost of refinancing over 30 years, they would rather have the additional revenue today. Many revenue streams within banks' have been cut in half and many are laying off personnel, e.g. Bank of America announced lay offs of 40,000 people over the next three years. Banks need revenue today, therefore somebody, whether it be the tax payer or someone else will have to pay those refinancing costs.

The other consideration is that banks have "rep and warrant risk" when they originate a loan and sell it to the Agencies. When a bank originates a loan they ensure there is no fraud in the loan and that it conforms to their underwriting standards. Next, the bank sells that loan to either Freddie or Fannie. However, if that loan defaults and Freddie or Fannie find problems with the underwriting, they can come back and claim the loan did not conform to their process as there may be mistakes in the underlying application, i.e.,the assets were not verified, etc. That means, Freddie or Fannie have the right to "put" that loan back to the bank. Currently, liabilities for "put back" risk have been estimated, by some, to run upwards of $30 billion or $40 billion for the banking sector. Therefore, until you deal with the "rep and warrant risk" no bank wants to go and refinance someone potentially exposing themselves to additional risk.

If I were Bank of America, would I refinance a Citi loan, taking the "rep and warrant risk" on it? Absolutely not, no bank wants more potential liabilities on their balance sheets. Even refinancing existing mortgages for a single bank could uncover faulty underwriting on the existing loan and open the bank up to additional liability. In addition to "rep and warrant risk" a large refinance program would hurt many investors such as pensions funds, mutual funds, 401(k)s etc., who own premium mortgages. These institutions would take a large mark-to-market hit if such a large program were enacted. So when you talk about "cost-less" refinancing, there is really no such thing.

The FHFA, which is the regulator for Freddie and Fannie came out and said earlier in September, that they were going to try and reduce the frictions for refinancing. I think this is good for the market and the economy. But at the end of the day, they are the conservator for Freddie and Fannie and are not looking to take on additional risks or costs for those institutions by either paying for refinance costs or waiving "rep and warrant" clauses currently in place. Indeed I think any kind of stimulus where the government is taking on additional risk is politically untenable.

David Freelove

It was pretty much reiterated by everyone around the table that we are most likely going to go through five to ten years of a tough sledding in corporate America and corporate Western Europe.

I wonder how this will translate now to our business, the hedge fund business? Do you think investor expectations will change or adapt to this outlook? For example, when you look at the actuarial assumptions that underlie the pension world, which has now become a larger part of our business collectively in the industry, their payment assumptions are so far off, it is incredible.

Pension funds, for example, will have to reach out for higher return strategies. They can't buy bonds right now, government bonds aren't coming anywhere close to meeting a pension's obligations. The pensions just seem to become more and more and more underfunded.

How will investors adapt their expectations in this environment? I remember that ten years ago when I got into the business, if you told anybody that you were not going to generate 15%, you were not getting the money. People did not care how good you are, it seemed too little.

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Bill Collins

Right to your point, if I spoke to a potential client in 2005 about risk management, I did not get the account. In 2005 and 2006 investors wanted yield, risk be damned, it did not matter how far out on the risk curve you went or how much leverage you employed, as long as you got me a number or told me you were going to get me a number, you got the account. Of course, now things are very different.

In March I met with a large pension plan that was doing due diligence on one of our funds. They told us their actuarial expectations were 7.5%. And I said that I thought that would be challenging to hit in the near-term. They said "okay, but that is sort of what we are looking for, and we want people who do not lose money."

A couple of weeks later I was in Frankfurt, and the German insurance companies told us our actuarial assumptions are 5% and that they can no longer get that from German bonds, so they were looking at what we do.

Last month I had an insurance company from Japan in our office, they were looking for JGB-like returns of around 1%, and asked if we could do that after the currency hedge?

Point here is that it is interesting how things change as we move through cycles. Investor expectations adjust and managers have to manage expectations as well as returns as a result.

What is unfortunate though is that the majority of people you meet in this business are driving through the rearview mirror. They want to invest in what worked last year and get the same returns this year. Not too many people are saying: "what do you think is going to happen in the next six months and where should I invest? Are the circumstances that allowed for past performance likely to be present today or in 2012?"

