



# Opalesque Round Table Series '11 BOSTON

Opalesque 2011 Roundtable Series Sponsor:



# Editor's Note

**“Ultimate” risk management, how to raise assets, and how to deal with high frequency traders?**

This 2011 Opalesque Boston Roundtable offers plenty food for thought, advice and strategies **how hedge funds can market to family offices, fund of funds, pension funds, consultants, foundations and endowments, registered investment advisors and ERISA investors, and set up mutual or closed-end funds:**

- **Why are the ERISA and RIA communities interested in hedge funds and alternatives now?**
- **What type of funds are they looking for?**
- **What is the best way to market to ERISA investors and RIAs?**
- **Can and should hedge fund managers set up mutual funds or closed-end funds?**

Which type of strategies can hedge fund managers run in a mutual fund format? What are the advantages for hedge fund managers running mutual funds? Can closed-end fund structures be an alternative?

**High-frequency traders: A blessing or a curse?**

Frerunners or liquidity providers? Reducing transaction costs for all investors, or putting the financial markets at great risk? Are they “just noise”, or drive retail investors out of the market? How do hedge funds deal with them? How have high frequency traders changed the way other hedge funds invest?

**Is risk management just fighting the last war while remaining exposed to new risks?**

Many hedge fund managers do not use VAR or complex algorithms for their risk management, saying the fundamental flaw with most established risk management tools is that they look backwards. But knowledge of the past can only teach you so much when it comes to future risks. Everyone had access to all the past data, and yet many large, diversified funds with substantial risk-management teams weren't saved in 2002 or 2008. Everyone operating off the same historical data and memorable precedents is exactly what causes so many to fight the last war and remain exposed to new risks.

So, **what really works in risk management? What is the “ultimate” risk management?** And, what is the single most important mistaken assumption investors, and especially quants, have fallen into in terms of risk management?

Hear more about these questions from:

- **Craig Kelleher, Co-Founder and Chief Investment Officer, Millstreet Capital**
- **Frank Casey, Managing Director, Skyview Investment Advisors**
- **George Tall, Founding Partner, Burl Capital**
- **Kirt Corregan, Partner, Tara Hill Capital**
- **Michael Dunn, Chief Research Officer, TruColor Capital Management**
- **Natasha Koprivica, Senior Vice President, Venus Capital Management**
- **Peter Kolchinsky, PhD, Managing Director, RA Capital**
- **Steven Giordano, Partner, Bingham McCutchen**
- **Ted Kellogg, Portfolio Manager, GRT Capital Partners**

The Opalesque 2011 Boston Roundtable took place October 2011 and was sponsored by Custom House Group and Bingham McCutchen. This Roundtable also discusses:

- How much of a fund's risk management needs to be disclosed in the DDQ document?
- How can the TIPS formula improve due diligence?
- How can investors best integrate and use highly concentrated hedge funds?
- Why is emerging market debt experiencing significant traction from institutional investors like sovereign wealth funds?
- Why it is important that investors understand the debt deflation phenomenon and its likely effects on the equity markets?

Enjoy the read!

Matthias Knab

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Cover Photo: Boston



# Participant Profiles



(LEFT TO RIGHT)

George Tall, Ted Kellogg, Frank Casey, Michael Dunn, Craig Kelleher, Peter Kolchinsky  
Matthias Knab, Kirt Corregan, Natasha Koprivica, Steven Giordano

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# Introduction

## Michael Dunn

TruColor Capital Management

My name is Mike Dunn, I am the Chief Research Officer for TruColor Capital Management, which is a start-up hedge fund based in Newton, MA. The company was formed last year and our live track record began as of January this year. Our strategy is what we call tactical volatility rotation – a movement from higher-risk assets to lower-risk assets and back, based on the volatility characteristics of each particular market. For example, we go long when volatility signals indicate a lower chance of a steeply declining market, and into cash or a short position when volatility signals indicate a higher chance for downward moves.

Our first fund is an emerging markets portfolio. It is long biased; over time it has a beta of about 0.7, but, again, we can be short as well as leveraged long sometimes. Our basic objective in investing is simply to provide upside participation in the returns of any risky asset – we decided to start with emerging markets – combined with downside protection. By truncating the left tail of the distribution, we aim to provide much better compound returns.

Central to our investment approach is the concept that market returns do not behave according to a symmetrical “normal” distribution. By focusing on downside volatility – the “fat” left tail – we believe we can gain proprietary insights into market behavior.

Our President and COO is Arlene Rockefeller, who was formerly the CIO of Global Equities at State Street. Our other main researcher is Luke Smith, who joined us from Gartmore.

## George Tall

Burl Capital

I am George Tall of Burl Capital. Burl Capital is a Boston-based institutional manager of long/short equity hedge funds. I co-founded Burl in 2006. Previously I had spent 24 years as a portfolio manager and analyst for three large institutional buy-side managers. These three firms were MassMutual’s Babson Capital unit, Allianz Asset Mgmt. and Aetna Capital Mgmt. I have managed long/short portfolios since 1993.

Burl Capital has four employees managing \$53 million, primarily for US-ERISA pension clients. As we will complete our five year track record in January-2012, we anticipate much higher marketability towards a far broader pension fund client base. We think that 2012 could be a significant year from an asset-raising perspective.

Today the whole pension and actuarial industry assumes future equity trend-returns that are unsupportable by either history or within finance theory. There is no way for responsible fiduciaries to avoid these inconsistencies in the near future. Pension plans will logically be driven towards extra returns achievable within alternatives and in long/short portfolios. Therefore, we think this is a growth environment and are gearing up for that.

Currently long/short equity is under-represented among pensions and in the ERISA market, when compared with endowments and foundations. But, importantly, corporate cash flows are available to address many under-funded pension situations. Unless corporate managements address under-funding, the pension deficit now spills into dialogue with stock analysts that publish EPS estimates, due to accounting rules. This feedback loop to the plan sponsor’s stock price is an important new motivation. Managements generally are anxious about personal risk due to unintentional taint from past hedge fund scandals.

Burl Capital feels that by utilizing blue-chip auditors and top service suppliers, these anxieties can

be responsibly addressed. Our best fit today is probably with a pension plan near a billion in assets, or less. Current pension clients generally fit that profile.

**Steven Giordano**  
Bingham

My name is Steve Giordano. I am a partner in the Boston office of Bingham. I have been practicing as a hedge fund lawyer since 1999 and joined Bingham in 2004. My practice focuses on the formation of domestic and offshore private investment funds, including hedge funds, private equity, venture capital, real estate investment funds and funds of funds, from both a legal and tax perspective. I advise fund managers on a variety of issues ranging from capital formations, regulatory compliance and internal governance to the structuring and negotiating of portfolio investment transactions. I am experienced in matters relating to management company structuring, employment agreements, joint ventures, seed capital arrangements, and issues involving regulatory compliance. I started my legal career as a tax lawyer and prior to that I was a certified public accountant with a Big Four accounting firm. I also served as portfolio counsel to an international venture capital firm.

Bingham was selected by the editors of Chambers USA, the premier business law guide, as the winner of “2011 Award for Excellence” in the investment funds category. We have a very robust and diversified hedge fund practice in the U.S., London, Hong Kong and Tokyo.

We represent a variety of funds, including start-ups as well as very large, well established funds, institutional money management firms and various asset allocators, such as fund of funds, endowments and family offices.

**Natasha Koprivica**  
Venus Capital

My name is Natasha Koprivica. I am the Senior Vice President and Head of Institutional Sales and Marketing at Venus Capital. My investment career started at the trading floor at Fidelity Investments here in Boston. In 1998, I joined Vik Mehrotra, founder of Venus Capital at the very early stages of our business and I have been participating in its strategic development ever since.

Venus specializes in emerging markets in Asia. Over the years, Venus Capital have been known as a pioneer in creating niche, liquid, alpha generating strategies in Asia and emerging markets. Venus Capital has launched the first long-short India Fund in 1996 and in 2003, the first India market neutral arbitrage fund.

Over the years, our team won multiple awards and attracted worldwide recognition for providing alpha with very low volatility and correlation market indices.

Our platform consists of Venus Relative Value Fund (relative value market neutral), Venus Global Marco Fund (emerging market, global), Venus India Opportunities Fund (India mid and small cap). For all investors looking for emerging market fixed income solutions, Venus launched Venus India Structured Finance Fund. This strategy is capitalizing on short-term development financing in India, ring-fencing 15% p.a. with further equity upside.

**Kirt Corregan**  
Tara Hill Capital

My name is Kirt Corregan. I am the co-founder of Tara Hill Capital, along with my partner Howard Rubin. Tara Hill is a U.S. focused multi-cap long/short equity fund that was established in March 2010. Our strategy is to use insider activity for idea generation on a company, industry, and sector level, and from there use fundamental analysis for actual security selection.

I started my career in the early 1990's working for George Muzea analyzing insider activity. I was the first analyst he hired when he started his firm, Muzea Insider Consulting Services, where my job there was to help him build a database of insider activity. Our aim was to identify so-called smart insiders, corporate officers and directors, whose track records as insider buyers or sellers provided strong value added idea generation. Along the way we also discovered other patterns that proved to have good predictive value.

As the database grew, it also could be analyzed on an industry, sector, and market level. Currently, there is a large amount of historical data which can also be used for back tests and to develop useful insider sell/buy and other similar ratios. For example, we can compare time periods and are able to identify at what point a particular ratio becomes significant as a buy or sell signal on a market level.