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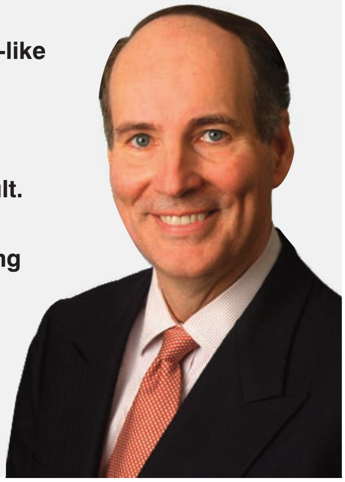
A couple of weeks later I was in Frankfurt, and the German insurance companies told us our actuarial assumptions are 5% and that they can no longer get that from German bonds, so they were looking at what we do.

Last month I had an insurance company from Japan in our office, they were looking for JGB-like returns of around 1%, and asked if we could do that after the currency hedge?

Point here is that it is interesting how things change as we move through cycles. Investor expectations adjust and managers have to manage expectations as well as returns as a result.

What is unfortunate though is that the majority of people you meet in this business are driving through the rearview mirror. They want to invest in what worked last year and get the same returns this year. Not too many people are saying: "what do you think is going to happen in the next six months and where should I invest? Are the circumstances that allowed for past performance likely to be present today or in 2012?"

Bill Collins



Scott Price What requirements or demands other than performance are investors now putting on you managers?

David Freelove I think that one of the most challenging things that we have not touched upon yet is that investors want to make money, but they want to do it without risk, they also want to do it with maximum liquidity. I don't know a single arbitrage or quasi-arbitrage strategies where you can actually make money at unrestricted liquidity. I believe investors will have to adjust over time and invest their money for longer periods of time if they want to actually generate performance.

Andy Ball I agree with David and we also see investors that are actually more comfortable locking their money up for longer periods. However, we try to give our investors as much liquidity as possible. If you think back to the 2008 crisis when a lot of funds were gated and investors could not get their money out, I believe that if a manager has liquidity in his market, he should try to pass that along to his investors.

We have had frank discussions with some investors who experienced liquidity requirements on their side and were looking to redeem. We discussed the opportunity set in our markets and whether they could stay in the Fund. For the most part, they have said "yes, I agree with you, I think your value proposition is good, I will cancel the redemption." In my opinion building that kind of close relationship with the investor is very important and goes hand in hand with providing liquidity.

Joe Taussig I think a lot of times the issue is to really know and understand the investor's profile. For example, Swiss private banking clients (which represent between 20% to 30% of all the assets in the hedge fund industry) can take their money out on a whim, so Swiss private banks generally demand monthly liquidity or they will not even look at you. Funds of funds (40% of all assets in the hedge fund industry – and a lot of overlap with the Swiss banks) have a similar problem and often offer monthly liquidity, too. Thus, many a manager unable to liquidate on an orderly basis in less than a month has prostituted himself to access these investors by offering monthly liquidity that can never survive a run on the bank. That was very clear in 2008, but also in any other crisis over the last 15 or 20 years.

When Swiss banks and funds of funds face withdrawals or redemptions, they go to the ATM machine – underlying funds with the best liquidity - instead of taking things out proportionately. I would think that if a Swiss bank or a fund of funds had a great portfolio, it should liquidate proportionately, and not just take out from where they can, leaving the remaining portfolio more or less destroyed, which exacerbates the problem and hurts loyal investors.

Let's talk about haircuts. I think that pension obligors (generally life insurance companies in Europe) need to take haircuts. Whether it is a federal pension system (and I will give you personal examples in a second) or in a privately funded pension system, when these systems were setup, a human being was expected to live only five years past the time of retirement.

Today, that is just not happening. The number of years you are going to live past retirement is orders of magnitude greater than five (but pension systems in general have not adjusted for this and those that have, have not adjusted enough). I spend virtually every waking hour financing insurance and reinsurance companies and banks, and a lot of that time is spent thinking about how long human beings are going to live.