After working for George for a couple of years, I went to a series of fundamental analyst positions on both the sell side and the buy side, where I covered a variety of industries at Raymond James, Loomis Sayles, Pioneer Investments, and eventually Delta Partners where I managed a carve-out and began to combine my experience of insider activity analysis with fundamental analysis. It was at Delta Partners where I crystallized the strategy that we are pursuing at Tara Hill Capital.

**Peter Kolchinsky**  
RA Capital

I am Peter Kolchinsky, co-founder and Managing Director of RA Capital. We were seeded in 2002 by a successful biotechnology executive with a mandate to generate high returns by investing in healthcare companies. I am a virologist by training, which gave me a good understanding of science on which I built an appreciation of medicine over the years. Most importantly, without much received conventional wisdom of how to value companies, we learned from the simplest fundamentals by years of “doing” how to pick good, undervalued healthcare companies and how to recognize the right time to sell.

At this point, we are managing about \$150M and have generated net annualized returns of over 23% for our investors with low correlation to the broader equity markets. In 2008, a year that some use as a litmus test, we stayed consistent with our strategy and were able to finish the year net positive 11% because of both gains on the long and short side.

We believe in investing in what we know, and therefore we tend to focus on companies that are developing drugs, devices, and diagnostics. These firms are generally small to mid cap, under a billion dollars. We try to find companies that are off the radar, overlooked or neglected. Metaphorically speaking, if you think in terms of judging a book by its cover, these are books most people are not reading and some are throwing out. We are voracious readers, one might say.

We evaluate hundreds of companies through really extensive scientific, clinical, market, and financial analysis. When we are right, then the broader investment community eventually recognizes that they have overlooked a really great company, and such stocks can then go significantly higher as our thesis plays out.

We tend not to take binary risk. We appreciate there are significant variables that we cannot solve with our research and that even an event that seems to be low risk may carry more uncertainty than we realize. It’s happened too many times that a clinical trial has failed or a drug been rejected by the FDA for reasons that were unanticipated but became all too obvious after the fact.

We are not a low-vol fund, but we take the risks worth taking, and that has paid off quite well and helped overcome a lot of the inherent dangers in our space. We believe we operate in an exceptional segment of the market that can offer significant inefficiencies from which to generate alpha. Indeed, over the years, our approach has allowed us to generate very high returns.

**Craig Kelleher**  
Millstreet Capital Management

I am Craig Kelleher, co-founder and Chief Investment Officer of Millstreet Capital Management. We formed the company in 2010 and began our investing track record on June 1, 2010. My partner and I used to work together at Regiment Capital, which is a Harvard Management Company spin-off that manages the High Yield allocation of the University’s endowment.

Millstreet was seeded by the Palmer Square Emerging Manager Fund earlier this year. Palmer Square is a joint venture between Montage Investments and Atlantic Asset Management, which each have about \$7 billion under management. My partner, Brian Connolly, and I have spent over 30 years combined in High Yield credit.

Millstreet employs a fundamental, credit-intensive process to identify under-researched and under-exploited opportunities in mid-market High Yield credit from both the long and short perspective. High Yield is an interesting asset class when you start analyzing it. The asset base is approximately a trillion dollars in the U.S. with the top 50 or so issuers representing roughly 35% of the High Yield Index. The largest names tend to be super-liquid and well-known. Many of them are large-LBOs, but others are serial issuers and “fallen angels.” On the other end of the spectrum you will find the super-



illiquid direct lending segment of the market. Here investors tend to make longer-term direct loans and may have more of an investment banking type relationship with the borrower.

At Millstreet, we have found that the mid-market segment of High Yield, which lies between the large issuers and direct lending, tends to be significantly underexploited. This is an area with several hundred billion dollars of paper outstanding and this is where we focus our efforts. Within mid-market, we look for the names that are orphaned, unloved, and overlooked. This is where we can achieve attractive total returns by creating an informational edge in an underserved niche, especially given the dearth of third-party research and backward-looking nature of credit ratings. Over longer periods of time, mid-market High Yield produces higher returns with less volatility than the overall High Yield Index.

In general, mid-market issuers tend to be somewhat capital-starved because they tend to be smaller businesses. Many issuers may have only one debt issue outstanding, so they do not get the attention that larger, more frequent issuers get in terms of access to the capital markets. As a result, mid-market credits tend to not do ten-year bond deals, but rather five- or seven-year bond deals. These credits usually have to pay significantly higher interest rates, but in some cases have simpler capital structures, tighter covenants and less leverage relative to comparables. This creates the ability for us to construct a portfolio that tends to be shorter duration with high total return potential. This can often be augmented by certain catalysts that specifically impact the underlying issuer.

However attractive, what we have found is that the mega hedge funds, insurance companies, pension and mutual funds do not consistently invest in mid-market credit. The reason for this usually relates to the size of the instruments or other institutional constraints, such as credit ratings. The most often story told is that even if they owned a large percentage of a \$150 million bond issue, it does not move the needle enough for them to justify the work. However, this inefficiency creates some of the opportunities Millstreet wants to exploit.

**Frank Casey**  
SkyView Investment Advisors

My name is Frank Casey. I have been in the derivatives and alternative business for 37 years now. I started as a portfolio manager using equity options, and then gravitated to corporate risk management using futures. I then built a business in bank risk management hedging Fannie and Freddie coupon production with options on treasury futures. In 1999, I partnered with Harry Markopolos, Neil Chelo and Mike Ocrant in hunting Bernie Madoff for ten years and whistleblowing on his Ponzi scheme to the SEC. In 2002, I helped build a fund of funds ten fold to 2.2 billion over 6-years.

I am a strong believer in the convergence between the alternative investment business and Registered Investment Companies such as mutual funds in addressing the needs of registered investment advisors, independent broker dealers, wealth managers, and family offices. They have been largely underserved by the alternative industry. I partnered with SkyView Investment Advisors from New Jersey, a manager of hedge fund managers. The firm was previously known as Gartmore Riverview where they ran a couple of billion dollars across funds of hedge funds and bespoke portfolios, mostly for the general accounts of insurance companies. The management team lifted out from Gartmore and reconstituted as SkyView.

We are the sub-manager advisor to a new alternatives mutual fund family called Orinda. Orinda's first mutual fund product is called the Orinda Multi-Manager Hedged Equity Fund (OHEIX), a long/short equity fund for which we are the chief sub-advisor. We pick the sub-managers, allocate assets and manage overall portfolio beta or volatility.

The objective of the fund is to achieve S&P-type returns with reduced beta. While past performance is not indicative of future results, we have a track record of doing such very successfully in an LP format since the end of 2001. I believe this concept will be in big demand by the RIA community whose present investment vehicles are mostly beta. Their typical investments for example using ETFs and specialized futures/swaps-driven mutual funds etc. really deliver mostly beta with no inherent way for the RIA to produce alpha and manage volatility.

The RIA Advisor needs to manage a beta budget for their clients to meet objectives while controlling



downside risks. If we can deliver, on a 50:50 stock-bond portfolio with the S&P side of that ledger at half the risk, then that manager can take and re-allocate that portfolio beta budget of 25% that we have not used to the fixed income side of the portfolio. There they may find specialized fixed income managers who might have a little higher beta, but greater return than would be offered by fixed income at targeted credit spreads.

SkyView would like to manage other alternative fund products in the liquid global opportunistic and multi-strategy space.

**Ted Kellogg**  
GRT Concentric fund

I'm Ted Kellogg manager of the GRT Concentric fund. I have been in the investment business for 31 years and have managed hedge funds for 14 of those years. The fund that I manage is a core long/short fund designed to serve either as an investor's sole hedge fund holding or as a core fund around which other more aggressive or specialized funds can be placed. Our objective is to generate annualized returns significantly exceeding those of the S&P 500 over a market cycle with a standard deviation lower than the historical volatility of the S&P500. We expect that returns will have a low correlation to US equity markets.

What makes Concentric a core fund is that we are consistently hedged and highly diversified. As a general rule, for each dollar of capital committed, approximately \$1.10 is invested long and approximately \$0.40-0.80 is placed short. We use a diversified investment structure typically holding 90 to 100 positions long and 80 to 150 positions short.

In order to efficiently review and examine constantly changing market conditions and corporate information streams, we use quantitative screens to focus our research in the most promising areas then do our fundamental work. We believe that successful investing is as much a question of getting the right facts as getting the facts right.

Our quantitative techniques are only the first step in our analysis and are tailored to produce candidates that we will find attractive on a fundamental basis. We then read the financials and where appropriate interview managements to get further insights into business conditions. Typical questions that we are seeking to find answers to are: What are the key success factors to superior performance in your business? Define your market opportunity. What barriers to entry are there for competitors that are targeting the same space? What is the relative power of customers, suppliers, competitors and regulators to set prices? How & how much can a good company differentiate itself from a bad one? Why are you good at what you do? Can you sustain it? What are the key metric(s)? What drives earnings growth? Pricing, Volume, Cost Reduction? How does your compensation line your interests up with shareholders?

Once we have the right facts, interpreting the facts correctly is the next step. For each company that we invest in, we perform an additional series of analyses of the company's historic performance to see if the company has built its shareholder's wealth over time adjusting for inflation, accounting and off balance sheet items. Finally, we judge if the stock's valuation is appropriate in light of reasonable forecasted revenue growth, asset utilization and profitability assumptions and establish a target price. By the time our analysis is done, we are confident that we have established long and short portfolios whose characteristics differ materially in their investment merit.