I remember working on a securitization of a large life settlements portfolio in the late 90s. As we studied it, I came to the conclusion the actuarial tables were very, very wrong. It seemed obvious to me that the rush into life settlements (particularly for funds of funds) would end very badly and that the bloodbath that occurred was predictable. It was like driving down the Autobahn looking in the rear view mirror. Even though the life expectancy tables were eventually adjusted upward by three years (causing major havoc in the life settlements industry), I still feel that they are still way understated.

Let us assume I am right for argument's sake, think about the implications for the pension arena. It is not really what your rate of return is, but how long do you expect to be paying these people. I think this is a haircut that just has to happen. I also think that it is an opportunity of a lifetime.

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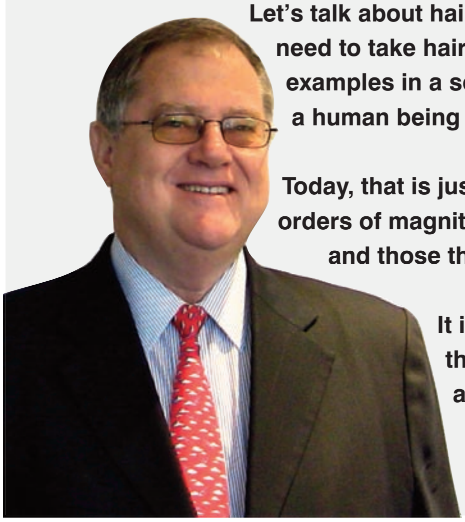

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Joe Taussig

I said earlier that I have had personal experiences in this area. I just started drawing social security, which was originally premised on my living five years beyond my start date. My life expectancy is roughly 23 years now, but my payments into the system were premised on only five years. I had a great personal debate with myself on whether I should take it or not. In the end I did, since I had paid into it and feel that I am getting back money that I should not have had to pay in the first place, but I do not feel very good about it. Who knows, I may eventually get run over by a truck, so the system will benefit, but it is actuarily unlikely.

As for the other personal experience, I graduated from the US Naval Academy and so 20 odd years ago I had classmates retiring (with pensions for the rest of their lives) and asking me advice on what to do with the rest of their lives. Many had enough working years left (vs. the 47 year life expectancy in 1900 around the time that the military system was set up) to have full second careers. I am going to my 45th reunion shortly and a lot of them are retiring from their second careers (with second pensions). They always ask me, "what are your retirement plans"? I answer that mine are a gurney and a toe tag. Working is the most fun I can have with my clothes on, so I want to continue to work until I do not. I think that many of them would prefer working to "every day is Saturday", but the system does not encourage that.

So I am sitting here saying, wait a minute, I am now drawing pension for the rest of my life, if you would, when I have no intention of quitting work and do not envision myself quitting in anytime in the next five to ten years for sure.

If you look at Wilbur Ross when he basically reorganized the steel companies of the U.S., he was able to pull it off because the cost per ton of steel that was embedded in all these legacy problems made the industry uncompetitive and when he got the U.S. government to take the burden, profitability was restored and it was a huge home run. I think that the haircuts have got to be taken.

David Freelove

It is the same with airlines.

Bill Collins

The procedure for those industries is generally the same. You roll them up, take them into bankruptcy and once in bankruptcy you dump all the pension obligations on to the Pension Benefit Guarantee Corporation, which is what they did. Now you have a clean company without the legacy costs no different than what has happened in other industries.

Joe Taussig

But eventually the Pension Benefit Guarantee Corporation is going to arguably run out of money at some point.

Bill Collins

Maybe you socialize it, and cover the loss by having everybody else pay a higher fee into the Pension Benefit Guarantee Corporation.

Joe Taussig

But the average taxpayer, say my kids, are not going to be happy about paying for this when there was virtually no value for them created. It was again vote buying in the present to sacrifice the future.

Bill Collins

That is the challenge of democracies.