**George, you said you wanted to grow your firm by marketing to the ERISA community. How do you plan to do that specifically, what are some of the steps you will be taking to penetrate this market?**

**George Tall**

We highlight a history of sound risk controls. Plan sponsors worry that hedge funds might just be “beta on margin”. Therefore it is critical to demonstrate what this institutional audience wants, which is effective risk control. The past five years surely provided robust opportunity to showcase risk controls, or not?

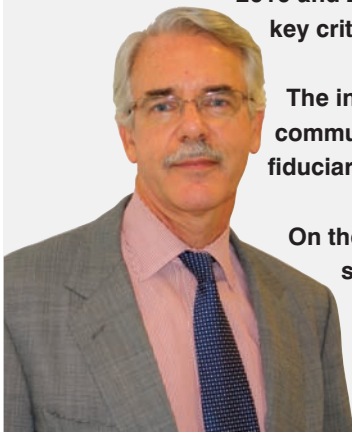
What we have done for five years is to carefully pair-off macro risks in the portfolio between the longs and shorts. This allowed us to amplify the gross exposure of the funds to individual stock selections, while keeping a collar on short-run volatility. We typically run 160-180% gross exposure, but maintain a short-run volatility that is less than the S&P. Net exposure is typically 50%.

Our investor-audience is typically converting from a long-only equity fund into a long-short fund. In long-only they are used to the volatility of broad equity market averages. If we successfully pair-off the macro-risks long-vs-short, then we amplify fund exposure to “alpha” of individual stock selection, while dialing-down the beta-exposure. Burl aims to keep Fund volatility below the long-only index market level, even with the relatively high gross exposures.

There is one scenario where this portfolio structure would face a real challenge to beat the broader market. That would be during an “up+10% quarter” like Q2 and Q3-2009. We cannot keep up with that.

**But I think the trend line for overall equity markets for the next five years is more likely; 5%, 6%, or 7%. There are several intellectual constructions that get you there – like “nominal dollar GDP less some de-leveraging” and so forth. The reason that a risk-controlled long/short fund is of interest to pensions, is because we believe an extra ten points above a market trend of 5%, 6% is deliverable. That is enough extra return to get attention of ERISA audiences.**

**Our initial institutional investors are with us since 2007, and existing investors have upped their allocation to us in 2010 and 2011. So I believe we will see some higher interest from a broader audience once we meet key criteria like a five year track record that has been audited by Deloitte.**



**The institutions as well as their gatekeepers, the consultant community, are a risk averse community and individually terrified they are going to step on another Madoff. These are fiduciaries and agents, so not principals. Therefore the upside does not belong to them.**

**On the other hand, auditors may be signing off plans that are not an honest representation of soundness when they assume 8.5% returns on total assets, including the bond piece! This is something that really has to be addressed.**

George Tall

And it will be front and center after everybody writes Form 10-Ks this year, as the liability side of pension plans is re-priced to the current bond yields. Most plans were fully funded at the end of 2007, and they are now about 80% funded. I believe they will be less funded at the end of 2011 when those Ks are written, and it will force more and more inquiries at Cambridge Associates and other consultants to get advice on how to be responsibly participate more in alternatives.

**As a small fund, how do you now actually plan to approach and market to the ERISA community?**

## George Tall

We think our existing channels can generate more corporate plans in the future, as the “emerging manager” moniker fades with time. Further, we are in conversations with three or four different marketing structures that are now in various stages. There is a lot going on.

**Frank Casey:** As I pointed out in my introduction, the RIA marketplace offers a similar growth potential for alternative asset managers. The RIAs need a fund format offering total transparency, daily net asset value, daily liquidity, and hedged exposures – in other words, from our multi-manager space, liquid alternatives can be included in their product mix. I believe that RIAs and other wealth managers, like single or multi-family offices, will gravitate towards such investments in order to be able to allocate risk budgets dynamically.

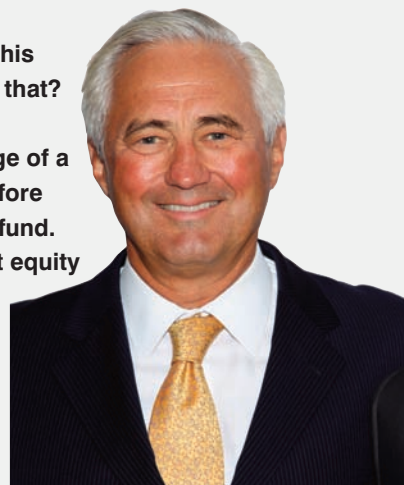
The marketing of such products is done by distributors within the mutual fund arena, captive as Orinda does, where they have hired one of the top markets from Putnam who already has relationships with various RIA platforms. Or, one can use third party marketing operations that are basically an amalgamation of distributor talents from different mutual fund families who formed a third party marketing operation concentrating on the RIAs.

We launched on April 1st with under \$1 million and have now \$70 million. I believe we will be at \$250 million by the end of 2012, and \$1 billion in around three to four years. Why do I believe that? Because the RIA community tells me so.

Apart from the marketing, another question is why would a manager consider running his fund inside of a mutual fund format and giving up performance fees. Why would he do that?

Well, if you have very limited capacity, if you are in a specialized niche taking advantage of a certain capital market inefficiency that you can exploit with maybe \$250-300 million before you begin to trade yourself into efficiency, you probably do not want to raise a mutual fund. However, if you are in a marketplace discipline that is rather deep such as a long/short equity small/mid to large cap, you can surely run a good piece of volume in a mutual fund format. Or, if you have been incubated inside a long-only shop for 3-5 years and are looking for an avenue to show your wares, a mutual fund format is a good way to go, because it will pay the light bill and it will bring attention to your firm.

Frank Casey



We launched our fund of funds with five managers, so each one has now about \$15 million. We have a stable of 25 managers we can use as we grow. Larry Chiarello, one of our partners at SkyView who has been with us since 2000 when the firm was launched, previously ran third party managers for George Soros for a dozen years. He ran \$5 billion with a daily mark to market. So, SkyView is experienced in managing daily NAV products, which we believe will be multiple billions of dollars for us in five years.

When I talk to some very well established mutual fund families about this concept of liquid alternatives in a mutual fund format, they often say “oh yes, we are addressing the RIA marketplace long/short equities products with our 130/30 funds.” I may have a bias here, but I do not believe 130/30 is the solution. I doubt that a manager who may be strong on the long-only side will suddenly become better at delivering alpha by leveraging it up 30% in shorts. To give you an example, when people coming out of a long-only shop in order to set up a hedge fund ask me for help marketing their fund, I always tell them to first get themselves a dedicated short seller from a prop desk or a hedge fund, because what makes me believe that he as a long-only manager is going to be extremely good at picking and executing short sales? That is a problem area for a lot of long-only managers. So, I personally do not believe that 130/30 is the way.

And by the way, packaging your 130/30 venue and delivering it as a long/short equity portfolio vehicle for RIAs will be just viewed by the RIA community as a repackaging of an existing concept, and they will ask “what else do you have?” However, delivering a multimanager, best of breed, portfolio at low costs will bring real value to the RIAs, because they would never find these managers



and access them through any other vehicle.

My last point is about costs. As you know, a fund of funds would normally run you performance and flat management fees at multiple layers ranging from about 450 basis points to maybe as high as 600 basis points. Mutual funds tend to come in at 260 on institutional shares and up to 290 on retail shares.

**Steven Giordano**

Is your firm actually setting up the mutual funds or are the mutual funds being set up by the managers?

**Frank Casey**

We partnered with Orinda, who basically set up the mutual fund. I am going to study other strategies that do not compete with Orinda's Long Short Equity vehicle, such as global opportunistic or multi-strategy, liquid alpha, something along that line, all multi-manager in application. I think you might be able to do it all in for somewhere between \$500,000 and a million dollar. Now, they have these "rent the mutual fund structures" that you can use at lower initial costs. US Bank Corp is the mutual fund structure for Orinda.

**Matthias Knab**

**Has anyone else of you looked at the mutual fund format for your strategy?**

**Michael Dunn**

We have not looked at a mutual fund structure for our current strategy at TruColor Capital, but in my career I have been involved in at least three different attempts to get retail investors interested in long/short equity as either the sole strategy of a fund or as a sleeve within a multi-strategy fund, all with daily liquidity. Dreyfus tried and it did not work, Citigroup tried and it did not work, and more recently TransAmerica and Morningstar tried; I am not sure if that one is still alive, but I don't believe that the fund has been highly successful.

It always seemed that long/short was too complicated, or too suspicious, for the typical retail investor. All those attempts were made over the last ten years or so. Given that history, my question would be, what do you think has changed that could have made individuals and RIAs more receptive to these "exotic" strategies today?

**Frank Casey**

The RIAs are citing volatility, and they were enamored with the idea of delivering beta and multiples of beta, dynamically where they as the CIO of the portfolio could do tactical asset allocation, beta risk management and leverage across various asset classes. They have played that game. They realized that they do not produce alpha at the RIA level. They are now looking for a way to reduce volatility. They and their clients both do not really speak the language that we speak as managers. We talk about things like "deliver the S&P return with 0.5 beta". To RIAs and their clients, family offices down to retail, rather look at volatility, what is the maximum draw-down, how much can I lose?

Whether you are achieving it through some form of dynamic tactical asset allocation modeling across various sectors, trying to cut of the left hand side of the distribution of returns, or through a manager of manager approach, I think they appreciate the help. I do believe that the industry in this mutual fund format has raised a couple of billion dollars since 2008.