Katiana Guzman MacNabb

One of the reasons money is flowing into emerging markets is that they do not have these problems. We do not have the pension obligations, everybody is going to the way of a version of 401(k) pay-in system. Even in Nigeria they are implementing it. So you are seeing the allocation to emerging markets increase. However, the problem that will be faced is liquidity and it also does not have the diversification in terms of product strategies; as an example, local investors in emerging markets are very sensitive to dividends. As a result, there are several markets that offer high dividend yields. Yet there are no funds dedicated to dividend strategies in emerging markets. The introduction of differentiated strategies is only beginning in emerging markets.

The potential is huge when investors decide to up their allocation to more or less the weight emerging markets have on the global index, which is about 30%. Most people are still somewhere between 8% and 15%. That means that at some point a massive wall of money will start moving towards emerging markets, and there may not be not enough products or managers to manage that.

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Katiana Guzman MacNabb

Bill Collins

How do you manage through that if you are an emerging markets manager, your companies are performing, but a large part of your asset growth is going to come from Europe and North America? Sure, people invest in emerging markets because that is where the growth is going to be for the next 15, 25 years. But when something bad happens in the U.S. or Europe, they all pull their money out, which has nothing to do with what is going on with your companies. How do you manage through those kinds of events?

Katiana Guzman MacNabb

What we as an emerging market specialist do is take advantage of volatility. Generally speaking, we buy into volatility, and we use cash as a hedge where we have no other instruments available.

80% of our clients are high net worth and individuals and family offices. Right now, a lot of sophisticated families and some institutions are putting money in, so we are deploying cash. We are going through exactly such a phase, and people do take advantage of the opportunities. We follow a niche strategy with concentrated portfolios. Bottom up, with a top-down overlay, about 60 stocks we know really well and have a lot of confidence in them.

But to be quite honest, the real opportunity is with the large institutions like pensions, endowments and foundations - if they want to participate in the long term, outsized opportunities that emerging and frontier markets offer. The issue is that most of them will not buy into such dips, they get scared by the indexes. This is the challenge.

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Joe Taussig

Let me ask you a question. How many times did you managers pitch somebody on the other side and thought that I would really like to hire this person? I would submit very rarely… I have a different perspective, as my clients are hedge fund managers, and I'd like to be in a position to hire many of them.

Here is an illustration of the whole issue. I had dinner one time with this incredible person who took over corresponding and clearing of prime brokerage for Bear Stearns, before that he was a SEC commissioner and prior he had been a Professor of Finance at Yale. I asked: "Did any of your students every go and work in banking?" "Oh sure." "What about hedge funds, asset management, big consulting firms?" "Sure enough!" "How about insurance?" He could not think of a single one.

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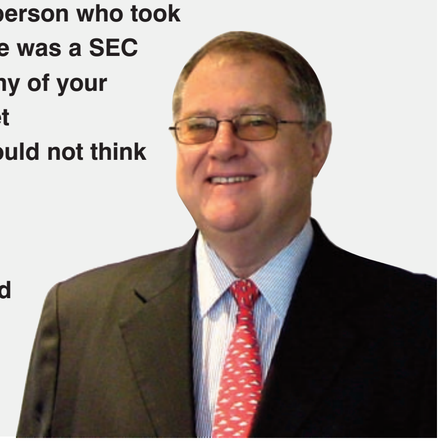
To me, that has always been our great opportunity. You are dealing in an incredibly inefficient industry and it is inefficient at the investment level. And it is sort of forced to be that way by the regulatory, ratings, accounting, and tax systems.

Joe Taussig



To me, that has always been our great opportunity. You are dealing in an incredibly inefficient industry and it is inefficient at the investment level. And it is sort of forced to be that way by the regulatory, ratings, accounting, and tax systems. Again, for some reason rarely have I ever sat with an insurance company and said “I really need to hire this person.” By contrast, I cannot think one of our companies that has underperformed the funds, not one.

Greenlight Re is public and has out performed David’s funds by 6% per year since inception or about 9% for taxables, because there are no K1s involved. The shares trade with $2.5 or $3 million of daily liquidity, so the manager gets permanent capital and the investor gets daily liquidity and a better rate of return.