**Ted Kellogg**

Frank has made some really great points about the use of mutual funds in the RIA market. I would add two points that perhaps address Michael's question from a different perspective.

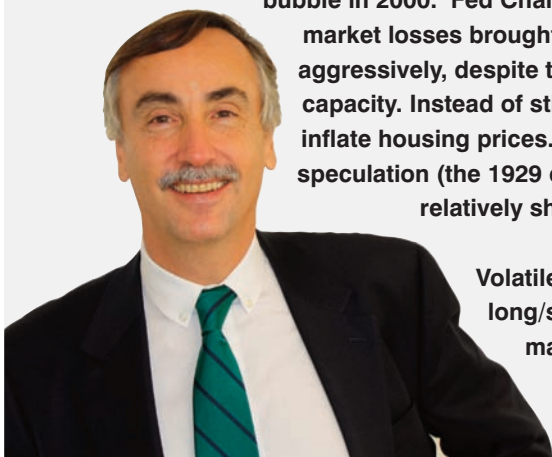
**First, many hedged strategies will not work within a mutual fund structure. If the anomaly that you are seeking to exploit is small, illiquid or discontinuous (by which I mean they happen once or twice in a decade like George Soros' bet against the British pound or John Paulson's bet against mortgages), then the strategy probably will not work within a mutual fund context. Also partnerships that want to keep their holdings private will not want to participate in mutual fund structures where their holdings are widely disclosed.**

**The strategies that will work in a mutual fund context must by construction be liquid and be built to work on a large market anomaly like value or business quality.**

The second point that I would make is why long/short funds are particularly attractive in the current economic climate from an investment perspective. In our view, the key investment point to understand is that we are currently in a debt deflation. Debt deflations are thankfully rare, but when they occur, they determine the fate of economies, markets, workers and investors for long periods. Debt deflations occur in the wake of asset inflations where a significant portion of the assets' upward run was financed with debt. Once the peak in asset prices passes, prices collapse, but the debt remains. That debt weakens demand and slows economic growth until the debt has been cleared or "deflated." How the economy deflates that debt is, in our view, the central question for investors now, and if past is prologue, will be the central investment question for years to come.

What concerns us as stock market investors is trying to understand the likely effects on equity markets of the debt deflation, and the likely policy options that will be taken to clear the debt.

Looking at historical parallels can be instructive. If you look at market charts of the U.S. in the 1930 – 1950 period or Japan since 1990, you will note that debt deflations have historically resulted in very volatile markets that cycle energetically but make little progress. The current situation in the U.S. is if anything potentially worse than the previous two. The reason is that the 2008 housing crash was immediately preceded by the deflation of the internet bubble in 2000. Fed Chairman Alan Greenspan attempting to stabilize the economy after the market losses brought about by the 2000 market crash expanded the money supply aggressively, despite the fact that U.S. GDP was growing at around 3.5% at the time - fairly near capacity. Instead of stimulating economic growth, the monetary stimulus served chiefly to inflate housing prices. Bottom line, instead of a debt deflation caused by stock market speculation (the 1929 case) or a speculative real estate bubble (Japan) we have had both over a relatively short historical timeframe.



Volatile sideways markets are, at least theoretically, a great environment for long/short managers who should be able to make money in either up or down markets and at the very least should mitigate volatility for their investors.

Ted Kellogg

I say this with some basis, as before launching Concentric I was the founding portfolio manager of the Boston Partners' Long Short Equity fund (BPLSX) which was ranked as the #1 Specialty Diversified Equity Fund by Lipper for the five years ending 1993. As you may remember that was a fairly volatile period for equity investors as well.

**Natasha Koprivica:** Looking at the market place today, we can see that the emerging market debt is getting significant traction from institutional allocators.

In all its forms, emerging market debt accounts for about 10% of the global investable debt and yet institutional investors allocate only 1-1.5% on average to this asset class. Some investors are pointing out that it is not a question whether to allocate to this asset class or not, but rather what is the best way to do so.

Emerging market debt products have been in demand since late 2009 and the first active allocators were Sovereign Wealth Funds.

Natasha Koprivica



The total assets institutional investors currently hold in this asset class is close to \$300 billion. In 2010, while Sovereign Wealth Funds maintained steady allocations, others were just starting to pick up the pace.

We will continue to see searches for returns turning away from strategies focused on developed economies in favor to global strategies, particularly emerging markets equities. Inflows in these strategies had an exceptional trend in 2010, with total inflows of \$75.5 billion, which continued its uptrend throughout 2011.

Unquestionably, the global investment outlook indicates that institutional investors have to be heavily allocated to emerging economies to avoid stale returns and dragging recoveries of the developed countries. These facts underline the necessity for niche and highly specialized emerging market managers. Their skills are becoming highly valuable and will be in demand in years to come.

**Matthias Knab**

**We are still looking at the question how else can alternative investment managements grow their business in times like these? What are your suggestions?**

**Natasha Koprivica**

Allocations that took place right after 2008 were going to large institutions and managers with long track record. Large platforms and large fund of funds were taking advantage of open gates of “hard-to-get-in” funds and put some money there for their clients. “Fly to Safety” took place. Small and mid size funds were relaying on support of the existing relationships which they hopefully maintained well over the years. The name of the game was not only to raise assets, but not to lose them as well. Termination of the relationships with managers were quite frequent. In Europe, Nordic and French investors were quick to replace managers, while the Italians were the most loyal. eVestment Alliance reported that inflows in 2008 and 2009 in U.S. domestic equity were all actual manager replacements.

**If you are a fund manager who is planning to launch a fund and have several years of prior track record in similar strategies, your chances with seeders are much higher than a brand new start up fund. It is not unusual to see requirement of 18-24 months of performance to be considered for a seed. The capital got more expensive as well. In regards to fund raising activity, I can give you an example of few distribution channels:**

- **Family Offices:** Conservative family offices exhibit “flight to safety” and decrease exposure to alternatives favoring more regulated structures like UCIT and SIF in Europe or separate accounts. Sophisticated family offices continue to allocate to alternatives and look for opportunities created by market aberrations. Economic growth of India and China resulted in many wealthy families. These investors are particularly active in alternative space in their local markets. In the coming years, we will see more and more family offices from this region participating in the market place.
- **Fund of Funds:** The business model of funds of funds has been significantly affected during the time of recession. Large funds survived, many others closed the doors. Currently there is a high demand for the sector specialized fund of funds. These funds will be allocating to niche managers, so this channel might be effective source of funding.
- **Pension Funds:** Although allocation to alternatives has been reduced during the recession, pensions will be actively participating in alternatives to boost their performance going forward. Large institutions will continue to outsource, not only for the service of manager selection and asset allocation, but also for prompt action in market turnarounds and for counterparty risk assessment. Good number of their searches can be found through large platforms like eVestment Alliance, Camradata and others.
- **Consultants:** NEPC consultants based in Boston indicated that in 2010, 27% of all searches were for non-traditional strategies. In last few years a new trend of specialized consultants emerged, focusing on particular region or servicing special group of clients; for example consulting firm selecting only niche Asia managers or firm in Germany servicing only institutional investors in German-speaking countries.
- **Foundations and Endowments:** For Foundations and Endowments, outsourcing of due diligence and selection of



managers will continue. In Switzerland, for example, only 30% of them manage in-house their capital. Estimated number of philanthropic foundations is close to 12,000 with total financial assets of 30-50 billion Swiss francs. 2/3 of them lost up to 30% of assets during the recession and will not be able to reach their yearly distributions. Research indicates that European foundations cut their allocations to alternatives from 14% to 7% since 2008. In US, east coast based endowments allocate across asset classes, regions and investment themes. Some of them in the \$500m- \$1bn size do allocate to emerging managers with 2-3 years track record.



- **Registered Investment Advisors:** Couple of years pre-recession, wealth management firms started to develop internal due diligence teams to select handful of good manager for their clients. As a fund manager, once you pass the due diligence and get the first allocations, this channel could become a steady stream of constant inflows over time. For the most part, several years of track record is necessary.

**Natasha Koprivica**

**Steven Giordano**

One of the key issues for managers wanting to grow their businesses is whether the manager is performing well in the current environment.

The current environment has hurt the performance of many funds. But managers that were able to get through these hard times, who controlled their risk exposure, put up solid returns and beat their peers or benchmarks, are in a good position to gain attention and interest from investors.

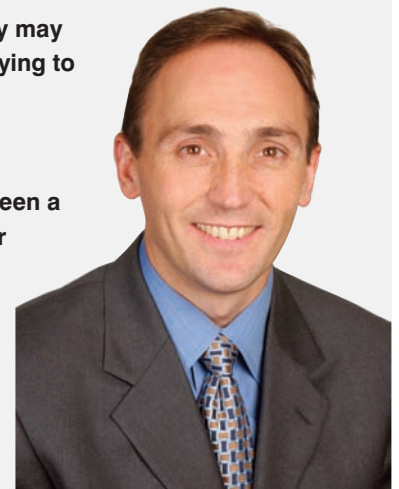
The participants in this Roundtable noted that managers are focused on attracting ERISA money or gathering assets via a mutual fund structure, but we are also seeing managers turn to closed-end registered fund structures that are not publicly offered as well. We often field questions like, “Should we set up a UCITS for European investors?” or, “How do we go after the ERISA markets?”. The answer I generally give managers is that it depends on your investment strategy. For example, an investment strategy implemented through a mutual fund is subject to certain limitations under the Investment Company Act of 1940, some of which may be too restrictive on a hedge fund manager..