This could not exist if the industry we are involved in ran itself intelligently. The same thing I submit when talking to financial institutions, especially the pension arena. I think the pensions have to come to the hedge fund industry, I just do not see how they can’t.

Bill Collins

Joe I do not disagree with you, we touched on that subject before and pointed to the so-called IBM mentality. That was clearly evident in second half of 2009 and into 2010 when people started to come out of their foxholes. If you look at the demographics, the typical pension allocator is usually older and thinking defensively. Why is he going to allocate to bright rising young managers? There is limited upside for him. It is safer to allocate to the largest managers (like buying IBM). Since the larger managers are a significant portion of the index, it is unlikely the allocator’s return will drift far from the index and therefore he/she won’t get fired.

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Bill Collins

David Freelove

I deal with state pension funds quiet frequently and right, what you just said was told to me as well almost word for word by a person who runs a very large fund.

There is another dynamic at play here. Most of the money that has come into hedge funds over the last decade has come through fund of funds and/or consultants who want to be fund of funds, but we are not going into that debate here. This has changed now with more and more pensions going directly into hedge funds. However, that has only magnified the IBM situation, because even the biggest pension funds in America, for example, do not have the staff to do the research and find a manager running 300 million with returns that are twice as good as the guy running 7.5 billion. They just do not have those resources.

So there is no reason for them to hire staff, and given the way a State Pension Fund is mandated to run, they may not even be able to afford to pay somebody or a whole team that would be really qualified to manage a portfolio of hedge funds. Therefore, the big hedge funds will continue to get large flows from the biggest pension funds for quite some time going forward.

Scott Price

I would say probably 75% of the inflow that is coming into all of our funds goes into the larger funds.

David Freelove

If you want to access the big pension funds you are undoubtedly dealing with a consultant, very few pension funds do not use a consultant. And if you are $300 million fund, you probably do not have the manpower or expertise to even know how to deal with a consultant. It is a very complex, time consuming issue and even a tricky thing at times to deal with the big consulting firms.

Matthias Knab **How then do you succeed in dealing with consultants?**

David Freelove Doing serious business – no matter if you sell steel or banking services - is in the end a relationship sale. It is about creating and maintaining a rapport, because at the end of the day we are in a trust me business. They have got to be able to look across the table and feel as though there is a level of trust and feel as though they want to give you the shot to manage their money, I mean sure we are fiduciaries, but at the end of the day it is a relationship sale.

Matthias Knab **And this trust factor is a thing you cannot really regulate or put rules on it, right?**

David Freelove We are already in one of the most highly regulated business in the world, people saying that we need more regulation are now aware of that. I can only think of one other industry in America that is more regulated than we are, and that is the medical industry. I am sure almost everyone has been registered for years. We do have fiduciary obligations, and particularly if you manage money like we do for pensions, you are operating at a much higher level.

Matthias Knab **What is your view then of Soros who is giving up a hedge fund status in order to become a family office, because according to press reports he wants to avoid all these regulations and rules?**

Bill Collins I can only answer for us. We have been registered at Brencourt since inception in 2001 and at my previous fund back to 1996, so it has been a non-event for us. It is an extra layer of work but you have to be responsive to the market.

The hedge fund industry is an industry that still offers the opportunity for the American dream. If you can do really well, if you perform and do a good job overall, you can attract assets and get paid more in this industry than you can in most others. Willie Sutton the bank robber said, he goes where the money is. Inevitably you are going to have someone who gets tempted and commits bad deeds and then creates a fraud.

Scott Price Additional regulation will not mean fraud does not occur. What is also very interesting is that the fund administration world is completely regulated in Europe and it is not regulated at all in the U.S. I always thought this was somewhat peculiar where there is so much regulation on the managers domestically, but nothing at all for the person who is actually valuing or communicating the NAVs to the investors. A manager can just create a fund and send his NAV to Bloomberg or other databases without any regulation or independent verification in the U.S.