Those who want to go into the mutual fund market have to understand the restraints of the regulated fund world compared to the hedge fund world. For some managers, making that leap can be very difficult.

We have other clients that want to market to pension plans, but their investment strategy may be too volatile for this type of investor. The best advice we can give a manager who is trying to grow their business (i.e. raise more assets) is to know who they are and identify which investors are best suited for their strategy.

We do see more activity within closed-end funds, which can be viewed as a hybrid between a mutual fund and a hedge fund. A privately offered closed-end fund may allow a manager to replicate many of the same types of strategies that a hedge fund manager would run in a non-registered fund. In addition, the manager can also get a performance allocation on their assets, unlike mutual fund where you might have to go with a fulcrum fee. And, as we all know, the SEC is not a big fan of fulcrum fees.

**Steven Giordano**



**Craig Kelleher:** As we set up Millstreet in early 2010, we were clearly in a difficult capital-raising environment. Having just experienced the Great Recession, investors were typically only allocating money to the largest, most well-known hedge funds, if they were allocating at all. Now that we have been around a little longer, we are starting to hear from investors the story that some of the larger hedge funds are correlating more with each other as they get bigger and crowd into the same trades. Some investors have expressed concern that some players have gotten so big that they are not as nimble as they once were. This is raising interest again in smaller and newer managers. The pendulum may just be swinging back to where we are getting close to a more favorable capital-raising environment.



The problem for emerging managers is exactly that - we are “emerging” in terms of not having an extensive track record or what can also be called institutional credibility when compared to older and larger managers. For us, partnering with an institutional seed investor was a way to overcome many of these obstacles. They did their own thorough due diligence on us and invested with us early. This has helped us cross critical institutional AUM thresholds quicker and helped to start drawing more interest from potential investors.

**Matthias Knab**

**Does your seeder Palmer Square also give you active marketing support for your fund?**

**Craig Kelleher**

Yes, they do. We were in a fortunate position because we actually had a couple of term sheets from different seeders, so we were able to choose the one that made the most sense for us. For us, it wasn't about the biggest investment but who would be the best long-term partner. By providing both operational support as well as institutional marketing, we found Palmer Square to be the most attractive. We have only just started the process of marketing and building relationships with institutional investors. As we are all aware, this takes time and hopefully we will see the benefits over the next several years.

**Kirt Corregan**

I am lucky that my partner Howard Rubin handles the marketing of our fund. He has a strong investment and operational background and well developed marketing contacts from having been a partner at Standish, Ayer & Wood for years and after that having founded another hedge fund, Boldwater Capital. He has approximately 6000 potential hedge fund investors in his database.

We also believe we run a unique strategy on the investment side for which you need a lot of experience. I am not really aware of any one else who has had the experience of working side by side with George Muzea and then went on to have a career as a fundamental analyst and portfolio manager. George started analyzing insider activity in the 70s, and has the most in-depth perspective in the insider activity analysis area. He has been a tremendous mentor to me.

Given the experience of our internal team and our advisors, we believe that our product is operationally ready from an institutional perspective, and it is just a matter of time to continue to build out the track record.

**Natasha Koprivica:** I cannot stress enough how important is to clearly communicate what your strategy is and where you add value to prospective investors. The simpler you explain your investment strategy and your investment process, the higher the comfort level of investors will be. Know your competitors. Know where your niche is.

In the process of efficient fund raising, it is important to understand risk profile and investment style of the particular investor you approach. Spending time to learn about their portfolio and their manager selection process will go long ways. As a fund manager, the ultimate goal is to find investors whose views and investment style matches yours, as this insures greater mutual understanding and, we all hope, long term beneficial relationships.

**Natasha Koprivica**





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**Peter Kolchinsky**

Through all ten years that we have been investing, we have always been very bottoms up, fundamentally oriented. We simply meet with one company after another; we look at their data and the market they are trying to address. If they say that they have a drug for gout, we will look at whether or not the drug lowers uric acid levels in the serum and for any side effects. If it looks clean, we know that the gout market can be quite large and we will invest, provided we get the right valuation. Our process is very straightforward, very commonsense, if you understand the scientific and clinical details.

When we really like the company and can buy it cheaply, we will generally buy a lot of stock, typically up to 10% of our fund, and if we think the firm is mediocre or bad, we will throw them into the short basket, which we keep relatively diversified. When it comes to shorts, we do not want to waste our time trying to get a short perfectly right – we all know that if you are wrong in a concentrated short, you can lose your shirt – so it makes sense to be very well diversified on the short side.

**What I just explained is really the heart of our strategy and describes at the same time our risk management. We do not use VAR or any kind of complex algorithms. The issue or fundamental flaw I see with all these established risk management tools is that they all look backwards.**

**In my view, ultimate risk management is based on what you know about what is knowable today and what you think will happen in the future. Knowledge of the past can only teach you so much when it comes to future risks. Everyone had access to all the past data, and yet so many large, diversified funds with risk-management teams weren't saved in 2002 or 2008. The fact that everyone is operating off the same historical data and memorable precedents is exactly what causes so many to fight the last war and remain exposed to new risks. Many investors call these risks "black swan" events, as if they were all unforeseeable. But in our space, the kinds of risks that to many investors seem like black swans are actually risks that one can anticipate with substantial diligence.**

**Let us say a company has clinical data coming up and you do not think they designed the trial well. Then you might fear that the trial will fail and stock will drop. There is no backwards-looking technical model that can predict what might happen, but it's pretty clear that the stock will go down a lot if an important trial fails – most people don't even need a model to know that. So the easiest way to avoid the risk is to not own the stock when they announce the data.**

**Yet many investors gravitate towards these binary events because they think that it's the only way to get a big return. But many stocks don't go up much on positive data precisely because many investors already bid it up on the expectation that the trial would work – they all drew the same conclusion from the information in the public domain. So when the trial fails, they might think it's a black swan... a highly unlikely outcome given the confidence everyone had that the trial should work.**

**We dig much deeper than the average investor and often see risks that they do not. We have certainly been caught holding a stock through a catastrophe, but we have nearly always known what risks we were taking, and we took them because the upside was substantial and we found the risk was worth it.**

Peter Kolchinsky



Maybe to put it another way, because of our deeper understanding of this space, we can see some of the black swans that others can't. Since the market has been substantially flat over 10 years, by avoiding more catastrophes than the average investor, we have generated positive returns. Of course, this means that all those who took the other side of our trades have come away with losses. Our returns confirm that we have, on the whole, taken the risks worth taking.

What can be said about the large diversified funds that lost big in 2002 and 2008? Did the upside they were aiming for justify the risks now evident in their portfolios? We do not want to emulate those funds and rely on risk mitigation strategies that gave false comfort in 2005, 2006, and 2007 only to fail miserably in 2008. Our annualized net returns have been over 20% since inception – that's the kind of alpha we aim for.

If we have a bad year because of an unforeseen risk, the loss will be absorbed by our alpha and we'll get back to the business of generating positive returns. All our good months make it worth the risk of a bad month.

An important aspect of how we both make money and deal with risk is that we don't bother going for stocks with 10% or 20% or 30% upside. There are too many things we might get wrong to bother chasing after so little upside. We look for companies that are so misunderstood that they should at least double in the next 12 months if people were to pay more attention. As a stock climbs and upside shrinks, we sell. And if we're wrong about the magnitude of the upside, maybe we are still walking away with some gains. But in our sector, when a stock has only 20% upside to what people may think is fair value, it is as good as fairly valued.

To some extent, shooting for high returns is a kind of risk management strategy in and of itself.

We have found the people who invest in our fund often are suspicious of the large funds that, in the end, follow conventional investment parameters such as liquidity, diversification, and a track record of earnings growth; anyone can do that using numbers published in Bloomberg or Yahoo. Our investors believe that to generate a really high return, you need to see what no one else sees and invest in a company that others hate, and that means risking looking foolish if you are wrong.

And vice versa, people who like big diversified conventional funds may realize that they won't get much alpha, but at least if they lose money they will be in good company. The uncorrelated volatility of our portfolio makes them uncomfortable, because they do not want to be seen losing money when others aren't.

It's a question of priorities – are you trying to make money or not lose any more money than anyone else? As I mentioned before, we were seeded by an individual who gave us a mandate to make money investing in healthcare companies – all the other objectives, whether liquidity or diversification, were secondary priorities that mattered, but not as much as maximizing alpha.

Usually the final decision maker for family offices and HNW assets are looking for strong returns and a clearly describable strategy where it makes sense why a particular manager is generating alpha. We have that clear simple story and are successful in attracting capital from this group of investors. But often the analysts and committees running big institutional money have an overpowering loss aversion instinct – high vol is a deal killer even if it comes with a long track record of high alpha and a clear strategy for profiting from perpetual market inefficiencies. A large portion of our fund comes from one east coast endowment that invested years ago and has frankly spoiled us – we used to think that many institutions were alpha-oriented, but we now appreciate just how special that team is. They encourage us to take the risks worth taking to generate excess alpha for them. We love doing well for them.



Peter Kolchinsky

Of course, I am polarizing things here a bit. I believe that most investors want to have a portfolio where the majority of their assets go into various types of “rock solid, low vol and low risk funds”, but they also have a portion of their assets with which they want to generate high alpha. That is the portion we compete for.