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Scott Price

Katiana Guzman MacNabb We manage about $200 million now, have been registered with the SEC since 2006, and our investor base is expanding from family high net worth into institutions, and the reputational issue about who is your administrator is huge. You have to have an administrator with the best reputation.

Even on the high net worth side, many family offices have started to adopt a sort of institutional mentality of checking all components. Maybe the best thing that could happen is that SEC audits you, because then you have that letter that shows you have been audited and that your are okay.

Scott Price

Administrators have a similar procedure where you get a SAS 70 which is a letter of confidence from an audit firm. Originally this had just been in our European offices, but we are actually going through a process at the moment where all the offices that are not in regulated jurisdiction will be tested. So for example Singapore and our Chicago office are now going to be falling under that SAS70 Type II banner. Again, just so that we can check the box and move on, so we do not have to deal with those conversations. It is somewhat interesting though that it is not regulated in the U.S. though.

Matthias Knab

Where in general do you see the hedge fund industry going?

David Freelove

I believe investors are going to demand not only more transparency, a trend that has been going on for a while, but also higher degrees of specialization in the types of products and types of strategies you are really mandated to trade.

Large parts of our investor base have reached a very high degree of sophistication over the last decade. Often the most sophisticated clients are the ones with the most money, they can model out their portfolios pretty accurately and therefore they really need to be able to pinpoint what you are doing.

The hedge fund paradigm of the old days does not fly any more – like “we are nimble in what we do, when there are opportunities we will buy high yield, if we find opportunities somewhere else we will go for it, we are flexible, etc.” I believe a manager’s flexibility will decrease over time, because investors are now asking you give them a very particular exposure. Our firm’s products are tailored to give clients the exact exposure that they want, and we think there is no way back in this trend.

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David Freelove

Andy Ball

I totally agree with that statement, especially as it relates to the MBS space. I think there are quite a few mortgage managers whose strategy mixes credit and interest rate risk, they are trading mortgages, but they are up and down in the capital structure. I believe that over time firms will split those products apart in order to offer more tailored risk to their investors.

As far as industry direction in general, I think the next five years are going to be very interesting on the housing front. While we will reduce homeownership rates somewhat from the peak to a more sustainable level, I don't believe public sentiment wants to reduce home ownership drastically. We have a $13 trillion mortgage market, but now both the government and tax-payers believe the Freddie/Fannie model really did not work.

I think the next five years will determine whether we as a country want to support home ownership from a public policy prospective. If the answer to that question is yes, then we have to decide what type of residential finance system we want in place in order to support homeownership. I would submit that government involvement is a necessity to support homeownership at or near current levels. That support could come in the form of a credit backstop or insurance more similar to the Freddie/Fannie model of today. The reason is many investors who purchase mortgage securities are pension funds and mutual funds, who do not want to take on the credit risk of individual borrowers and would likely boycott the market if they were forced to do so.

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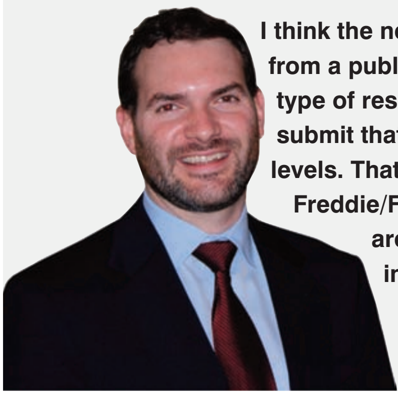

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Andy Ball

A security that has interest rate risk, prepayment risk along with credit risk, limits the potential buyers for those products and would likely drive up interest rates. I doubt there would be enough buyers for a $12 trillion residential mortgage market without some type of government backing. That said, if Freddie and Fannie go away and without some government involvement, the private capital needed to support the system would have to be very large. Regardless of the system that is put in place, the opportunity set grows for an MBS hedge fund as change and uncertainty presents opportunities to invest.

However, today , the correct public policy goal should be to get home prices rising again. I think the primary tool should be coaxing investors back into the mortgage market (whether they be individuals or institutions) and incenting them to purchase homes. Here too I believe there will be many opportunities for investors in the mortgage space moving forward.