**Matthias Knab**

**Peter said many people invest or do their risk management looking through the rear mirror. What is your view on that? What other procedures, what other types of risk management do you apply?**

**Craig Kelleher**

Peter made some really good points about reliance on VAR or other similar metrics. Some of the greatest fundamental value investors of all time say they actually measure risk by looking at the likelihood of permanent capital loss rather than specific volatility measures. Many of them have sought investments characterized by large margins of safety. Another way of saying that is that investments need to have room for margin of error. The larger that margin of safety, the less risk and higher degree of downside protection for an individual investment. By combining a diversified pool of such investments, overall portfolio risk can be reduced.

At Millstreet, the risk management process begins with Brian and me as the portfolio managers. We believe the risk process is inseparable from the investment process. A conservative/value-oriented approach, careful security selection and hedging are all important aspects of the process. We typically operate our portfolio with between 40 and 60 positions. For us, that is our comfort zone. We want to make sure that our best ideas are properly represented from both the long and short perspective, but that we do not overly dilute those best ideas.

**Ted Kellogg:** I do not think there is any one final answer or closed form solution to these things. I believe risk control is something that you have to tailor to the fund. For example, Peter makes a wonderful case for his fund and his risk control process, which is that he knows more about virology than most of the people in this room or this building, and that works for his fund. As I mentioned before, I run a relatively low risk fund where my clients demand daily liquidity. For me, diversification the oldest and most proven of risk control methods, works best for me.

What I am attempting to do is a classic fundamental arbitrage. By owning 100 stocks long with solid balance sheets, strong cash flows, wide margins etc. and shorting 100 expensive story stocks with either negative cash flow or some other weakness to their business model, I get a risk control process that has proven to be very effective for me over time.

**Ted Kellogg**



While there are certainly times when investors want nothing but momentum, and other times early in an economic cycle when risk has gotten so cheap that it is a good value, over the great majority of history, financial high quality cash producing businesses do better than weak, negative cash flow businesses. As Damon Runyon once said paraphrasing Ecclesiastes: “The race is not always to the swift, nor the battle to the strong, but that’s how the smart money bets.”



**Michael Dunn:** I would like to raise a - let's call it philosophical - objection to Peter's rejection of risk control on the grounds that it is backward looking. If you think about it, everything that we do as investors and even as human beings is backward looking. None of us can tell the future. Therefore, what we do is look at the past and then we filter it through knowledge and experience in order to extrapolate the future to a certain extent. That is the only thing which is possible to do. It doesn't have to be a straight-line extrapolation of the past to the future, but the art of forecasting is deciding how much or little the future will look like the past.



Now, some people may be good extrapolators and some may be bad ones, but that does not mean that the process is by definition an ineffective process. I certainly agree that a lot of the standard risk models, the extrapolations used by the industry, failed badly over the last few years. There is no question about that, VAR probably being one of the best examples of that failure. But that does not mean that you can't do it better, that you can't have better models.

I agree with Ted that diversification is one of the oldest and still most effective ways to reduce risk, but I believe there are other ways to manage risk too.

My final point here is that I believe one of the most important mistaken assumptions that investors, and especially quants, have fallen into is that markets follow a normal distribution, in other words, that everything works in a nice “bell curve” manner. They do that, to be honest, because it makes the math a lot easier, but everyone would agree that it is not actually the way the world works. Looking at the world from a non-normal viewpoint can lead to insights that are often missed by other investors. Thus users of standard risk modeling approaches are surprised when markets behave wildly differently than these simplistic models would predict, and much more often.

Michael Dunn



**Steven Giordano:** From a lawyer's perspective I cannot go deeper and talk about real risk controls that managers utilize when managing their portfolios. What I can talk about, and what I do talk about with many of our managers, is making sure they can articulate the relevant risk metrics in their due diligence questionnaires. The DDQ is one of the documents that ties it all together, not only how you run your portfolio but how you actually raise assets from the various constituents you are targeting.

It is very important for a manager to articulate those risk parameters very clearly in the due diligence questionnaire because, generally, you will not find them in the offering documents.



But the other aspect of risk control that managers should be concerned about is the risk of their own operation. The investors' expanded due diligence not only looks at how a manager manages the risk of their portfolio, but also at the risks of their business.

These business risks come in many different forms. For example, how do you manage your counterparty risk? What are your own internal risk controls regarding trade execution or the movement of cash? Do you have adequate checks and balances between your internal accounting group and your administrator? Are you reconciling your broker statements daily and spotting trade errors in a timely manner?

**Frank Casey:** I agree that on the quant metric side, risk is backward looking, and we have to look backward. I think the big danger comes when you find mathematical wizards who extrapolate certain, limited information sets and project into the future. I will give you an example for that.

I once spoke with a head of risk management of a multi-strategy shop who amongst others was also supervising a natural-gas trader. The trader was heavily short natural gas, and it blew up phenomenally against them. They lost most of their assets. So I asked the head of risk management, “on which basis did you make your assumptions when granting that trading limit to that manager?” “VAR analysis.” So I asked “on what instrument did you calculate your

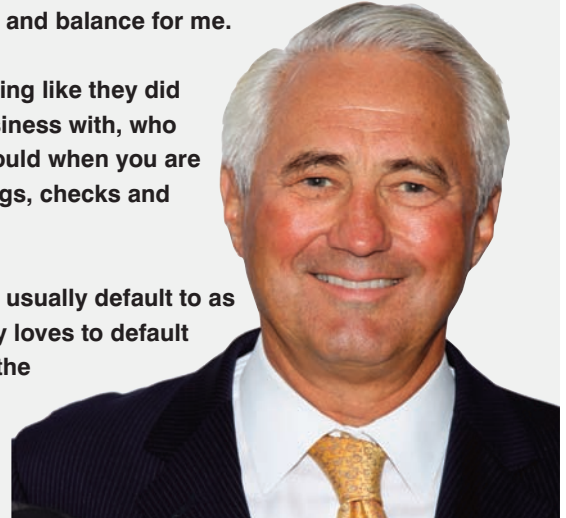
VAR?" He says, "well, natural gas futures. Unfortunately, they have a very limited history." I told him that if he ever went back to the cash markets and took a look at natural gas from there, he would have seen that volatility can go from 15% to 50% overnight, for example if you get a cold snap in a region as they did in Chicago years ago.

Therefore, extrapolating a limited amount of information and projecting it into a regimen in the future quantitatively is akin to me changing deck chairs on the Titanic. I am not a big VAR proponent as you can tell. I do believe though that one of the best ways of controlling risk is proper due diligence. But what is proper due diligence? I made up an acronym "TIPS", the "T" stands for "Third Party Verification of Everything". The "I" includes internal controls in the fund - I want to see either an outsourced CFO if they are too small or in-house CFO if they are larger. Why? Because the CFO reports to no one, they basically ensure everything is properly accounted for in the funds and they are staying within their risk budgets. That is an important check and balance for me.

The pedigree of the manager is the 'P' in TIPS, but don't just take everything like they did with Madoff at face value. You have to figure out who they have done business with, who their suppliers are, who are the end users of their product, just as you would when you are looking at bottom up fundamentals on a company to determine its earnings, checks and balances on everything.

Strategy is the last letter in TIPS, and note that this is where most people usually default to as the first of the regimens within due diligence in my estimation. Everybody loves to default to their quantitative metrics on the strategy: what is the reward, the risk, the maximum draw down etcetera? That is important, but even half of that is qualitative in nature.

Frank Casey



If you accept my acronym of TIPS, about 75% of that due diligence process is qualitative in nature. That means I need to understand your business, I need to know how you have identified an inefficiency in the capital market structures and how you exploit that inefficiency to produce excess return for given risks, or alpha. I also believe that concentration risk is a given in certain strategies. However, if I know the manager has proprietary information that others cannot exploit, that helps me accept that risk.

I may pick up some information on the golf course or sailing as a great stock idea, but in fact I do not know much about the company, whereas a fundamental bottoms-up microcap drug specialist manager might very well know the handicapping regimen on FDA approval, and they are going to have a lot better shot at running a portfolio than I would, trying to pick it up on the golf course.

Therefore, proprietary information is very important in concentrated type managers, but as a manager of managers I want to diversify that concentration risk of certain strategies - microcap, deep value, or a handicapping FDA approval - with broadly diversified managers that have volatility dampening effects in their own portfolio.

Frank Casey



Summing up, risk to me is three quarters qualitatively and one quarter quantitatively managed. And it really defaults to the regimen of a full due TIPS diligence process. Analysts performing due diligence on Madoff would have determined that Bernie failed most of the TIPS criteria.

**Peter Kolchinsky:** It seems that most investors ultimately want to diversify across a number of funds in order to mitigate two different risks: the market and stock risks of each fund's portfolio, and the operational risks. So an investor may diversify across 10 or 20 or 30 funds to reduce those risks. But if each manager then diversifies across 100 positions and therefore the investor has exposure to thousands of positions, how does the investor beat the market, especially paying all those fees? Diversification is a comfortable and easy risk management tool, but there is such a thing as over-diversification. Funds are paid to beat the market, not ride it.

As the manager of my fund, I am not running the fund as my own personal retirement account. Basically, I am running it to be one component of somebody else's retirement account. So, there is almost a mandate for me to take on personal risk. We have to take those risks in order to generate the highest alpha for our investor. Since I know my positions very well, they seem less risky to me than to the investor one step removed, and that's how it should be. That's why our fund, which tends to be concentrated in high conviction ideas, has both the right level of diversification for us as managers and for our investors who are further diversified across many managers. But concentration requires deeper diligence than what you can glean from newspapers and analyst reports or even from speaking with management of companies.

**Peter Kolchinsky**



There are thousands of funds and millions of individuals out there that invest to some extent in our segment of the healthcare market, but few have the tools and experience to understand these companies at a deeper level. So, while most investors compensate for their less sophisticated understanding of these companies by diversifying, a much smaller group of dedicated healthcare managers can sleep well at night with greater concentration in their high conviction positions. There's only a handful of such funds out there with a long track record of success.

And our investors sleep well at night because they know they have dozens of people like us working for them. Therefore, if investors really want to focus on alpha, they should not demand that the underlying managers use diversification as a risk management strategy. In fact, they should advocate against excessive diversification. And similar to Frank's point, if you can't resort to the comfort of diversification to protect a portfolio from risk, then all that is really left is rigorous due diligence of each position to identify their particular risks in order to avoid them.

**Coming back to Michael's philosophical objection that all investing is based on the past: that may be the case with certain asset classes, but when it comes to a healthcare company developing a product, it very much requires you to make an effort to predict the future. That is what we do. We try to predict the future. We certainly study history to better understand all the precedents of how companies succeed and fail, but we still spend time exploring novel risks and novel ways in which companies can succeed in the future.**

**Predicting the future is not impossible. We've seen snippets of what we believed to be a likely future outcome many times – clinical trials failed exactly for the reasons we predicted, products failed to sell for the reasons we predicted, and likewise companies have been successful for the reasons we predicted. We haven't always been right, but we have consistently put more money to work on those predictions that did come to pass and that's why we have generated substantial returns for our investors over the last 10 years. Looking backwards can be informative and educational, but ultimately we are paid to reach forward, wipe the fog from the window, and squint to see a glimmer of what's to come so we can avoid losses and capture gains.**

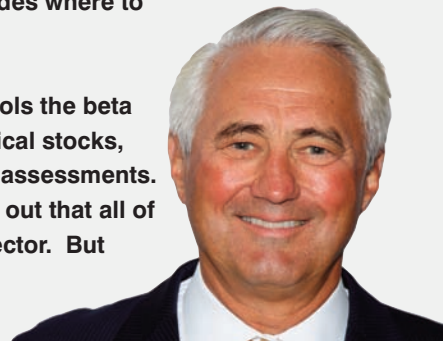
**Peter Kolchinsky**



**Frank Casey:** I believe in taking concentrated risk to achieve alpha. I also disagree with the thought that all risk management regimens are backward looking. In order to do our job properly, that means if we want to correspond to parameters like trying to “deliver S&P like returns in the equity market with substantially less correlation or half the beta”, the requirement necessitates having a dynamic risk management process, which is forward looking. I just cannot be a reactor. I need to have a macro top-down overlay where my team decides where to allocate capital dynamically.

On top of that allocation management, I have a risk management overlay that controls the beta of my sub-managers. If my manager wants to be 100% long on a given day in medical stocks, then God bless him, that is what I am paying him to do. I do not second-guess his assessments. What I need to do though is lay off the beta of the portfolio. For example, if it turns out that all of my sub-managers are becoming heavily sector lopsided, I have to de-weight the sector. But certainly, I want my alpha from the managers’ stock selections.

Frank Casey



Matthias Knab

Boston has a history of professional stock picking, there is a high concentration of know-how and talent in this area. But over the last decade or so, the market structure has fundamentally changed, and in some shops there are computers doing the same job, and you are competing with them and they compete with you. How has high frequency trading influenced your way of investing?

Ted Kellogg

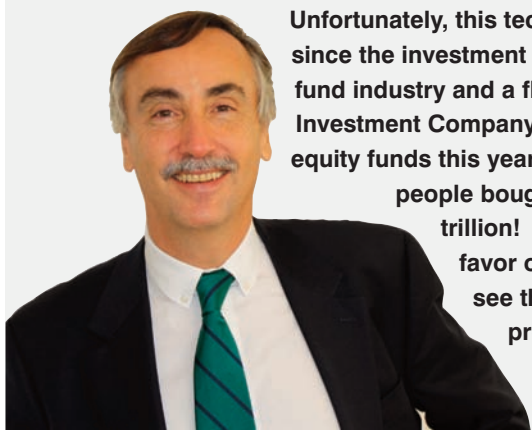
Let me just set the stage and I will give one side of the argument, which is the con side and then let us see who picks up the other side.

I believe that high frequency trading and other strategies that are basically designed to front-run other investors are a major source of risk to capital market stability.

The way high frequency traders operate is to send out one share bids more or less continuously, several times a second. As soon as you put in a buy order for 100 shares of a larger batch, their bid gets hit and they start buying the stock. They make money only if they are correct and you keep buying, as soon as your volume stops, they sell. They are not adding value in this trade, just profiting at your expense. Of course this is a greatly simplified version of what they are doing, but it captures the central function of these systems.

In my view, the strategies have no social and/or economic value and threaten the domestic markets' long-term health. Computers do not sleep, they do not get tired, and they do not care about economic fundamentals. All they do is add volatility to the market by amplifying moves down and up, as they did yesterday afternoon when we had a two-and-a-quarter percent move based on maybe something that someone in Greece may have said. At any rate, that was closest objective reason that I could find in yesterday's news flow.

Unfortunately, this technique / technology is hitting the markets at a particularly bad time. Ever since the investment shocks of 2008 to 2009, there has been a general de-risking of the hedge fund industry and a flight of capital out of the equity markets. According to data collected by the Investment Company Institute, individual investors have sold about \$89 billion of domestic equity funds this year. Since 2007, net outflows have been \$422 billion, while at the same time people bought \$839 billion worth of fixed income funds. That is a spread of \$1.26 trillion! While there are certainly many reasons that people have sold equities in favor of bonds, I think that a major reason is that many investors are starting to see the equity markets as a rigged game and they do not want to play. And the process is self reinforcing.



Ted Kellogg



Capital flight has basically served to take a lot of the more stable classes of intermediate to long term investors out of the market, and it removed liquidity. According to estimates that I have seen, high frequency trading can now account for up to three-quarters of all trading volume on some days.

There was a terrific article on The Wall Street Journal a little while ago called “A Wild Ride of Profits”. The article is about the events of August 8th this year - I do not know if you remember that day in particular, but the S&P Index was down 6.8% that day, and that happened to be the single most profitable day in the history of high frequency trading. According to the Journal, the high frequency traders made \$65 million that day, while the stock market lost \$850 billion worth of profits.

**Matthias Knab**

**They made how much? Just \$65 million?**

**Ted Kellogg**

Correct, the high frequency traders made \$65 million on a day where the stock market went down \$850 billion. Those are the facts, but they claim to add liquidity to the markets, which I believe is essentially false. What they actually do is consistently front running everybody else's trades. They are trying to get ahead of things. It is amazing to me that the New York Stock Exchange put a high frequency trading facility right next door to their data facility in New Jersey.

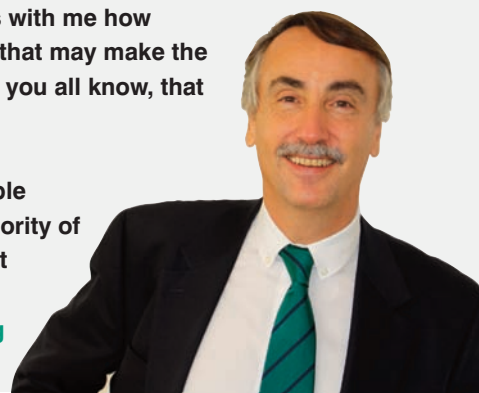
There was big feature in 60 Minutes a while back, and I would suggest taking a look at it to show what this thing actually looks like. They took 20 of the highest volume high frequency traders and co-located them closer to the exchange so that they get micro-second advantages of time over their competition.

So, you and I are not playing in this game, rather they are playing with other computers at this point. How do you stop it? There is a fairly simple way: you reinstate the uptick rule, which was repealed in July 7, 2007. While that action may sound easy, a change of the rules here may be a challenge because these exchanges will not like to lose that kind of volume. The large investment firms and hedge funds make a fair amount of money with the current regime, and will not like the idea of bringing back the uptick rule.

In the meantime, the SEC apparently does not seem to understand or disagrees with me how destructive high frequency trading really is. I am concerned that the only thing that may make the regulators pay attention is another situation like the 1987 crash on steroids. As you all know, that crash was basically caused by portfolio insurance.

Portfolio insurance was a strategy which made total sense when just a few people engaged in it in a very deep marketplace, but as soon as even a substantial minority of people started to apply it, the market liquidity could not handle it and the market collapsed.

**Ted Kellogg**



I expect that is exactly what is going to happen with high frequency trading as other investors back out from the markets and high frequency traders do more and more volume trading with themselves. We will see increased volatility and short lived directional moves as they start to feed on each other's trades.

**Matthias Knab**

**The so-called “Flash Crash” on May 6, 2010 saw the Dow Jones Industrial Average plunge about 1000 points - about nine percent - only to recover those losses within minutes. It was the second largest point swing, and the biggest one-day point decline on an intraday basis in the history of the Dow Jones Industrial Average. What is your interpretation of those events?**

**Ted Kellogg**

To me the Flash Crash was a very clear warning. As you said, we moved 1,000 points and then there was all this pressure to back out of those trades. It seems to me that a good analogy imagining you are walking on a pond in early winter, all of a sudden the ice goes “thunk!” and there is a quick shudder under your feet. Well, the good news is you are not wet, but you are an idiot if you keep walking towards the middle of the pond.

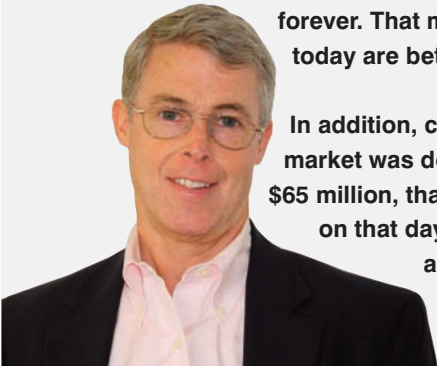
**Michael Dunn**

I will take the counter side of that argument; I like being the contrarian. Let me say first that I do not have any vested interest in high frequency trading. None of the funds or strategies I have ever been involved with have had anything to do with HFT.

**In my view high frequency trading is not taking away from liquidity, it is adding to liquidity. Trading volumes in the past were much lower than they are today, and while high frequency trading may be a big chunk of the volume now, it is because they have added to the market.**

**As a buy-side investor, I like the idea that there is a more or less permanent kind of ferment of trading underneath my trades. There is no question that costs are being reduced and bid-ask spreads are kept low. Studies of equity transaction costs, including commissions, spreads, and market impact, show they are lower today than they were 20 years ago.**

**High frequency traders have basically taken over the function of the specialists, except that they have to compete for their fractions of pennies; the specialists had a more or less regulatory right to 1/8th dollar spreads forever. That means that the spreads you get from the market or from a high frequency trader today are better than what you used to get from the specialist.**



**In addition, coming back to the numbers Ted referred to, on that big day recently when the market was down \$800 billion in capitalization and the high frequency traders made a profit of \$65 million, that does not strike me as egregious. It means that they made less than a basis point on that day. This is not a highly profitable business, and they are not committing large amounts of capital to front-run you.**

**Michael Dunn**

It is not like they can say, “Oh, Fido is in the market today, I will put \$1 billion or \$200 million into that stock and front-run it.” They are basically firms with relatively small capital.

**Matthias Knab**

**Not all of them, though.**

**Michael Dunn**

Now, Goldman’s prop desk is a different matter. They may commit much more capital and have more insider knowledge than the high frequency traders. High frequency trading is not a capital-based business, it is a transaction-based business with a profit of a small fraction of a cent per trade. From what I know, it is not highly profitable. Now, if you want to put Goldman’s prop desk out of business, I would be all in favor of it, but I think high frequency traders actually on balance perform a useful service.

They increase liquidity, and if they occasionally want to pull back on that liquidity, as they may have done during the flash crash. Well, they aren’t utilities and they aren’t too-big-to-fail, so that isn’t an unreasonable thing to do for them. There may be some abuses and market manipulation, but I believe that can be handled with relatively minor changes in regulations and oversight. And sure, other traders need to avoid telegraphing their trades, but that has been a good idea for a long time; the technology is just more sophisticated now.

**Kirt Corregan:** I tend to agree with Ted. I think high frequency trading creates unnecessary volatility and we have reached a point where it has scared people out of the market, especially the retail investor, and that is a disservice to people saving for retirement.

My bottom line is that high frequency trading creates just noise in the markets. From my observation they really just bounce stocks back and forth between technical support and resistance, and if it breaks the support level they keep pushing it down until it holds somewhere, and vice versa.

As a portfolio manager, the real issue is that we all have to figure out how to deal with these new stock patterns and volatility. For example, if I have a position that gaps up 20% in a single day, which has happened, it is probably a good idea to take some off the table. And conversely if the stock you are interested in gets taken down 10% for no apparent reason, there is probably an opportunity to start building or expanding your position of this stock.

These issues also play into your risk management as a manager. How are you sizing your positions relative to where you think the upside is, while continuously maintaining both the long and short book? It may cause you to be more active or more tactical on the risk management side. I have come to the realization that volatility might be an asset class, at least in the current environment. Therefore, I am using some of the ETFs or ETNs to manage these kinds of exposures.

**Kirt Corregan**



So again, the bottom line is that high frequency trading is just noise, and if your strategy is a bottom-up fundamental strategy, you need to stick to your strategy.

**Peter Kolchinsky**

Thankfully we have a very talented trader - he is like one of those people from the Matrix movies who just knows what's happening from looking at a screen with lots of blinking red and green characters. I asked him once about the impact of high frequency algorithms, and he said that they probably make some profits off of guys like us, but given how small their profits are, a point that was made here earlier as well, it doesn't affect us much.

When we buy a stock, it is because we think it should at least double within the next 12 months. It helps that our trader knows how to get extra dimes and quarters from the investor taking the other side of the trade by being patient or aggressive when it is called for, but if a high frequency trading algorithm gets in between and shaves a penny or two for itself, we won't even notice. In my opinion, whenever you have a fundamental view on a stock being that mispriced, the high frequency guys are irrelevant.

We recently did an assessment of capital allocation in major markets and estimated that, of all the capital that is invested in equities, only 5% of it is invested in companies with valuations under \$1 billion, which make up over two-thirds of all securities. That's a pretty inefficient segment of the market, and, in the grand scheme of things, maybe it's even a good thing if the high frequency algorithms increase liquidity and decrease spreads a bit.

**Peter Kolchinsky**



**Matthias Knab**

That was a very relevant discussion. What other important points do you want to raise here at our Roundtable?

## Kirt Corregan

A brief comment on what we see happening around insider activity. We do not try to be market timers; like Peter we pick stocks that we think have significant upside, we are not playing for 5% or 10% returns. I explained before that we have a unique framework and methodology to identify and interpret insider activity, and the insider buying we have been seeing recently, particularly in August, is among the strongest we have observed over the past decade. Historically, we can compare the current phase to just two periods: the late 2008 / early 2009 timeframe and then further back earlier the August to October 2002 timeframe.

I do not know if we have seen the bottom or if the market might make new lows, but insiders indicate that there is considerable value in the US equity market. We see these positive signals not just in the ratios that I monitor, such as the overall sell/buy ratio and issues bought versus sold ratio, but, on top of that, what we found interesting is the composition of the signals. For example, there has been a lot of activity in cyclical sectors, such as industrials, and other sectors that should not as impacted by the macroeconomic environment. This indicates to me that there was a lot of indiscriminate selling in the markets in the third quarter. For example, we also saw a sizable pick-up of insider buying in healthcare and pharma stocks.

We found it fascinating to see that a lot of the buyers that are coming in now have not bought for years. These are people with really great track records related to insider activity. Just one example of that: The Chairman of the Board of Kansas City Southern has an excellent track record of not just buying the stock, but also in selling the stock. He has not bought the stock since the early 2000s and he was actually a seller in the 2007/2008 timeframe near the peak for his stock.

Kirt Corregan



We found it quite appealing that someone with his experience is buying in times of crisis when most others are frozen by fear of a recession. Insider activity in the US seems to be indicating that if there is a recession coming it might be priced-in already in certain areas of the market, or it may be the case that insiders at these companies or industries are not seeing a recession.



**Frank Casey:** As a final and strictly anecdotal comment, let me add to this Boston Roundtable discussion that I personally believe Boston will become one of the biggest hedge fund centers in the world, because there is tremendous stock management and stock picking talent here. In those long-only shops based around here, I see a lot of top talent gearing up to spin out on their own. They say, “well, I was the major alpha producer in a very big diversified portfolio, why should I not be running a concentrated long-only or long/short specialized niche strategy on my own?”

I think we are just on the dawning of new era of great hedge fund managers coming from the asset management shops in Boston, and, therefore, in my view as a manager of managers, I believe more of my peers will at some point need to be in Boston as well, as they need to be in New York, as more alternative shops will open up their doors here.

## Matthias Knab

You are based here, can you add more details to what activities you see with people spinning out and setting up their own hedge fund?

## Frank Casey

There were more and more spinouts over the last few years. Ted Kellogg was one of them, but he was very early; you will see more and more talent coming out of the large management shops here. You can also see this in the activities here of the so-called “hedge fund hotels”, the broker-dealer platforms



that incubate managers. Many of the new hedge funds are previous long-only managers that may have teamed up with a proprietary trader who may help him on the short side.

This trend has been growing and will further accelerate as you can replicate most long-only strategies through a derivatives contract much cheaper than paying management fees for the long-only piece of your portfolio. Why not do a core-satellite strategy wherein you replicate the indices to the degree you need through Index futures or similar instruments, and buy alpha talent around that core?

#### **George Tall**

When you analyze market inefficiencies and successfully implement a core-satellite strategies, I would concur that the alpha is structurally always more available from the short side. This is due to the nature of the investment business, it is the way “the Street” works. Capturing extra alpha from the short side is really the lynchpin for long/short funds. It will be critical for pensions to capture more of that alpha in the future; and this is where the greatest inefficiencies lie. Shorting is a scarce skill set which can be learned in investment banking and other related disciplines, but generally is not seen within long-only asset management firms for a variety of reasons.

**Natasha Koprivica:** All these talented managers that Frank mentioned have a great exposure to the substantial investment community of endowments and foundations based right here in Boston. This segment of investors has been the largest allocator to emerging managers in last few years, especially to ones with elite background. Boston is known for its RIA and wealth management community with an access to family offices of all sizes. So, it is a great place to be. And still, as I do, you can sit in Boston and raise money globally.

**Natasha Koprivica**



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